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FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

PAPERS SUBMITTED BY PANELISTS APPEARING BEFORE THE SUBCOMMITTEE ON TAX POLICY

JOINT COMMITTEE ON THE ECONOMIC REPORT

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LETTERS OF TRANSMITTAL

November 9, 1955.

Hon. Paul H. Douglas,
Chairman, Joint Committee on the Economic Report,
United States Senate, Washington, D. C.

Dear Senator Douglas: Transmitted herewith are the papers submitted by the panelists invited to appear before the Subcommittee on Tax Policy. Pursuant to instructions contained in the March 14, 1955, report of the full committee, the subcommittee is conducting a study of Federal tax policy for economic growth and stability.

These papers are presented in advance of the subcommittee's hearings to be held December 5-16 to provide the members of the subcommittee, the panelists, and the public an opportunity to examine the major issues lying within the scope of the study as they will be developed in oral statements and discussion at the hearings.

Wilbur D. Mills,
Chairman, Subcommittee on Tax Policy.

November 9, 1955.

Hon. Wilbur D. Mills,
Chairman, Subcommittee on Tax Policy,
House of Representatives, Washington, D. C.

Dear Mr. Mills: Transmitted herewith are the papers submitted by the panelists invited to appear before the Subcommittee on Tax Policy in its study of Federal tax policy for economic growth and stability. The papers are presented in order of the scheduled appearance of the panelists during the subcommittee's hearings, December 5-16.

The selection of the topics and issues in Federal tax policy with which these papers deal reflects in part the results of the meeting of the subcommittee with the panelists on May 24, 1955. At the meeting, the panelists were invited to offer suggestions with respect to the questions which should be examined in the subcommittee's study. Their interest and cooperation have been of great assistance to the staff.

Included as an appendix are certain additional materials which have been submitted for the subcommittee's examination. While it was not possible to invite all those wishing to do so to appear during the hearings, every effort has been made to make their views available to the subcommittee, either in the appendix or by direct transmittal to the subcommittee.

These papers were assembled in this volume by Norman B. Ture, economist for the subcommittee. The papers are presented as submitted without editing by the staff.

Grover W. Ensley,
Staff Director.

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INTRODUCTION BY WILBUR D. MILLS, CHAIRMAN, SUBCOMMITTEE ON TAX POLICY[1]

The present complexion of world affairs places a premium upon strength and growth in our national economy. To a very substantial extent, the conflict between the East and West today is an economic one, a struggle between conflicting economic ideologies. Our most potent armament is our ability to provide a continually expanding economic horizon and a continually improving standard of living for all. Accordingly, these must be the basic objectives of all public policies affecting our economy.

Our record in accomplishing these objectives was the subject of a study and report prepared last year by the Joint Economic Committee staff entitled "Trends in Economic Growth."[2] This study shows that, contrary to the basic premise of communism that a capitalistic system cannot adjust to the needs of the masses of the people, the United States and other free countries can grow more rapidly than the totalitarian, communistic systems. The staff report shows, moreover, that the economic gap between eastern communism and western democracy is actually widening. So long as the conflict between the free world and communism continues, we must constantly strive to improve on this past record.

One measure of our economic objective was provided in a study by the Joint Economic Committee staff and released last fall under the title of "Potential Economic Growth of the United States During the Next Decade."[3] This study shows that we can, during the next 10 years, increase our national production by 50 percent; that we can raise our standard of living at least 30 percent, with a total production exceeding $535 billion in 1953 price levels by 1965.

We must be sure of the road we follow toward the attainment of these growth objectives. It is altogether possible that we could reach our goals by following a bumpy road of fits and starts in economic activity; by spurting ahead under the impetus of inflation and lagging behind in recession, while gathering force for the next economic push.

This clearly is not an effective way to proceed. What is required instead is a steady, sustainable pushing ahead, year by year. A stable, even course on our road will give the lie to the Communist propaganda that we can expand only under the inflationary stimulus of war. We must have courageous leadership in private business and government to provide the programs necessary for this economic growth.

Such programs are called for in the declaration of policy in the Employment Act of 1946, under which the Joint Committee on the Economic Report was established. The act emphasizes the continuing responsibility of Congress to use all practicable means to promote "maximum employment, production, and purchasing power" within

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[1] This statement was delivered by Mr. Mills at a planning meeting of the subcommittee and the panelists, May 21, 1955.

[2] Trends in Economic Growth, a Comparison of the Western Powers and the Soviet Bloc. A study prepared for the Joint Committee on the Economic Report by the Legislative Reference Service of the Library of Congress, 83d Cong., 2d sess., Washington, 1955.

[3] Potential Economic Growth of the United States During the Next Decade. Materials prepared for the Joint Committee on the Economic Report by the committee staff, 83d Cong., 2d sess., Washington, 1954.

the framework of "free, competitive enterprise." While achievement of these objectives was originally conceived as necessary for purely domestic reasons, today it is vital for foreign policy reasons as well.

One of the most important programs which will contribute to or detract from achieving steady economic growth in the years ahead is our Federal tax policy.

The Joint Economic Committee is not a legislating committee but under the Employment Act it is charged with making continuous studies of the major economic programs of the Federal Government as a guide to the legislating committees—in this case, the House Ways and Means Committee and the Senate Finance Committee, whose responsibility it is to act on revenue matters. In discharging its responsibilities under the Employment Act, the Joint Economic Committee is undertaking a broad-scale, comprehensive study of our tax system. The objective of this study is the broad outline of a tax policy to meet our economic challenges. We are hopeful—I dare say we are confident—that the results of our study will be of great value to congressional tax committees and to the whole Congress in the tax legislative program of next year and the years to come. As a member of the House Ways and Means Committee, I am personally sure that this inquiry will be of great service to the tax writing committees of the Congress.

The study breaks down into three major parts:

1. What should be the focus of tax policy, both from the standpoint of short-run stabilization and long-run growth? Under this heading we are interested in considering budget policies and automatic and discretionary stabilizers in the Federal revenue system.

2. What is the impact of Federal taxation on the distribution of real income and levels of consumption, the amount and character of private investment, managerial efforts and incentives and the supply of labor and professional skills, and what should be the relative emphasis on direct stimulation of consumption and investment?

3. The third part of the study deals with a number of specific tax issues. Those which we believe are the most important from an economic standpoint include the capital gains tax, the treatment of natural resources, depreciation, excises, taxation of small business, corporate income, deferred compensation, individual exemptions and deductions, foreign income, estate and gift taxes, and intergovernmental relations.

It is the desire of the subcommittee that in the course of this study we have before us all of the various viewpoints that exist on each and every aspect which can be presented when the time comes for the committee to make recommendations with respect to these momentous issues of taxation. The list of witnesses suggested by the staff, I believe, fully reflects this instruction.

It is our intent that the study be factual and not political. There are three distinct facets of taxation. One is political, one is economic, and one is technical.

This committee is not, in my opinion, concerned with the political nor the technical facets and aspects of taxation in this study. What we are studying are the economic aspects of taxation, with respect to which, I should think, we could reach conclusions to which all of the members of the subcommittee could agree. The efforts of our panelists, as presented in these papers, will be of very great assistance to us in attaining this objective.

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

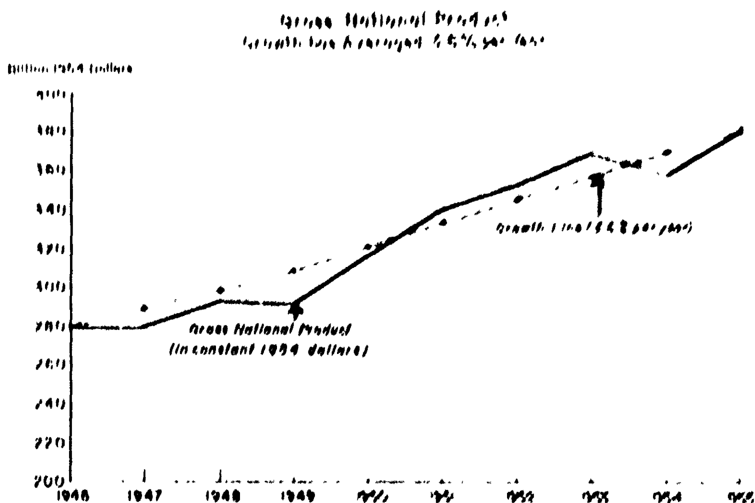
I. GOALS OF TAX POLICY: SHORT-RUN STABILIZATION AND LONG-RUN GROWTH

ECONOMIC STABILITY AND GROWTH

Dexter M. Keezer, McGraw-Hill Publishing Co., Inc., New York City

In spite of the fact that it has been operating in a [illegible] mixed environment, the American economy has since the end of World War II made an extraordinary record of both growth and stability. As measured by the gross national product, its growth in physical terms has averaged about 3.6 percent annually for the postwar period. This is a rate of growth about 20 percent higher than the long-term rate of growth since 1910.

This growth has also been remarkably sustained, as is indicated by the following chart. In only 1 year (1954) during the postwar period has the gross national product, in physical terms, dropped more than 1 percent from a straight line of growth. And, over the period, employment of the Nation's civilian labor force has ranged from [illegible] to [illegible] percent of the total, with unemployment [illegible] percent of the labor force only for brief periods.



Source: U.S. Department of Commerce, McGraw-Hill Dept. of Economics

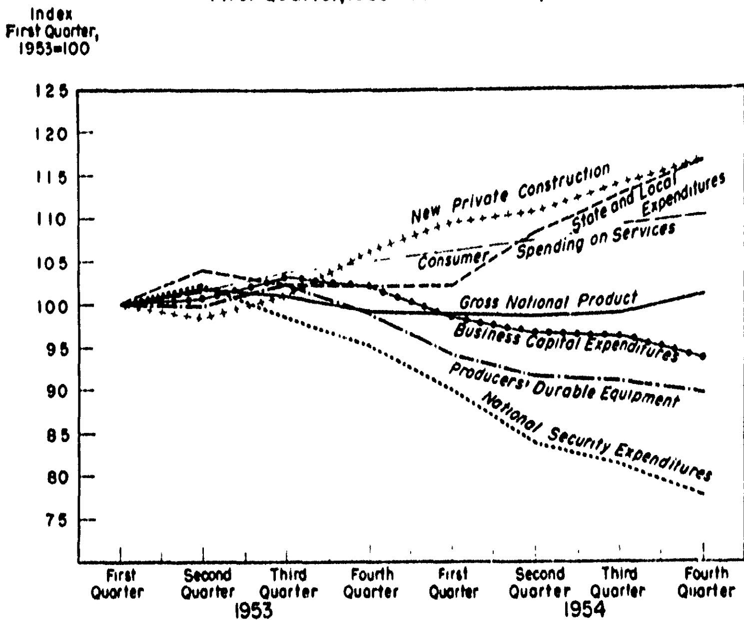
I take it to be the purpose of these hearings to study the possibilities of sustaining and, if possible, improving upon this record of growth and stability in the years ahead, and more particularly to study how the tax policy pursued by the Federal Government might contribute to this end. I feel honored by the invitation to make observations introductory to this undertaking which, so far as I know, is unprecedented in the operations of the Congress, at least in the magnitude of the roundup of economists involved. The responsibility for my observations is mine alone, although I have had the benefit of the counsel of a large number of economists, in addition to that of my associates in the department of economics of the McGraw-Hill Publishing Co.

Although the economy as a whole has made an imposing record of growth and stability in this postwar period, there is reason to believe that, if we are well enough informed and wise enough, it could be improved upon. For one thing, the record has upon it the great blight of a decline of about one-third in the value of the dollar since 1945. While stimulating to some types of economic activity, this has worked cruel hardship on millions of relatively helpless people living on fixed incomes such as pensions. The belief that price inflation is not an essential element of the growth we have attained in the postwar period is encouraged by the fact that we have had relative price stability in the last few years, and along with it a continuation of growth. This has also been true at earlier periods in our history.

Concept of Stability

At the same time there is no reason to suspect that we shall soon develop a sure-fire formula to assure that our economy will sustain both a rapid and absolutely steady rate of growth. In the concept of stability used in these observations such a development is conceivable. This concept of stability is that of a relatively small deviation from the course being followed, rather than the failure to wobble or indeed make any movement at all which is associated with something that is completely dead.

In this conception of stability an economy would be stable even if it were growing fast but steadily. And it is conceivable that the myriad of forces at work in our economy at any given time would so fall into balance that for a time there would be growth and perfect stability so far as the economy as a whole is concerned. Indeed, in the postwar period there have been times when conflicting forces within the economy have so offset each other as to produce relative stability overall, or what economists have taken to calling a rolling readjustment. Such a development is illustrated by the chart which follows.



Disturbing nature of growth

If our economy were to grow both rapidly and at an absolutely steady rate for a sustained period, it would be a fluke, the result of a chance balancing of a myriad of disturbances against which no electronic computer yet produced seems capable of calculating the odds. For the very process of growth is disturbing. New people show up or old people show up in new places; new products are introduced and replace old products; new processes are introduced and replace present workers—all disturbing the existing state of economic affairs and introducing unstable elements. To be sure of perfect stability it would be necessary to eliminate these disturbing elements, and growth with it. The problem thus becomes not how we can have growth and perfect stability, but how, on a compromise basis, it is possible to have arrangements accommodating an adequate rate of growth and a degree of stability which is relatively satisfactory.

Our postwar experience suggests that it is not too much to hope that a long-term rate of economic growth of 3 to 4 percent a year can be maintained without having fluctuations of much greater magnitude in the total volume of economic activity. It seems quite clear, however, that the vision of perfect stability and rapid growth is a dangerous mirage. If the stability were provided by trying to have more jobs than job seekers available at all times, the outcome to be anticipated would be a price inflation so violent that it would court violent interruption of all growth. If perfect stability were sought by having perfect individual income equality all around, the result would be the elimination of those incentives which, in a free society, are essential

inducements to the economic pioneering and adventuring which are of the essence of economic growth.

There are those, of course, who reject the objective of growth as a fool's objective. Some of these, intent primarily on getting into heaven, observe that there is no reason to believe that economic growth, either individually or collectively, increases happiness or peace of mind, and that, in fact, something of the reverse is true. In this connection the (London) Economist has observed:

> * * * The intensely competitive American system has produced, according to the claims of its advocates—and some at least of them must be conceded—the highest standard of living, the greatest technical achievements, the most invincible military and naval power, the highest level of athletic excellence, and for that matter the best-looking girls and the finest babies, that the world has ever seen. It is also just as well for the Old World to remember that it provided the wherewithal for lend lease and for ERP. But it has undeniably produced in addition a larger crop of stomach ulcers, psychoses, neuroses, suicides, divorces, and miscellaneous and highly colored crime than in less competitive countries.

United States economic strength and the free world

It is significant, however, that along with some of the more dubious fruits of our Nation's economic growth and power, the Economist cited the great boon to the free world provided by our capacity to finance the European reconstruction program. Thus economic growth and economic strength are equated, and properly, not merely with individual well-being and tranquillity, or the lack of it, but with the capacity to survive in the continuing struggle between the free world and the Communist world. This relationship was stressed by the chairman of the subcommittee conducting these hearings in his opening remarks when he said:

> The present complexion of world affairs places a premium upon strength and growth in our national economy. To a very substantial extent, the conflict between East and West today is an economic one, a struggle between conflicting ideologies. Our most potent weapon is our ability to provide a continually expanding horizon and a continually improving standard of living for all.

This "ability to provide a continually expanding horizon and improving standard of living" to which Congressman Mills referred has a crucial bearing not only on our survival value internationally, but on the successful conduct of our American economy, for which opportunity and incentive, rather than command, provide most of the driving power. A growing community or a growing enterprise offers these vital elements of opportunity and incentive to a degree which is inevitably lacking where growth is lacking. It also provides room for individual economic advancement, the absence of which is an invitation to what may be a debilitating struggle over income redistribution.

Difficulty of measuring growth

As a measure of our Nation's economic growth, the gross national product, which has already been used here and is perhaps most frequently used, leaves a great deal to be desired. For example, in conception at least, it would include the billion dollars which Dr. William C. Foster, president of the Manufacturing Chemists Association, recently estimated is being spent annually for materials and services by American industry to combat smog,[1] an operation which at best

[1] Dispatch to the New York Times from Pasadena, Calif., April 21, 1955, p. 30.

merely gets rid of a drag on the economy with no net addition to its strength or capacity to contribute to human welfare. At the same time, the per capita increase in the consumption of goods and services contributing positively to human welfare, which is urged by some as a better measure of economic growth, also is defective. It leaves out of account that element of growth required for the military defenses needed for us to be tolerably sure of continuing to have any welfare at all. Embedded in the idea of economic growth at this juncture must be both advance in economic welfare and the military strength to defend it. Until some satisfactory common denominator for measuring these elements is devised, the gross national product serves as a rough, very rough, measure of economic growth.

Causes of Growth and Stability

At this juncture it would be gratifying to be able to launch into a series of decisive generalizations about economic growth and economic stability which would at least gesture in the direction of policies that would lead to the most salubrious possible combination of them. But while, as I shall indicate subsequently, it is possible to make a few general observations of this type which may be helpful, the possibilities along this line are limited.

This is due, in part, to the fact that it is only in recent years that the study of economic growth and its relationships with economic stability has become a major subject of inquiry by economists. Theretofore, economic growth had been pretty well taken for granted, and in the United States at least not without some cause. For until the great depression of the thirties temporarily halted the Nation's economic growth in the process of attaining an unprecedented degree of instability, the economy seems to have continued to grow in spite of widely varying degrees of stability.

In their study of the relationships between growth and stability, economists must also bear their constant cross of never having economic events unfold in the same way twice. In this postwar period there have been elements bearing on both growth and stability, such as tremendous backlogs of war-created demand, which are nonrecurring and elements such as a Korean war, which no one wants to recur. And, finally, there are so many important variables shaping both growth and stability that the number of combinations in which they can and do occur is enormous.

Elements determining growth

It is possible to catalog in a general way the elements which may play key roles in permitting or producing economic growth, most of which also have a bearing on stability because they are disturbing. For the American economy the conventional catalog of these elements includes relative abundance of natural resources, population increase, advance in knowledge and technology, adequate saving and investment to exploit this advance and the incentive to do it voluntarily, widely diffused consumer income and a strong individual drive to get and spend more.

In other nations and economies, of course, the catalog of elements determining growth or lack of it would be quite different. For example, one recalls the poignant closing of a letter from an East Indian

civil servant to a friend in England on the occasion of the birth of his 19th child, "Oh, Lord, when will this mischief cease?" There were not the drive or the resources at hand to make this addition to the population a boon. In the Soviet Union the command of a dictatorship is a driving force for economic growth whereas the United States, in happy contrast, relies largely on incentives to produce it voluntarily.

Factors bearing on stability

As it is possible to catalog the main factors bearing on economic growth, it is possible to produce a similar catalog of the elements which, in addition to those covered in the catalog of growth elements, may have important bearings on the stability of an economy. A full-blown catalog of this type would perhaps take as many words as I am permitted for this whole statement and include elements as diverse as the decisions of the Federal Reserve Board on monetary and credit policy and the decision of M. Christian Dior, the Paris dressmaker, on feminine adornment.

Some of the main headings of such a catalog would note that the Federal Government contributes to the stability or instability of the economy by what it does about defense spending, public works, foreign aid, transfer payments, taxation, money, and credit and lending. Business management makes the same contribution by what it does about wage payments, the introduction of new products, methods, and models, its spending for new producing facilities, and the handling of its inventories. What wageworkers seek in the way of wage adjustments and the methods used to secure the adjustments have an important bearing on the economic stability. And so does the pattern of the distribution of income to consumers and what they decide to do with the income received, and the degree to which they decide to supplement it by borrowing. And playing over all these elements, and shaping virtually all of them are such elemental factors as the weather and the ebb and flow of war and peace.

In this postwar period the defense expenditures of the Federal Government have been the principal unstabilizing element in our economy, certainly not through design but as a reflection of the fortunes of wars. Between 1945 and 1947 expenditures of the Federal Government for goods and services dropped by 84 percent; between 1947 and 1953 these expenditures increased by 227 percent, and since then have declined by about 24 percent, exercising leverage on the economy accordingly. It is obvious that if stability is the goal, the most important single step is to eliminate war and threats of war.

Second only to defense expenditures in the breadth of their fluctuations in the postwar period have been the fluctuations in the rate of business inventory formation. Between 1948 and 1949 it dropped about $8.5 billion; between 1949 and 1951 it went up by about $12.6 billion, and then from 1951 to 1954 declined by about the same amount. These swings had the effect of upsetting the balance between sales and production and employment, a large increase in inventories representing an increase in production without sales to balance and a large runoff of inventories, the reverse. But the inventory swings were, in turn, reflections of other basic developments, such as prospective changes in prices.

EXPLANATIONS OF BUSINESS FLUCTUATIONS

After sorting the myriad of different kinds of economic fluctuations into broad categories such as those stemming from the changes in the seasons and those stemming from long-term developments, economists have, as you know, made it a principal branch of their art to develop broad basic explanations of business fluctuations, and particularly what historically have been more or less regularly recurring ups and downs in the total volume of business, or business cycles. Study of these ebbs and flows of business has resulted in an enormous body of descriptive and analytical literature, and a majestic array of explanatory theories, ranging from those which rely primarily on such elemental phenomena as the pull of gravity to those which look primarily to monetary management for the basic explanation.

This study, however, has resulted in considerably less than unanimity among duly accredited economists about the true explanation of business cycles. These hearings will be most unusual if, among the several score of economists to be assembled, there is none to offer what is purported to be a sovereign cure for economic stability which also doubles as a perfect elixir for economic growth. But those who claim a sure-fire explanation of business cycles will not be representative of the economist's craft, where there is anything but unanimity about the causes and cures of business cycles. Indeed, there are many reputable economists who tend toward the view that the classical pattern of business cycles may have been shattered by such developments as the emergence of government as a dominant force in the economy. Dr. Arthur F. Burns who, prior to his appointment as Chairman of the President's Council of Economic Advisers, was Director of Research of the National Bureau of Economic Research, which has illustriously concentrated on the study of business cycles, remarked in his annual report to the Bureau's Board of Directors on March 2, 1953, that—

> Not only have recent fluctuations and aggregate activity become less regular in direction but many of their internal features have been modified.

It would be a disservice to the economist's craft to leave the impression that the state of opinion about the nature of business cycles and their causes is completely chaotic. For example, there is a broad range of agreement about the key role of monetary and credit expansion and contraction in producing surges of business and recessions. There is also general agreement that a lack of balance between investment and consumption may precipitate severe economic ups and downs. But it would be an even greater disservice to intimate that economists see eye to eye in the explanation of business fluctuations.

RELATION BETWEEN GROWTH AND STABILITY

If, however, there is lack of unanimity among economists about the basic causes of cyclical fluctuations in business, there is still less unanimity about the relationships between these fluctuations and economic growth. This is understandable enough, for many more variables get involved in the study of these relationships. At one extreme there is the theory, developed by the British economist, J. R. Hicks, that the mechanisms producing business cycles and economic growth have quite different and distinct origins. At the other extreme is

the theory, perhaps most extensively developed by the late Joseph A. Schumpeter, that both economic growth and cyclical fluctuations have a common parentage in economic innovation, with innovation resulting in growth and the uneven bunching of innovations and the subsequent exploitation of them at particular times resulting in instability.

In between these extremes there are theories that cyclical fluctuations are the cause of economic growth and theories that the reverse is true. In the view of the British economist, Nicholas Kaldor, of Cambridge University, "it is the strength and duration of booms which shapes the trend rate of growth."[2] On the contrary, the young American economist, John Power, has developed a model (a new name for a theory now extensively used by economists) in which it is growth which causes cyclical fluctuations.[3]

In the light of the broad diversity of opinion among distinguished economists about the relationships between economic stability and economic growth, it would be very presumptuous to attempt to dogmatize broadly on this subject. It does not follow, however, that there is nothing constructively suggestive to be said about these relationships, at least as a basis for further exploration.

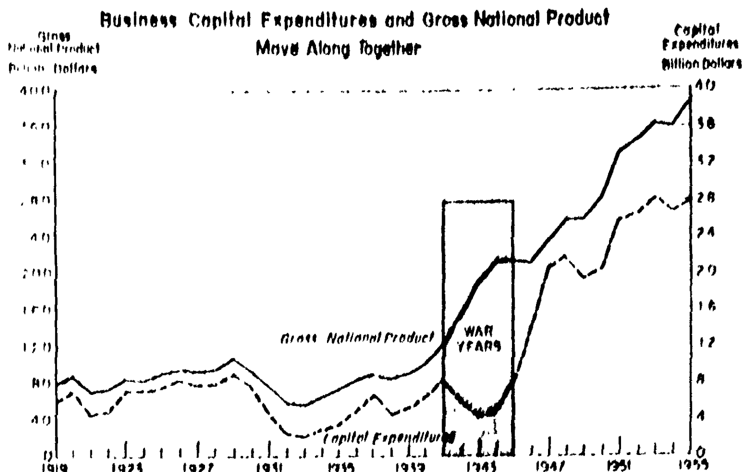
KEY ROLE OF BUSINESS INVESTMENTS

In the available record of both economic fluctuations and economic growth in the United States one crucial relationship stands out very clearly. Wartimes excepted, when we have had a high level of business investment in new producing facilities, we have had a high level of prosperity, and when we have had a low level of such investment the reverse has been true.[4] The companionship between the movement of the gross national product and the movement of the total of business investment in new producing facilities in other than war years is indicated by the chart which follows.

[2] The Economic Journal, No. 253, March 1954, p. 68. London, England.

[3] For the schematic arraying of these theories I am indebted to the Swiss economist, Jurg Niehans, who did it in the course of a conference of economists on economic growth at the Merrill Center for Economics at Southampton, N. Y., during the summer of 1955.

[4] As already indicated, during the postwar period changes in the level of inventories and defense spending have resulted in considerable fluctuations in the general level of business. But the fluctuations have not been such as to invalidate this general proposition.



Source: U.S. Department of Commerce, Securities and Exchange Commission, Board of Governors of the Federal Reserve System; McGraw Hill Department of Economics

When we have had a high level of business investment in new producing facilities, we have also had a relatively rapid rate of economic growth. For, of the very essence of economic growth is the development and installation of more and better producing equipment for more and better products which a high level of capital investment by business provides. Thus, when there is a high level of capital investment by business, there are both prosperity and a relatively rapid rate of economic growth.

Importance of consumer expenditure

It is true, of course, that a high level of consumer expenditures is also a concomitant of a high level of prosperity, and axiomatically so since about two thirds of the gross national product is accounted for by consumer expenditure. But consumption in itself does not result in growth. Capital investment, in contrast, makes a key contribution to both prosperity and growth.

There is a line of economic theory which holds that a dollar of capital investment plays a much more crucial role in the creation of prosperity or the lack of it than a dollar of consumer expenditure because, with multiplying force, it is spent and respent many times in the complex process of creating capital goods. It is not necessary, however, to embrace this theory to accept the proposition that business investment in new producing facilities is a key ingredient of prosperity. This is the case if for no other reason than that about one-fourth of our industrial workers, and by and large the best-paid industrial workers, are engaged in producing and installing capital equipment. Their employment is obviously a key ingredient of prosperity as it is also a key ingredient of economic growth and the improvement of levels of living.

From this state of affairs it follows that if it were possible to stabilize capital investment by business at a high level, a major ingredient of both stable prosperity and growth would be provided. It does not follow, of course, that a high and stable level of prosperity for the economy as a whole would be tantamount to the same state of affairs for all of its separate segments and individual parts. As has already been observed, capital investment may have an upsetting impact on individual firms and individual workers by introducing new products which replace present products and sometimes existing firms along with them and by introducing new processes which upset existing processes and those who carry them out.

The upsetting effects in question, however, are by no means directly proportional to the total amount of capital investment by business. There are several reasons for this. One is that a large share of the investment in new plant and equipment in the United States currently is made to replace facilities that are worn out. Of course, there is always an effort to replace worn out facilities with those which are both new and better, and in many cases the effort succeeds. But of about $28 billion spent for business facilities this year (1955) approximately $13 billion, or 45 percent, can be counted as going for facilities which are worn out.[5]

A second reason why the total amount of capital investment by business is not a direct measure of the economic disturbance involved is that new facilities resulting in new products and new processes create disturbances which have a considerable tendency to offset rather than reinforce each other. Hence the very diversity of new products and new processes introduced as a result of maintaining a high level of capital investment tends to have some stabilizing force. On this general point, Prof Sumner Slichter of Harvard has remarked that

> the increase in the number of industries diminishes the relative importance of each industry and, therefore, the effect upon the total economy of conditions that are particularly favorable or unfavorable for any particular industry. The greater the number of industries, the greater is the likelihood that effects of influences which are particularly favorable or unfavorable to certain industries will cancel out.[6]

Contributing to greater diversity of industry and product and constituting perhaps the most dramatic feature of the American economy today is the fact that we now have an annual expenditure of about $4 billion a year for research of all kinds. This expenditure, about 20 times greater than it was in the 1920's, can confidently be expected to result in a cascade of new products, processes, and industries, all calling for capital investment to advance their development.

The very nature of the industrial research and development process may well contribute an element of stability to the capital investment it prompts. This element arises from the fact that most of this process is not geared, at least directly, to market developments but is governed by developments in laboratories, where business fluctuations are at most only occasional intruders.

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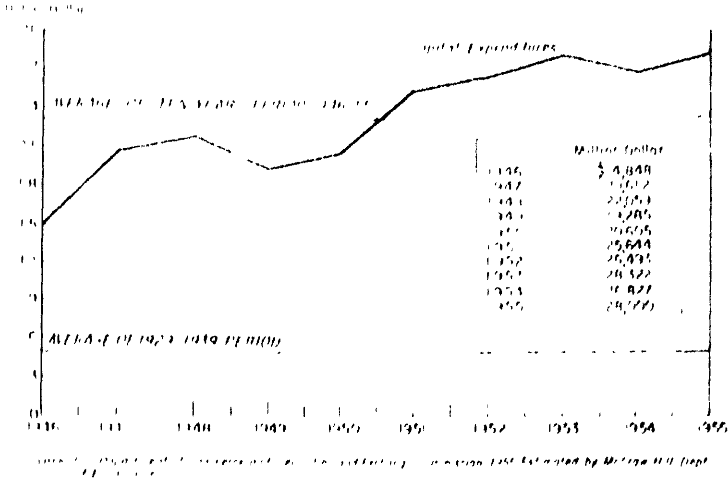
[5] This is a fact of key significance in making comparisons of the relative proportions of their national product which the United States and Soviet Union devote to investment in producing facilities. In the United States a much larger share of the investment in new facilities must go to replacement rather than expansion of capacity than is the case in a much less developed industrial nation such as the U. S. S. R.

[6] Are Business and the Government Succeeding in Breaking Up the Business Cycle? an address by Sumner H. Slichter before the 14th Stanford Business Conference, Stanford University, California, July 28, 1955.

One of the dominant economic characteristics of this postwar period has been the maintenance of a remarkably high level of investment in new plant and equipment by American industry, and along with it a high level of prosperity. The record of annual expenditures of this type since 1946 is set forth in the following table and chart:

Expenditures for New Plant and Equipment



Need for more investment

Because of the very heavy capital expenditure by business in this postwar period ($238 billion for the period August 1945 through December 1955) the fear is occasionally expressed, and sometimes by Members of the Congress, that the Nation's demand for capital equipment has been quite fully satisfied and must be expected to decline over the years immediately ahead. It is difficult, however, to reconcile this position with what seem to be the controlling facts.

Over the next 20 years, there is reason to expect that our population will increase by one-third. Over the same period, however, the total hours worked does not seem likely to increase by much more than 15 percent, both as a result of having more old and very young people and because of a continuing trend toward a shorter workweek. The inevitable result is greater dependence upon capital equipment, a result which wage increases of greater relative magnitude than the increase in productivity seems likely to stimulate.

Another key element bearing upon the prospective need of capital equipment, to which reference has been made, is the need of heavy investment to replace wornout facilities. The urgency of this need is underlined by the results of surveys of the state of our industrial equipment, of which it is a national misfortune that we have so few and these of such limited scope. For example, a survey of the age of the metalworking machinery used by American industry, made

by the McGraw-Hill magazine American Machinist in 1953, disclosed that 56 percent of this machinery, which is perhaps our most basic industrial equipment, was over 10 years old, or too old to take advantage of the manifold improvements in tool design since the end of World War II. The survey also disclosed that 19 percent of all machine tools, 25 percent of all metalworking tools and 10 percent of other machine shop equipment was over 20 years, an age making them thoroughly obsolete.

Long-range business planning

Coupled with a national need of a high level of business investment in the years immediately ahead is a will on the part of American business to meet this need, and a will to meet it in a manner steadily enough sustained to make the process a stabilizing force. Surveys of business plans for new plant and equipment, made by the McGraw-Hill department of economics over the past 8 years, disclose that over this period there has been a great growth of longer range planning of business investment.

Eight years ago, only a small fraction of the firms cooperating in our surveys could give us any investment plans for the year ahead. Over 90 percent of the companies cooperating in our 1955 survey, and companies representing a very broad segment of American business, could give estimates of their expenditures for 1956, and an imposing number had developed investment programs running several years ahead. This year's survey, which covered business investment plans not only for 1955 but for the years 1956 through 1958 indicated clearly that, so far as its plans are concerned, American business management is prepared to maintain a relatively high level of capital investment over these years, and thus make a key contribution to both economic growth and economic stability.

Tax Policy and Investment

It is one thing to have a national need of a high level of capital investment and plans on the part of business to meet the need; it is quite another to have the financial capacity to carry out the plans. This capacity obviously depends on having the necessary funds available, and quite as obviously this, in turn, depends in decisive degree on the tax policy of the Federal Government. Through the taxes imposed upon business and individual income and the methods prescribed for their administration, Federal tax policy has a key bearing both on the funds available for capital investment, and the incentive to use it for that purpose.

In developing its tax policy the Federal Government faces the uncomfortable necessity of working out a compromise in pursuing different and possibly conflicting purposes which a preponderance of the electorate will find relatively tolerable. There is the purpose of seeing that taxes are so apportioned as to comport with the prevailing community sense of fairness, as an ethical consideration. There is the technical purpose of not having too much of the tax collections eaten up by the cost of making them. While a beleaguered but unbowed body of economists still deplores the purpose of using tax collections as an economic stabilizing device, there is no conflict with the purpose of having the impact of taxation disturb the economy as little

as possible. And insofar as growth and economic stability are joint objectives of Federal tax policy, it is axiomatic that this policy will give encouragement to a high level of capital investment, and to the educational and research activities which are a prelude to much of it.

The encouragement of a high level of capital investment is, of course, much more than a matter of tax rates. To be sure, these rates have a decisive role in determining whether business firms and individuals have the funds necessary to maintain such a level, and they have a major role in determining whether they have the incentive to use the funds for this purpose. But incentive is a compound of a complex array of other elements such as confidence in the future fairness of the Government in taxing private capital investment and sparing it destructive competition from Government-sponsored elements.

Viewed superficially, the high level of business investment in new plant and equipment during the postwar period would suggest that the taxation as well as other key elements bearing upon it have been in generally salubrious adjustment. Before resting too comfortably on this impression it should be noted that capital investment by business during this period has had some very unusual stimulants. These include a great backlog of capital requirements built up during World War II and the great rush to create more defense facilities which was prompted by the outbreak of the Korean war. To expedite the creation of these facilities through private investment, the Federal Government has granted over $30 billion in accelerated depreciation and thus given a great direct stimulus to such investment.

Balancing investment and consumer spending

These hearings will be most unusual if the taxation of the sources of capital investment by business is not treated by some witnesses as involving essentially a crude tug-o-war between those who favor "soaking" business firms and individuals in the upper income brackets for the benefit of the great mass of consumers and those who favor the opposite course. No matter how much traction it may have politically, however, this is a phony economic issue. It is axiomatic that the sustained maintenance of a high level of capital investment by business is dependent upon a high level of consumer expenditure. But it by no means follows that an increase in the consumer income available for expenditure is promptly translated into an increase in capital investment to take care of the increased consumer demand. Nor does it follow that an increase in the funds available for capital investment automatically carries with it the increase in consumer expenditure necessary to validate such an increase.

The problem involved is one of maintaining a balance between capital investment by business and spending by consumers which keeps both on a relatively even and expanding keel. At present the average American industrial worker is backed by about $12,500 in capital investment,[1] much of it in complicated equipment the production of which is a long time-consuming process. It is the fact of this investment in capital equipment which explains in large part the high productiveness of American workers and high level of living enjoyed by Americans. The fact that the provision of the capital equipment is a complicated, time-consuming process explains, or should explain, in

[1] Capital Goods Review, August 1955, published by the Machinery and Allied Products Institute, Washington, D. C.

decisive degree why the process of capital investment must be steadily sustained to secure steady advance in the productivity of American workers and economic stability.

Perhaps happily, the ground to be covered by these introductory observations does not include the detailed prescription of the Federal tax policies to be followed to assure the steady maintenance of a high level of capital investment by business. I say happily because what can be said on this subject with assurance of scientific rectitude is limited. It is my impression that in itself a 52-percent Federal income-tax rate on all corporate incomes above $25,000 per year is a threat to the maintenance of a high level of capital investment, and may work a particularly crippling sort of hardship on relatively small and rapidly growing companies. It is also my impression that this threat would have made itself felt in recent years if we had not had more or less continuous boom times, propelled in large part by war-created shortages, and if we had not had new and more generous provisions for accelerated depreciation allowances. The accelerated depreciation arrangements have served as a substantial offset for the high rates of taxation.

Pursuit of this line of reflection to any certainly useful purpose would take me both in the realm of speculation about our economic future and into the details of Federal taxation of business income and its administration, and hence beyond the scope of my assignment and, at least in part, beyond the scope of my competence. However, the observations prompted by this assignment have been ineptly stated if they have not made it clear that both economic growth and a crucial measure of economic stability depend on having a Federal tax policy which is conducive to the maintenance of a high level of investment in new plant and equipment by business.

ECONOMIC STABILITY AND GROWTH

ALVIN H. HANSEN, Harvard University

Investment is the key to both short-run stability and long-term growth. If a rate of investment high enough to maintain full employment—historically about 16 to 17 percent of GNP—could be maintained indefinitely, we would have achieved both stability and a reasonable guaranty of sustained long-term growth. Unfortunately, however, the rate required to maintain full employment is not maintainable. This is the dilemma. A boom level of investment rushes headlong into excessive capital accumulation. A boom level of investment, maintained for several years, causes the stock of capital to increase so rapidly that further investment eventually becomes unprofitable. It is this that sounds the death-knell of every boom. His tory reveals, and the current capital-stock-adjustment theories demonstrate, that the boom level of investment is considerably in excess of the maintainable rate. This, it cannot be emphasized too strongly, is the basic problem that confronts us as we consider the problem of economic stability and long-term growth.

The recent literature on growth has had a great deal to say about the ratio of capital to output. The comparative stability of this ratio over the long run has well nigh led some economists to forget

the law of diminishing marginal productivity. It is just not true that one can continue to build more and more plant and more and more equipment and out of this process obtain a commensurate growth of final output. Historically, the capital-output-ratio has indeed been fairly stable but that is only because whenever the declining marginal productivity of capital sets in, investment falls off, and so a new balance is reached.

Observing the historical ratio of capital to output, it is easy to fall into the error which currently we frequently encounter, namely, that any desired rate of growth is possible if we but push the rate of investment hard enough. If the historical rate of capital accumulation has made possible an increase in output of, say, 3½ percent per annum, why then, it is asked, should we not double the rate and thereby obtain an annual rate of growth of output of say 7 percent per annum. If output is a function of the rate of capital accumulation, there would be virtually no limit to the rate of long-term growth. We might, it would seem, enjoy any desired rate of growth if we were only prepared to push investment to the limit. Some recent pronouncements from high Government officials stem, I suggest, from this philosophy.

As we open our discussions on stability and growth we will do well, I believe, to consider carefully this all important matter.

For the moment, let us set aside the problem of stability and concentrate attention on long-term growth. What now are the real bases of long-term growth? The answer, I believe, is not capital accumulation though this plays a necessary, albeit restricted role. The answer, I suggest, is rather scientific research and invention. If these can be made to grow at a more rapid rate than in the past, then we shall in the usual case be able to open up deeper and broader outlets for investment, and thereby accelerate the rate of long-term growth. These new outlets, would probably, but not necessarily, raise the ratio of investment to GNP to a figure higher than the long-term maintainable rate which we have found possible in the past.

Recently, however, we have been talking altogether too much I feel, not about ways and means of opening investment outlets, but merely about, ways and means of artificially stimulating investment. Accelerated depreciation is a case in point. This could, of course, be applied in a cyclically stabilizing manner. But this has not been done. Instead the measure recently adopted is in effect a subsidy which made continuously, without regard to cyclical fluctuations, would tend to push investment faster than otherwise beyond the maintainable rate.

It would of course be quite possible to carry the process of subsidization of investment very much further than is contemplated with respect to the accelerated-depreciation device. Indeed, it could be carried to almost any desired point. The rate of obsolescence and replacement would thereby be greatly accelerated. We could, if we wished to, raise the rate of capital replacement to a point at which no house would be no more than, say, 15 years old, no plant more than, say, 10 years old, and no machinery more than, say, 2 years old, or even further. If we are prepared to restrict our consumption with sufficient severity we could acquire, at least in the United States, an incredible degree of "newness" or "youth" in our stock of fixed capital goods.

Such a program would, however, clearly involve a highly wasteful use of resources. We would be spending a very high proportion of our productive power merely to scrap useful and comparatively new plant and equipment. We would indeed enjoy the possession of a strictly up-to-date stock of fixed capital all around. But the price we would pay for this artificial "newness" would necessarily be a lower output of consumer goods. Americans love gadgets. Farmers are often so enamored with the sight of expensive and uneconomical machinery that they are prepared to sacrifice their standard of living and that of their families to get it. And many urban families are prepared to sacrifice almost anything to get a new car.

In the United States we have reached a level of productivity so high that we could, if we wanted to, devote perhaps half of our resources to a highly accelerated rate of obsolescence and to an extravagantly large accumulation of new capital goods. But the price would be a severely restricted output of services, and of nondurable and semidurable consumer goods.

Clearly we should not aim at the maximum rate of capital accumulation. We should aim at the optimum rate. And that optimum rate would be determined, I suggest, primarily by the rate of scientific research and invention.

Scientific research and invention is indeed likely, as I have already indicated, to open up larger investment outlets in terms of volume, but not necessarily so. Scientific research and invention may at times increase productivity yet lessen the need for capital accumulation. Moreover, expenditures in human resources—education, health, and so forth—may not only directly contribute to living standards, but may also, no less than capital accumulation, increase the productive capacity of the society. There is far too great a tendency nowadays to plead for policies that encourage investment in material capital goods—plant and equipment; and to forget that outlays in the impromevent of our human resources may be even more productive. We are concerned altogether too much about increased investment in brick and mortar and not enough about investments designed to improve the quality and productivity of our people.

I have noted that we place too much stress on brick, mortar, and machines when we plan for long-term growth in our productive capacity. But we make matters still worse by measuring the growth in output primarily in terms of mere material goods. Material goods must necessarily be the chief cause of concern in a relatively poor society. But have we not by now reached in the United States a degree of plenty with respect to the physical necessities which would permit greater attention to education, health, recreation, and the rich, varied range of cultural activities in general? It is indeed true that a considerable proportion of our population still lacks decent housing and even an adequate diet. Nonetheless as a nation we have gone a long way toward meeting our purely material needs. Unfortunately we are compelled currently to devote much of our productive power to armaments, but are we not spending far too much on gadgets that have little relation to true values? In the next two decades we can, and I trust we shall, devote far less of our productive energies to gadgets, and much more to the intellectual, spiritual, and cultural needs of the community.

Twenty years hence our greatly increased GNP should consist of a relatively higher proportion of services and a relatively lower proportion of material goods. A larger proportion of our population should be teachers, doctors, musicians, actors, artists, and leaders in recreational, youth, and community activities. Factory workers should constitute a smaller ratio to the gainfully employed. A higher ratio should consist of professionally trained people devoted to the things that make for wholesome and civilized living. Services can be extended almost indefinitely, even though we achieve well-nigh "robot perfection" in the production of material goods. The old argument that we can't afford the skills and activities that make for richer living is utterly disproven by the events of the last 15 years. What we cannot afford is unemployed resources. But to what end are we going to use these resources? This is the question we need to ponder. A $750 billion GNP by 1975 is not enough. Quality and social priorities at long last must concern us or perish in the midst of material plenty.

Just now we are starving our schools while we race up and down 6-, 8-, and 10-lane highways in ever newer and longer cars.

Full employment and full production, yes, and thereby the long-term growth in output. But let us hope that an ever smaller fraction will consist of material goods. The essential characteristic of the welfare state of the future will be a much higher output of services designed to enrich family and community living.

And now I want to say a word about the much discussed problem of stability versus growth. Many conservatives worry a great deal lest social security and the welfare state may interfere with progress and the development of a dynamic economy. Strangely enough they are also the very people who are prepared to sacrifice full employment for stability. I fear, however, that if we sacrifice full employment we shall not reach our full growth potential. We cannot achieve the growth we are capable of, indeed we cannot even know what our potentialities are, unless we are prepared to place the economy under the pressure of full employment.

Operating under pressure the American economy has performed a miracle in terms of output. The output response to adequate aggregate demand has surprised everyone, and it has not led to the inflation that was feared. Clearly we are not out of the woods in this matter, but the experience of recent years is reassuring. One thing at least is certain. Our economy is equipped with two powerful safeguards against peacetime inflation: (1) Our prodigious capacity to increase production when under pressure, and (2) our capacity, both corporate and individual, to save at high income levels. There remains the problem of wages and collective bargaining. This requires, there can be no doubt, statesmanlike management. At all events, I think it is fair to say that experience thus far indicates that the alarmists may well have beaten the drums a little too loudly, and I am happy to note recently a little softer note in the discussion of this very important problem.

A high degree of stability in the value of money must be an important consideration of public policy. Yet we are, I fear, in considerable danger of making a fetish of rigid price stability. This fetish could easily become a serious obstacle to optimum expansion and growth.

If we are going to be frightened away by every slight increase in prices we are likely to fall far below the growth of which we are potentially capable.

We use the term "inflation" far too loosely. The word "inflation" is used to describe the astronomical price increases experienced by Germany after World War I, and the same word is applied to the comparatively moderate increases in prices in American history. The phrase "inflationary pressures" has often become, I suggest, virtually synonymous with "expansionary forces." Brakes are thereby applied, and output is sacrificed to rigid price stability.

Might it not contribute to clearer thinking if we agreed to speak only of "price increases" and not of "inflation" so long as output is increasing percentagewise at least as rapidly as general wholesale prices? I do not mean that we should rest quite content so long as every advance in prices is matched by a corresponding rate of increase in output. The monetary authorities should apply judgment to a wide range of data and should not be tied to any single rule. Moreover, as in the period since 1951, large output increases can at times be achieved without any price increases. More frequently the two will move in the same direction, though not necessarily at the same rate. In general, however, I believe that we should not worry so much about price increases so long as output is growing at a somewhat greater percentage rate than prices.

The Federal Reserve Act, including all its amendments, does not make it the duty or obligation of the System to maintain price stability. Rigid price stability has indeed from time to time been urged upon Congress and efforts have been made to obtain legislation which would make this a declared policy of the Federal Reserve System. These efforts were rightly resisted. Yet some recent pronouncements indicate that there is some danger that we are tending to drift in the direction of this rigid dogma.

It should not be the primary aim of economic policy to maintain rigid price stability. Nor should we set up goals to achieve either any given downtrend or any given uptrend in prices. Growth and expansion should be our primary aim; price stability a secondary aim. In the usual case we need not fear the free flow of expansionary forces on a scale adequate to produce full employment. If indeed we find that prices are increasing percentagewise more rapidly than output, brakes may then appropriately be applied. Indeed there may at times occur a combination of circumstances which may make a restrictive policy desirable prior to any significant rise in prices.

Following World War II we had, as we all know, a considerable price rise. There are those who regard this as simply due to war and postwar mismanagement. I cannot agree. Granted that the controls had to be removed—that politically speaking they could not be continued for a year or so longer—then I think it follows that some considerable price rise was inevitable. This is true because of the accumulated shortages. Under these postwar circumstances, price stability could not have been achieved unless indeed we had been prepared to cut employment and income sufficiently to reduce demand to the level of the then available output of consumer's goods. And a severe cut of this character would have been necessary, even though there had been no widespread holdings of liquid savings, since people

were quite prepared, in view of the backlog of demand for clothing, household furnishings, automobiles, etc., to spend all or nearly all their current income. Any net investment in excess of corporate net saving would under these circumstances have created inflationary pressures.

The path we chose was much to be preferred. It brought indeed a considerable rise in prices, but it gave us full employment and it stimulated a tremendous outpouring of goods which already by the middle of 1947 had drenched the inflationary fires.

Periods of rapid growth have usually also been periods of moderate price increases. In the usual case, the price system tends to respond in this manner to rapid expansion. It is not probable that we can achieve in the next 20 years anything like the growth we are capable of without some moderate increases in wholesale and consumer prices.

Economists generally tend to exaggerate the evils of moderate price increases. The accumulated savings, it is said, are eaten into. Inflation, it is said, tends to eliminate the sturdy middle class; and it concentrates income in the hands of the lucky few.

These things have indeed always happened in the great astronomical inflations. And conclusions based on these undoubted facts are then erroneously applied to such price increases as we have experienced in the United States during the last half century.

The alleged evils which are typically cited are in fact based on abstractions that have no relevance to conditions as we actually find them in the United States. We have indeed experienced a considerable price upheaval both in the first quarter and again in the second quarter of the current century. But private property continues firmly in the saddle. Savings per family (after correcting for price changes) are more than twice as large as in 1925. Urban home ownership has increased from 45 to 55 percent. Farm ownership has increased from 58 percent to 75 percent. The middle class is stronger than ever before in our history. There is less inequality in the distribution of income. Adjustments in social-security benefits can be made and have been made when price changes occur. It is, I believe, fair to say that under the protection of social-security payments, the problem of the impact of price changes on the fixed-income group has become negligible.

In this connection, it is well to remember that nothing eats so dangerously into family savings as deflation and unemployment. On the other hand such considerable price increases we have had since the end of World War II have not wiped out family savings. According to the Home Loan Bank Board, the accumulated savings, per family, in life insurance, savings accounts, United States savings bonds, and savings and loan associations has risen from $2,500 in 1944 to $4,200 in 1954, an increase (after correcting for consumer price changes) of 10 percent in real purchasing power. I do not say that we might not have done still better, had not the aftermath of the war brought the price increases. But I do say we have not suffered the serious effect on family savings that are so often quite irresponsibly alleged.

Thus I conclude that if in the pursuit of price stability, we permit, and even foster, a considerable amount of unemployment, we shall then fail to achieve the growth of which we are capable. If, fearful

of short-run instability, we fail to place the economy under the pressure of an aggregate demand adequate to produce full employment, we shall not even discover what our potentialities for growth are. Under these circumstances we could easily drift into a condition of stagnation.

Minor recessions from time to time we may not be able to avoid, but we should not welcome them. Playing with fire may start a conflagration. Formerly it was argued that even serious depressions were useful—they cleansed, so it was said, the economic system. This argument is no longer heard, but we still hear it said that minor recessions may prepare the way for vigorous growth. I venture the prophecy that this bit of diagnosis will go the way of the old "cleansing theory."

I do not contend that minor recessions would prevent the attainment of a satisfactory growth trend. Indeed even the great depression did not prevent our returning eventually to the long-term growth line of around 3½ percent. But it cost us the goods and services which full employment throughout the thirties would have given us. The aggregate cost in terms of 1955 dollars was about $650 billion. Minor periodic recessions would, of course, be less costly, but the loss is nonetheless considerable in terms of human discouragement and suffering and loss of aggregate national income. We worry about a $5 billion foreign-aid program but we often seem little concerned about a $20 billion loss of income due to a minor recession.

The pursuit of continuous long-term growth at a rate equal to our potentialities will require at times very large-scale financial operations by the Federal Government. This follows from the inherent instability of investment. These operations can and should take the form of both large changes in Government expenditure and large changes in tax rates. The long-run trend of expenditures will doubtless (I leave military expenditures out) be upward, and as in the past, this trend can be expected to rise more rapidly than the GNP. The long-run trend in tax rates (I assume adjustment to a more nearly peacetime basis) need not necessarily be upward. As income rises, tax receipts will rise (even though tax rates are left constant) more rapidly than income. But it is not probable (and in this matter we do well not to delude ourselves) that tax revenues, at constant tax rates, will rise sufficiently to equal the needed increase in Government expenditures. Nor is it necessary or even desirable that this should be the case. As the national income grows, so also, more or less, should our supply of money and "near money" increase. The public debt, under modern conditions, constitutes the backbone of our monetary and banking system. A country with the GNP which we shall be able to produce by 1975 will need a large increase in money and "near money." The public debt is "near money," and as such it serves a useful purpose. It provides savings institutions, businesses and individuals with a useful and necessary amount of liquidity. Indeed, to provide the optimum growth of money and "near money" we may well find it desirable to reduce tax rates.

Today we do not rely on the gold standard. We rely on the Federal Reserve System, and it has given us responsible monetary management. The balanced budget dogma, everyone now admits, has to go by the board when depression and unemployment threaten. It has in

fact (despite lip service to the contrary) been superseded by responsible fiscal management. Still we need to improve our fiscal management. This means a more careful eye on the efficient use of public funds, and it means a better allocation of resources as between public and private expenditures based on a careful concern for social priorities.

BUDGET POLICY FOR ECONOMIC GROWTH

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It is particularly appropriate that this series of congressional hearings devoted to a consideration of tax policy should open with a number of appraisals concerning (*a*) the economic outlook and (*b*) the budget outlook for the near and the longer run future. Discussions of changes in specific tax rates or of tax policy in general should consider not only the effect of such changes on particular taxpaying sectors, but also the effect on total budget activity and on the economy as a whole. Whether in the interest of balanced economic growth it is desirable that total tax revenues be increased or decreased or whether modifications in the tax structure should leave total revenues unchanged, are questions which involve consideration of economic implications as well as of budget impacts.

To provide this committee with some of the answers to these perplexing problems is the task which has been assigned to me. A discussion of the Nation's economic outlook is a topic primarily within the field in which economists should be competent. And yet, the record of performance of the economist even in his own field, I must admit, has not been very good. A discussion of the budget outlook, however, necessarily leads the economist into fields where he cannot be expected to have professional competence. Recognizing these shortcomings, therefore, I undertake my assignment very humbly.

I. THE BUDGET OUTLOOK IN THE NEAR AND LONGER RANGE FUTURE

Particularly since June 25, 1950, the Government's budget outlook has been influenced by the need for sharply building up and maintaining the Nation's military strength. Meanwhile, nondefense needs such as road construction, school projects, etc., continued to grow more pressing. The budget outlook for the near and longer range future, therefore, should consider what changes, if any, can be expected in these two principal areas of Government activity.

A. National security expenditures

If currently published reports about Soviet air strength and military power in general are correct, one would be inclined to draw the conclusion that the defense programs of the West are presently inade-

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[1] In this paper I am expressing my own views, not necessarily those of the National Planning Association. I acknowledge the assistance of Manuel Helzner in the preparation of this paper.

quate and that a substantial rise in defense expenditures is necessary. On the other hand, the responsible statesmen of the various countries are engaged in an attempt to ease existing tension and efforts are being made toward removing some of the underlying causes of conflict and toward finding some mutually acceptable basis for a reduction in armaments. This period of negotiation, then, may be regarded as a time for testing the sincerity and feasibility of these attempts. Thus, the most realistic assumption which can be made at this time concerning the level of defense expenditures in the near future probably is that until this newly created "spirit of Geneva" has been tested, the United States will not reduce its current military programs but will increase expenditures to the extent that higher outlays are made necessary by increases in costs.

National security expenditures for the current fiscal year are estimated at $38.7 billion in the Budget Review of August 1955. However, it appears that a substantial amount of expenditure cuts below 1955 levels must still be made if actual expenditures in fiscal 1956 are not to wind up somewhat higher than estimated. Moreover, even if no increase in defense programs or projected military strength takes place, I would imagine that, because of cost and pay increases, expenditures in the next fiscal year are not likely to be less than $40 billion.

For purposes of financial planning, however, we must look further into the future. Projected levels of national security expenditures depend, of course, on developments in the world situation. In appraising the longer run budget outlook at this time, therefore, I can conceive of two situations which are more likely to prevail. If some disarmament becomes a real possibility, national security expenditures could be substantially reduced. On the other hand, if world tension should not be relieved and the United States should feel that it has to strengthen its armament and defense preparations, expenditures for national defense would be substantially increased. For this reason table 1 shows two budget projections for the fiscal year 1960, one (case I) with national security expenditures rising to $50 billion and one (case III) with a reduction in defense spending to $29 billion. Both figures are obviously rather arbitrary, but are intended to illustrate two alternative trends in national security programs. Case II, while probably representing the least likely condition prevailing over the longer run, assumes maintenance of national security expenditures at approximately present levels and serves to demonstrate how the budget outlook might appear in 1960 if no change in defense spending takes place.

Without any major increase in defense spending a gross national product of $450 billion could be expected by 1960. However, should national security expenditures rise significantly, a gross national product of $460 billion might be reached through greater employment of the civilian labor force (i. e., a reduction even in frictional unemployment and a smaller decrease than might otherwise be expected in the average workweek).

TABLE 1.—*The budget outlook*

[Billions of dollars]

	1955 (actual)	1956 (estimated) (revised) August 1955	1957 (estimated)	1960 (estimated)		
				I	II	III
CONVENTIONAL BUDGET						
Net expenditures	64.5	63.8	66.0	78.0	70.0	60.0
National security	40.4	38.7	40.0	50.0	40.0	29.0
Defense Department	35.5	34.0	35.0	44.0	35.0	25.0
Other	4.9	4.7	5.0	6.0	5.0	4.0
Nondefense programs	24.1	25.1	26.0	28.0	30.0	31.0
Budget receipts	60.3	62.1	65.5	73.0	71.0	71.0
Surplus (+) or deficit (−)	−4.2	−1.7	−.5	−5.0	+1.0	+11.0
CONSOLIDATED CASH BUDGET						
Payments	70.8	70.6	72.0	86.0	78.5	68.5
Receipts	67.8	70.9	74.0	83.0	81.0	81.0
Excess of receipts (+) or payments (−)	−3.0	+.3	+2.0	−3.0	+2.5	+12.5
	Calendar years					
Gross national product	[1] 380.0	393.0	406.0	460.0	450.0	450.0

[1] 1st half.

EXPLANATORY NOTES.—Budget estimates for 1957 and 1960 assume continuation of current tax rates and conditions of full employment. However, the hypothetical computations in case III do not imply that the attainment of full employment goals and the projected level of GNP is compatible with such large budget surpluses. The feasibility of reaching full employment under this condition involves consideration of other economic factors.

1957 assumes continuation of the current defense buildup. Also assumes that some additional nondefense programs will be adopted and started.

1960 Case I assumes that a resumption of a major military buildup program will be necessary. Case II assumes a maintenance level for current military programs. Case III considers the possibility that a major reduction in world armaments will become feasible.

I cannot stress too strongly that the economist can contribute little to the speculation as to which of these three possibilities is most likely to materialize. Nevertheless, there is one observation which I feel I can and should make. If foreign policy and military-preparedness considerations suggest the need for an increase in national-security programs, it should not be argued on financial or economic grounds that we cannot afford such increases. Only very substantial increases in national-security programs, beyond those contemplated in recent discussions, would bring us to the point where we have to consider, as a limiting factor, the possibility that national-security programs would absorb such a sizable portion of our resources that the economy might be weakened in the long run. In 1953 the National Planning Association's study, Can We Afford Additional Programs for National Security? concluded that by 1956 the productive capacity of the country could support a national-security expenditures program of somewhere between $62 and $75 billion without necessitating the imposition of wartime controls. It assumed continuation of the 1953 level of taxes (which would mean canceling the recent tax reductions) but would still permit a continuing increase in private investment and a moderate increase in the standard of living.

The estimates presented in table 1 assume that perhaps a year from now we will be in a better position to decide what our longer range defense program should be and to determine the direction in which

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it will be going. The main point which I want to emphasize at this time, however, is that, barring any sudden break in world affairs, it does not appear likely that national-security programs will undergo any major increase or reduction during the next fiscal year. As for our overall longer range program, we must be prepared to cope with whatever new developments can be expected to take shape.

B. Other nondefense programs

During the last 15 years, because of war and cold-war requirements, programs for social and economic welfare objectives have been kept to a minimum. Since it was necessary that we devote a large portion of our resources, both human and material, to military strength and preparedness, our nondefense programs were delayed. However, the ever growing and pressing need for such programs has not abated. Deficiencies in some of these fields have become so glaring that an increase in expenditures for these purposes is a necessity. The net national product (that is total production minus allowances for depreciation) has increased by $175 billion (expressed in 1954 prices) above the level of the year 1939. (See table 2.) Deducting from this increase the amount absorbed by the rise in national-security expenditures, there remains an amount of $137 billion, which was available to the private sectors in the economy and for the nondefense purposes of government (Federal, State, and local). Comparing 1955 with 1939, the private sectors increased their consumption and investment expenditures by 90 percent while the nondefense public-activity expenditures of government increased only 25 percent.

TABLE 2.—*Absorption of net national product, 1955 over 1939*

[In billions of 1954 dollars]

	1939	1955,[1] 1st half	Difference, 1955-39
Gross national product	189	380	
Less: Capital consumption allowances	16	32	
Net national product	173	348	175
Less: National security expenditures	3	41	38
Net national product available for nonsecurity purposes	170	307	137
Private consumption and investment	143	273	130
Nonsecurity programs of government (Federal, State, and local)	27	34	7

[1] Assumes 1955 prices to be at 1954 levels.

Source: 1939 Economic Report of the President, 1955, pp. 138-139; 1955 Economic Indicators, September 1955.

Since I realize that no entirely objective conclusions are possible in this field, I ask permission to offer a purely subjective opinion. It is that these figures reflect a maladjustment and misallocation in our national resources. Certain very important public functions, such as provision for education, health, transportation, and development of natural resources, have been starved while our tremendously rising productivity has permitted us to increase national-security expenditures and to meet rising individual demands for essential needs as well as for certain less than essential purposes.

In order to sustain economic growth over the years, we must provide not only for business and consumer expansion but also for an increase

in certain publicly supported activities of the economy. As population, income, and productivity increase and the standard of living rises, there is a greater need for more and better schools, for improvements in our transportation system, for additional housing, medical facilities, and for development of our natural resources. These areas which constitute part of the nondefense activities of the Government are vitally important to our continued well-being and to our economic development. They provide the Nation with goods and services without which economic progress could not be maintained.

During the last session of Congress, hearings were held on various proposals designed to provide the Nation with better schools, roads, social-security benefits, and housing. The prevailing sentiment throughout these hearings appeared to be that substantial improvements in these fields were long overdue. I do not want to discuss here the question as to what portion of these urgently needed programs should be financed by the Federal Government and what part by the States and municipalities. I do, however, want to emphasize that some portion of the increase in expenditures for these programs will have to come from the Federal Government if all these programs are to be fully realized.

In my judgment the need for increasing these programs is so pressing that priority should be given to correcting these shortcomings over the desire to reduce taxes. Let me make it clear that we all would like to see taxes reduced. But from the point of view of economic priorities, I believe that the deficiencies in these areas are directly harmful to economic growth, whereas the present level of taxes does not appear to have interfered with incentives for business expansion in recent years.

In the hypothetical budget projections of table 1, I have assumed an increase in other nonsecurity expenditures of about $1 billion for fiscal year 1957. Conceivably, some of the additional programs could be so arranged that they are not reflected in the budget totals. In either case, however, for purposes of fiscal policy the need for added revenues is unaffected. In this sense it is immaterial whether these new programs are financed through the budget or are kept outside the budget purview. In the longer range outlook, should national-security expenditures be stepped up, we would probably proceed relatively slowly with making up for the current and growing deficiencies in the nondefense programs. In our guesses for 1960 we included an increase of $3 billion for nondefense programs over and above the 1955 level even in the case of rising national-security expenditures. An increase of $6 billion for these nondefense projects might occur if some progress is made toward general disarmament and an increase of $5 billion if defense expenditures remain at present levels. (See table 1.)

On the State and local level deficiencies in the nondefense needs of the community are more directly felt. Within the past few years State and local governments have substantially increased their expenditures for highway improvements, school construction, medical facilities, and so forth. However, the backlog of these needs remains large and grows even larger with the growth in population and in the standard of living. We cannot expect that the State and local governments will postpone undertaking the urgently needed projects in these

fields. Therefore, by 1960 an assumed increase in total State and local government budget expenditures of more than $10 billion above 1955 levels does not appear unreasonable.

C. Budget receipts and the budget balance

Budget receipts are expected to increase from fiscal year 1955 to fiscal year 1956 by about $2 billion. This rise in tax revenues is entirely due to a general rise in income levels, profits and economic transactions. In table 1 tax rates are assumed to remain at current levels. If the present business expansion should continue, a somewhat greater increase in revenues can be expected for fiscal 1957. Having already assumed for the next fiscal year only a small increase in budget expenditures over current levels, it appears that the budget, in its conventional definition, would be approximately in balance, and that a $2 billion surplus in the consolidated cash account could be expected. This could be true, however, only if no tax reduction becomes effective during this or the next fiscal year. The prospect of a balanced budget also rests on the two assumptions already stated—(a) that any increase in national-security programs which might be thought desirable is not effectuated during the next year, and (b) that the urgently needed additional nondefense programs do not require substantial expenditures in the fiscal year 1957. Finally, this balanced budget hypothesis rests on the premise that the current business expansion will continue during the ensuing year.

Using the consolidated cash budget as our measure of fiscal balance, we would achieve by 1960 a moderate deficit for the Federal Government in the case of an increase in defense spending, a moderate surplus if expenditures are at a maintenance level, and a very large surplus in the case of a major cut in national-security expenditures, again assuming continuation of present tax rates and a high level of employment.

Tax yields on the State and local level should continue to increase as a result of growth and expansion in the economy. However, tax revenues are not expected to rise sufficiently to meet the added expenditures so that on balance, State and local governments by 1960 will resort to some increased borrowing.

To sum up the budget outlook for government as a whole (Federal, State and local including public authorities), it appears that from the strictly budgetary point of view we can expect over the long run to have some leeway for tax reduction unless there are substantial increases in national-defense expenditures. However, a discussion of tax policy must go beyond the budget outlook and must also consider the requirements for economic growth.

II. BUDGET POLICY AND ECONOMIC GROWTH

A. Budget requirements for an expanding economy

In discussing the budget requirements for a growing economy it should be emphasized that the role of the Government in economic growth is important but in our economic system is not predominant. Without the forces of private initiative our economic system will not grow irrespective of what the Government does or does not do. However, it is equally true that a budget policy which does not meet the requirements of a growing economy may stymie economic expansion. It should also be emphasized that the budget reflects only

a part of Government activities and policies. A rise in Government expenditures or a reduction in taxes both of which are reflected in the budget generate additional income. However, increased income can also be generated through credit policies of the Government, by Government guaranties, changes in regulatory provisions and in many other ways which are not fully reflected in the budget. Our longer run estimates, therefore, assume that no drastic changes take place in the way the Government conducts its business and affects the economy.

In the longer run outlook we can expect an increase in the labor force and in productivity per hour of work. From 1950 to the first half of 1955 the labor force increased by 2.9 million or 4.5 percent, output per man-hour by 17 percent. By 1960 we can expect a further rise in the labor force of about 5 million and productivity may have gone up another 15 percent, which is probably a conservative estimate assuming only a very gradual spread of automation. Allowing for some reduction in the length of the workweek, total production of goods and services may reach $450 billion in 1960, an increase of $70 billion over the $380 billion of the first half of 1955. Where will the demand come from to buy that product?

Over the long run the economy grows when, in addition to the demand generated by incomes derived from current production, some demand is activated through an additional expansion of funds (private and public) becoming available. This increased demand strengthens incentives for rising production and creates the market which absorbs the output of the increased productive capacity of a growing economy. Rising production in turn generates rising incomes, additional consumer demand and rising business demand for producers plant, equipment and inventories. This is an admittedly simplified model of economic growth. It may, however, serve to demonstrate the point I am trying to make. I believe that if present tax rates are maintained over a number of years, the Government would absorb such a portion of any such additions to income and profit that active demand might not grow in accord with the rapidly growing full employment potential.

This judgment would be particularly applicable under the assumption that in the longer run no substantial increase in total national security expenditures above present levels is likely to take place (case II and III of table 1). Present estimates indicate that the yield in Federal, State, and local revenues increases by about $3 billion with each $10 billion increase in gross national product. If, as we assume, gross national product will increase by $70 billion between 1955 and 1960, the total Federal, State, and local tax take should go up by $21 billion even if no increase in tax rates should take place. Let us assume for argument's sake that over the long run total Government expenditures remain the same and also that in the private economy additions to saving happen to balance the amounts businessmen wish to invest under full employment conditions. If now the Government intake increases year after year by about $3 billion if the resulting surplus is used to retire, let us say, bank held loans, then there is the likelihood that over the long run active demand will fall behind the potential full employment supply of goods and services, unemployment will develop, and even the prospective budget surplus will be transformed into a budget deficit. Of course, if the surplus occurs

at a time when private demand for credit is high or when private saving is declining, it may help to counteract an otherwise inflationary trend as happened during part of the post-World War II period.

In the National Planning Association's study the American Economy in 1960, we assumed that tax rates which would yield revenues equal to all the expenditures of Federal, State, and local governments might not permit that increase in private demand which would be needed to induce and absorb potential full employment output in the year 1960. Consequently, the study concluded that Federal, State, and local outlays would have to exceed tax receipts by about $5 billion in order to create that dynamic economic balance between rising demand and rising productivity which would sustain economic growth. Considering recent trends in saving (individual saving and growth in pension funds) and in investment financing (reliance on retained earnings), there appears to be no reason why we should revise this conclusion which was formulated several years ago. This can, however, at best be regarded as a tentative conclusion until more is known about consumer saving and expenditure behavior, about prospective business investment policies, about likely trends in productivity, etc.

In order to reach conclusions for Federal budget policy, we still have to make assumptions with respect to State and local budget policy, including the financing activities of public authorities under State and local jurisdiction. If we assume that all outlays of State and local governments and authorities will exceed State and local revenues by $2 billion in 1960, it would follow that an excess of outlays over receipts of about $3 billion would be called for by the Federal Government. This latter figure would suggest that in 1960 a reduction in Federal taxes of about $5 or $6 billion would be indicated assuming a maintenance level for defense spending (case II), a much larger tax reduction in the case of a substantial reduction in national-security expenditures (case III), and virtually no tax reduction if national-security expenditures should be substantially increased (case I).

Whether we call such an excess of outlays a deficit or not depends largely on what definition of the budget we use. It is likely that a $5 billion excess of outlays over revenues for the Federal, State, and local governments combined (including public authorities) would be compatible with a balance in operating expenditure budgets as distinct from capital budgets. However, I should like to emphasize that the amount of Government capital outlays in itself does not measure the amount of Government borrowing which is justified and desirable in the interest of economic growth. Our estimates indicate only the kind of budget policy which promotes balanced economic growth. Such an approach to budget policy formulation on the one hand helps to bring total demand in line with the rising productive capacity of the economy and on the other hand considers whether the size of the debt of Federal, State, and local governments is compatible with the maintenance of sound public credit.

These two criteria for budget policy—balanced growth and sound credit—are implied in the requirements of the Employment Act. The Employment Act provides that the Government utilize all its resources for promoting maximum growth and stabilization. This would include utilizing fiscal policies along with monetary and credit policies. The Employment Act further provides that Government policies be

conducted with due regard for "obligations and other considerations of national policy." The maintenance of sound public credit is one of the "obligations" which, I believe, was implied by this provision. The general magnitude of the public borrowing which would be involved in these hypothetical estimates would result in a reduction in the proportion of the debt service to national income in a growing economy. This is compatible with a policy of reducing the debt burden.

I should like to add one further comment regarding budget requirements for economic growth. Just as we need a long-range military preparedness program for defense, so should we provide a long-range economic preparedness program which could be used when needed to maintain continued growth and stability. Possible tax reduction measures and stepped-up public projects would constitute our arsenal of economic defense which could be adopted to meet any attack on our economic growth.

B. Tax reduction and economic growth

Some people have suggested that because a balance in the conventional budget and a moderate surplus in the cash budget is in sight, tax reduction is justified. This, in my judgment, is not a convincing argument. On the contrary, the expected improvement in the budgetary position, as I have attempted to show, is exclusively the result of an expected rise in revenues, assuming a continuation of the current economic expansion. If, however, the business expansion should begin to slacken, it is not likely that the rise in revenue would materialize. The expected balance in the budget would disappear and we would end up with a budget deficit. If we were to follow the balanced budget argument, taxes would not be reduced in the face of a budget deficit. Consequently, to relate tax reduction to prospects for a balanced budget would mean that taxes should be reduced only if the current expansion continues and the increased revenues actually do materialize, but should not be reduced if an economic slack should develop resulting in a budget deficit. This concept which ties tax policy to a balanced budget runs counter to what we have learned and experienced in recent decades about a sound fiscal policy.

On the other hand, I can conceive of an argument for immediate tax reduction if an economist is convinced that the present expansion is bound to taper off in the near future. Considering the time needed for tax decision, some may reason that we run a lesser risk by going ahead with tax reduction now than by waiting until the economic slack has begun to develop.

Personally, I would approach the question somewhat differently. I would say, "Let us consider a program for tax reduction as the best way by which tax policy can be used most effectively to support a growing economy." I can imagine the possibility that the current economic expansion will begin to slow down in the near future and that tax reductions would then become desirable. Until such a development becomes apparent, however, I would recommend for the time being a tax program which achieves improvements in the tax structure without reducing the yield. I recognize that a tax program by which some taxes are reduced and others raised is not "neutral" in its economic effects. Nevertheless, we are probably not making a serious error by neglecting the net effect of such shifts on total demand

and purchasing power. For the longer run, however, our conclusion remains that substantial tax reduction will become feasible and desirable.

This appraisal of the longer run outlook is based on an evaluation of economic trends as they now appear. I recognize the hazards involved in offering tax recommendations based on an economic appraisal. Unexpected changes in saving or spending habits of individuals (including pension funds), unexpected technological changes, and international complications could affect the estimates materially. Nevertheless, the considerations which I have outlined suggest the conclusion that barring a serious deterioration in international relations a substantial cut in taxes should become possible over the next few years and in all likelihood will become necessary in order to support the rising level of purchasing power required for sustained economic growth. However, with respect to the immediate future, it is necessary to consider first what possible increases in defense and nondefense programs may have higher priority than tax reduction and, second, whether a tax-reduction program should be scheduled so that it becomes effective when needed to support economic growth.

III. PROCEDURES FOR BUDGET POLICY EXAMINATION

Up to this point I have attempted to establish two basic propositions:

1. That consideration should be given to preparing a program of tax reduction which can be executed over a period of years; and
2. That it may be wise to delay immediate tax-reduction measures until a time when such action would be most effective in support of economic growth.

I have based these recommendations on an appraisal of probable trends in certain Government expenditure programs and on our estimates of short run and longer run economic developments. I freely admit that I could not quarrel with anyone who questions the exactness of these appraisals. I am much more concerned about the usefulness of the approach which I have employed than about the specific numerical results.

Before any tax-reduction program is enacted—whether the decision is that it should be executed immediately or over a period of years—we should consider two basic problems: first, the relative necessity and desirability of maintaining or increasing certain Government expenditure programs versus tax reduction and, second, the impact which financial policies in general will have on the Government's responsibility for promoting conditions conducive to economic growth and stability. A serious question has been raised as to whether our present Government machinery is set up in a manner that permits the Legislators to take action on specific financial programs in the light of the budget picture as a whole and of economic requirements. The Congress and the Executive certainly have made great advances in recent decades both toward better budget review and toward better economic review. Legislators are now able to obtain information for their guidance which was not previously available. Nevertheless, I believe that further improvements are still possible and are needed in order

to realize the goal which is implied in the topic of these hearings, namely, formulating a "budget policy for economic growth." To attain this objective, in my opinion, requires arranging the budget process whereby the Congress can (1) view the budget in an economic perspective extending beyond a 1- or 2-year period, and (2) take prompt action when a change in economic conditions makes a change in Government programs or financing desirable. A number of improvements in the executive and legislative budget process have been proposed recently. Within this past year both the National Planning Association and the Committee for Economic Development issued reports concerning the Federal budget process. The National Planning Association has recommended [2] that—

1. The President's budget should be viewed in the prespective of several years. Besides the detailed appropriation request and estimated expenditures for the ensuing year or two, there should be presented a budget outlook covering several years. The budget outlook should present expenditure estimates by major functions (*a*) under present legislation and (*b*) under legislation which is proposed. Similarly revenue prospects, debt redemption, and possible borrowing should be estimated assuming (*a*) continuation of existing legislation and (*b*) proposed changes in revenue legislation.

2. The President's Economic Report should present a parallel economic outlook covering the same period of years. The economic outlook would include projections of economic developments assuming maintenance of maximum employment, production, and purchasing power and would indicate what changes in Government programs or methods of financing would be needed for promoting a desirable rate of economic expansion.

3. The Joint Committee on the Economic Report should be reconstituted as a Joint Committee on Economic and Fiscal Policy. This committee would then report to Congress both on economic and fiscal policies.

4. In appraising Government programs attention should be paid to those Government activities (credit and monetary policy, guaranties, and insurance of home finance, etc.) which are not fully reflected in the estimated budget expenditures no less than those which are included in the budget.

5. If on the basis of the longer range analysis it appears that tax increases or tax reduction, or other fiscal measures, may be needed, Congress should initiate hearings and begin to consider these longer range measures on an "as if" basis (exactly as this committee has done in undertaking hearings on tax policy without committing itself as to the time or the kind of tax action which may become necessary). Such hearings would have prepared the ground for legislation so thoroughly that, in case of a change in the economic outlook, prompt legislative action would be feasible.

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[2] The Need for Further Budget Reform, a joint statement of the National Planning Association, and the Federal Budget and the National Economy, a staff report by Gerhard Colm, with the assistance of Marilyn Young, Planning Pamphlets No. 90 (Washington, D. C., National Planning Association, March 1955).

ECONOMIC GROWTH AS A POLICY OBJECTIVE

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Economic growth has become the fetish of the postwar era. It provided the key to the defense program of this country and to the European recovery program. The underdeveloped countries of the world have, almost without exception, set economic growth as their goal; and in many cases the alternative to growth is excessive population and mass starvation. The ability of the respective systems to promote and achieve growth figures prominently in the ideological contest between capitalism and communism.

All this is in marked contrast to the preoccupation of the thirties—when full employment of labor and existing industrial capacity seemed such a distant goal that to think of increasing productive capacity appeared futile and unrealistic. At the present time there is no serious unemployment problem in any major country of the world. Nor is there any problem of serious inflation. The abundance of goods achieved through expansion has produced a remarkable degree of price stability throughout the world. In short, the dangers of short-run instability that inspired the Employment Act of 1946 have not so far materialized—partly, perhaps, because of the assurances of corrective action symbolized by the act itself. I do not venture to predict the preoccupations of the future, but the present interest in economic growth is readily understandable.

This reorientation of economic thinking from the pessimism induced by the great depression has been salutary and necessary. Now, however, there is a danger that the new enthusiasm be carried too far and accepted in too uncritical a manner. There is a popular tendency to approve all policies that contribute to growth; to deplore those that do not, whether or not they contribute to other policy objectives; and to regard all kinds of growth as contributory to the defense of the country. The gross national product and its rate of increase tends to become a shibboleth, whereas it is really a crude aggregation of statistics that cannot be understood without careful examination of its composition.

Since we have returned to the problems of the classical economists, I shall quote the views of Adam Smith and John Stuart Mill on the merits and demerits of a progressive economy. Adam Smith, writing at the dawn of the industrial revolution and in protest against the economic restriction of his time, had this to say in favor of the progressive economy:

> It deserves to be remarked, perhaps, that it is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the laboring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state. The progressive state is in reality the cheerful and the hearty state to all the different orders of the society. The stationary is dull; the declining melancholy.

Mill, writing some 50 years later and with some experience of the industrial revolution, pleaded for a stationary state in these terms:

> I cannot, therefore, regard the stationary state of capital and wealth with the unaffected aversion so generally manifested toward it by political economists of the old school. I am inclined to believe that it would be, on the whole, a very considerable improvement on our present condition. I confess I am not charmed with the ideal of life held out by those who think that the

normal state of human beings is that of struggling to get on; that the trampling, crushing, elbowing, and treading on each other's heels, which form the existing type of social life, are the most desirable lot of human kind, or anything but the disagreeable symptoms of one of the phases of industrial progress.

The American ideology is undoubtedly closer to Smith than to Mill. And if we had not hustled and pushed for over a century, we would not have won the freedom permitted by our opulence today. But now we can afford to take a more conservative attitude and to temper progress with urbanity. It seems to me that we should.

Economic development has been described by Schumpeter as a process of creative destruction. The creation of new products, new buildings, new techniques, and new skills is accompanied by destruction of the old. Progress has a price that is by no means fully revealed in the statistics. The national product figures take full account of the creation but only inadequate account of the destruction. Maximum economic growth means maximum creation and maximum destruction. The statistical rate of growth would increase if homes, apartment buildings, and hotels were torn down and rebuilt with increasing frequency. Changes in the tax laws with respect to depreciation could accelerate this process. But do we want, in the name of progress, to move toward a situation where houses are traded in like cars? And do we want cities to be in a perpetual state of being torn down and rebuilt? In the interests of social stability we might some day want buildings to last longer rather than shorter, and to that end slow down the rate of economic growth.

What is to be national policy with respect to industrial uses of atomic energy? Those uses could be accelerated or retarded by public policy, including tax policy. Will the Nation be best served by revolutionary change or by the more conservative processes of evolution? The answers to such questions must be given through the formation and expression of political opinion—or they may be given through inadvertence. But it is safe to say that on the one hand the country will not deny itself the industrial use of atomic energy and on the other, that the maximum feasible rate of adoption is unlikely to be the most beneficial.

More generally, do we want to move toward automation and the 3- or 4-day week as rapidly as possible? Or can social values be better conserved by a slower rate of progress? India, in contrast to China, is attempting to achieve a compromise between economic development and the preservation of its traditional values. Surely, a country as opulent as the United States can afford to abate the revolutionary effects of technological advance.

Arguments for economic growth have been most frequently advanced in connection with national defense. These arguments relate both to the capacity of the country for all-out mobilization and to its capacity or willingness to sustain the defense program required by the cold war.

World War II showed that an economy engaged largely in the production and consumption of durable goods had great mobilization advantages. It possessed productive facilities that could be readily converted to war production. And these facilities could be easily released for war production. Some consumers possessed "inventories" of automobiles and household appliances that could tide them over the war period. The World War II concept of a mobilization base—

both of specialized facilities and general industrial facilities still enters prominently into economic policy discussion and is used to support economic expansion in every form.

That argument, however, may have lost much of its validity under atomic conditions. Forces in being at the outbreak of war are likely to be the decisive factor at the outset. Initial large-scale distinction of facilities is to be expected and the economic effort, in that event, would be directed toward restoration of production of all kinds rather than to conversion. Even with our imperfect knowledge of what future wars will be like, it seems reasonably clear that emphasis needs to be placed more on dispersal of essential activities, and the construction of a highly specialized mobilization base. General economic expansion with its concentration of production in large centers cannot be relied on to produce the kind of economy needed to meet the mobilization needs of the future.

With respect to the cold war, it is difficult to see how a military program of the size needed will be maintained unless at the same time increasing productivity makes possible continually rising living standards. A defense program that contemplates curtailment or erosion of living standards can be sustained only in a crisis atmosphere. Even with the extraordinary prosperity and rising living standards of the last few years, pressure for tax reduction grows not when the crisis has passed, but when people get used to it. If income after taxes were not rising for the bulk of the population, these pressures would be far stronger than they already are. A rate of growth adequate to keep such pressures within bounds is therefore essential.

Policy objectives, other than defense, depend on economic growth for their attainment. The future is likely to see increasing public demands for protection against illness and unemployment, for improved education, and for provision for the aged part of an aging population. Without economic growth such demands are unlikely to be met and attempts to enforce them are likely to create bitter divisions of political opinion. But if economic growth continues, those demands can easily be met from increasing productivity. In practical terms, if recent growth trends continue, the yield of the present tax system would provide for most of the welfare programs that have been proposed and for tax reduction as well.

The policy objective that depends essentially on economic growth is stability of the price level. With the existing organization of the labor market, increasing money wages, year after year, are to be expected. Wage earners in their present occupations demand and are able to get increases. And to attract labor to new industries and occupations, wages above prevailing rates are needed. Money-wage stability on the average is only likely with a degree of unemployment that is generally considered intolerable. Without continuing increases in productivity, money-wage increases are therefore likely to lead to corresponding increases in the price level. With an adequate rate of growth wage increases and price stability can be compatible.

While continued economic growth is indispensable for meeting some of our essential national policy objectives, I have attempted to show that we should think in terms of an "adequate," "satisfactory," or "optimum" rate of growth rather than a "maximum" rate. Some types of growth that are most needed from the point of view of na-

tional security may have little impact on the gross national product statistics. Others may influence the statistics markedly without contributing markedly to national security or any other important policy objective. While the stationary state falls far short of a complete social prescription, its values should be allowed to modify the onrush of a progressive economy.

THE INFLUENCE OF BUDGETARY POLICY ON ECONOMIC GROWTH

To specify all the conditions of economic growth—involving as they do climate, natural resource endowment, religion, social structure, political organizations—goes far beyond the scope of this paper, to say nothing of the competence of the author. Those, however, that seem particularly relevant to budgetary policy are: the flow of technical knowledge; the supply of entrepreneurial ability; the skill of the labor force; the supply of savings and the prospects of profitable investment. My present task is to discuss how they are influenced in favorable or adverse directions by Government expenditure and tax policies.

Expenditures

With respect to expenditures, the first question to consider is whether the total size of the budget, apart from the way it is financed, influences the rate of growth. Does the fact that the Government, rather than private customers, purchases a substantial part of the national output of goods and services make any difference? The answer probably depends more on the composition of the Government's demand on whether the Government's activities tend to concentrate production in those areas where opportunities for technological advances are greatest. The history of the aircraft and electronics industries in recent years indicate that Government procurement has at least been no impediment to some of the most rapid technological advances that have ever been made. Despite the vicissitudes of the budgetary process, the Government can evidently provide a highly satisfactory market for private producers. From the point of view of economic growth, there seems to be no reason for cutting down Goxernment demand for modern weapons and substituting private demand for goods and services in general.

On the other hand, part of the Government's function is to abate the rigors of economic growth; to relieve casualties; and to broaden participation in its benefits. Programs to support uneconomic regions, to increase individual security at the expense of labor mobility, to preserve the beauty of the landscape, to cleanse the rivers, to conserve cultural values, and to provide for the aged and the sick, may either directly or through their effects on taxation, slow down the rate of economic growth. But that is no conclusive argument against them. One of the benefits of economic growth is that we can afford some economic inefficiency. But, as noted above, the feasibility of such measures depends essentially on continued growth. If carried too far, welfare programs can be self-defeating. However, I can see little likelihood that the interplay of political forces in the United States will permit welfare measure to be carried too far from this point of view.

Government expenditures on research and education are likely to be needed to realize an adequate rate of economic growth while high

business profits provide abundant funds for applied research. But that very fact draws superior talent away from fundamental research on which technological advance depends in the long run. The need for Government encouragement of pure research was recognized in the establishment of the National Science Foundation, but the meager appropriations the Foundation has received indicate that the research needs of the Nation have not fully entered its political consciousness.

With respect to education, there are strong indications that this country is not turning out enough graduates with the technical training needed to meet the requirements of a technological age. And the roots of the trouble go deep into the public-school system where science and mathematics have received inattention and discouragement for over a generation. The forces of demand and supply may rectify the situation in another generation. But defense needs alone may rule out this automatic remedy as far too slow. Government action may be needed.

A satisfactory rate of economic growth depends on the adequacy of the public-works programs of the Federal, State, and local governments. The present highway situation furnishes a dramatic example. Any automobile driver in an eastern State needs no argument to convince him that saturation of much of the highway system is approaching and that the continued expansion of the automobile industry depends on the construction of new highways. In other areas, such as the reclamation of land and the generation of power, Government investment is needed where the returns from the investment are too uncertain or too remote to attract private capital. How much Government investment is needed will depend on the rate of growth desired. Highway construction, for instance, can either lag behind or run ahead of automobile expansion. But it will afford a greater stimulus to economic growth in the latter case than in the former.

Taxation

With respect to taxation, the first question to consider is the perennial one of budget balance. From the point of view of stimulating economic growth should taxes exceed, equal, or fall short of expenditures. What this question should involve, but rarely does, is consideration of the relation of fiscal with monetary policy. Assume that the short-run objectives of the Employment Act are achieved and fiscal and monetary policy are consistent with the level of demand needed to provide full employment without inflation. Suppose, for the sake of argument, the level of expenditures is already determined and the Government is reviewing its monetary-taxation policy from the point of view of economic growth.

Taxes and interest rates, if changed at all, should be changed in opposite directions. An increase in taxation should be accompanied by reduction of interest rates and vice versa. Otherwise, short-run stability will not be preserved: Unemployment or inflation will result. If the Government decides to incur a deficit when the budget has previously been balanced, that should mean that it considers higher interest rates and lower taxes beneficial for economic growth. It should move in the direction of a surplus when it considers that lower interest rates and higher taxes are needed.

But before going further, the distinction should be made between those taxes, such as excise taxes and middle and low-bracket income

taxes, whose impact is mainly on consumption expenditures and those such as corporate taxes and top-bracket income taxes which tend to reduce the flow of investible funds. At the risk of some inaccuracy, I designate the former consumption and the latter business taxes. Of course, with present levels of expenditures, consumption taxes are inevitable, but the Government can place more or less emphasis on curtailing saving and investment according to the requirements of its policy objectives. It can emphasize investment by lowering interest rates and business taxes and raising consumption taxes. It can emphasize consumption by the reverse policy. Whether the budget is balanced or not should therefore depend on the relations the Government desires to establish among Government expenditures, private consumption and investment—and on its willingness to coordinate its monetary with its fiscal policies.

The Government, however, has by no means complete freedom in the relative degrees of emphasis it can place, through tax and monetary policy, on investment and consumption. After all, the purpose of investment is to increase the flow of goods to meet the demands of private consumers and the Government itself. The growth of the automobile and aircraft industries would not have occurred without consumer and Government demand. Furthermore, the major opportunities for investment occur in the mass-production industries, and mass production requires mass consumption and mass purchasing power.

Hence, efforts to stimulate economic growth by reducing business taxes and increasing consumption taxes may, if carried far enough, be self-defeating. The decline in consumer demand, induced by the change, may more than cancel out the added inducements to business given by taxation. Similarly, the reverse kind of policy—lowering consumption taxes and increasing business taxes—may fail to stimulate growth. The stimulus given by increased consumer demand may be offset by the contraction in the funds available for investment, arising from the increase in business taxation. In that event, the increased consumer demand would be reflected in higher costs and diminishing returns rather than in improved technology.

A steady rate of economic growth therefore requires that consumption and investment both increase in step with each other. Neither can outrun the other too far without causing trouble. From the point of view of tax policy even a maximum rate of economic growth does not mean concentration on consumption taxes. It means a balanced distribution of the tax load between business and consumption taxes.

In political terms, the situation is interestingly paradoxical. If business interests had their own way, it is likely that consumption taxes would be adverse to business expansion. On the other hand, if the welfare point of view prevailed, business taxes may be raised so high and consumption taxes reduced to an extent that the economic growth, on which welfare itself so basically depends, would be retarded. In our happily balanced society each side of the political argument tends to save the other from its excesses.

Surely the rate of growth of the American economy during the postwar decade has been no less than satisfactory. It has continued under conditions of demobilization, remobilization, mild recession and inflation and under Democratic and Republican administrations. The

common characteristic of the whole period, however, has been that the economy has been operating close to full employment and full production for a decade, and this performance has induced widespread confidence that it will continue.

This experience suggests that if Government policies successfully maintain high and stable levels of employment during the next decade, the question of economic growth in general need cause no great concern. With any array of political forces that is likely, middle-of-the-road measures that will do justice to both the investment and consumption aspects of growth can reasonably be expected.

My conclusion—an uneasy one for an economist—is that there is nothing radically wrong with our present budgetary policy from the point of view of economic growth. Expenditures are not too high, and can be increased if the need arises. The tax system appears to offer no impediment to a satisfactory rate of growth. There is evidently no lack of expanding consumer demand and adequate funds for investment. There is no evidence that the progressiveness of the income tax is diminishing incentives. In fact, the tax system as a whole may be attracting superior talent to business—which offers the prospect of capital gains in addition to highly taxed income.

At a less general level, improvements are always possible. I have mentioned the need for expenditures on research and training. On the tax side, loopholes may now provide incentives for more expansion in particular areas than is needed, while special incentives may be required to combine expansion with adequate dispersal of industry. A great deal of talent remains unproductively employed in wrestling with the complexities of the tax system.

I do not want complacency to divert attention from long-range issues. If my optimism is justified, the result has been due at least as much to good luck as to good management. But luck may not always be so kind, and the efforts of the joint committee to encourage congressional interest in the subject of growth are very much to be welcomed. But no amount of thinking can produce a long-run blueprint. The task of the policymaker is rather to observe the trends of the past and the present rate of economic growth and to devise measures for accelerating or retarding it in accord with national objectives.

BUDGET POLICY FOR ECONOMIC GROWTH

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I. ECONOMIC GROWTH AND BUDGET POLICY

Economic growth I take to mean broadly the achievement in most years of a higher standard of living for the preponderant part of the population than in any preceding year. The ideal, of course, would be a new high in the standard of living every year for every person, but in an imperfect world we shall probably have to settle for a little less, at least for a little while longer. In technical terms we presumably mean by economic growth a realization in most years of more output per unit of input, or, to state it differently, higher productivity by the factors of production.

The achievement of economic growth requires more and more tools and skill for workers so that they can produce more, and become better markets for the production of others. There is no other way, barring windfalls, for output to rise in relation to labor and resources used or for markets to expand faster than population. If there are to be more tools and skill, there must be saving to provide them. The supply of tools and skill cannot grow if all production is currently consumed. And not only must saving be made, but it must go, through investment, to the purposes and the places best suited to contribute to the desired economic growth.

In this urbanized and specialized economy, a large proportion of savings are made in money. For them to be used most appropriately, properly functioning instruments for the direction of the savings to such uses must exist; these include the many types of saving and fiduciary institutions, and the capital markets. And an atmosphere most conducive to their efficient functioning will greatly increase the chances for the desired economic growth.

Budget policy and consequent operation have a tremendously large influence upon these factors involved in economic growth. There are other influences of great importance also and the focus here on budget policy should not be taken as any suggestion that it alone is dominant, nor that even the wisest budget policy alone can assure economic growth. The reason that budget policy and operation are so important is that they largely determine whether Government is preempting some of the savings so important to economic growth, or whether Government operations are generating saving and making them available for the economic growth processes. The tax and expenditure policies encompassed in budget policy exert a great influence upon the level of saving and the direction of its investment. Budget policy strongly influences the expansion and contraction of bank credit, and thus fluctuation in the money supply. And budget policy is an important factor in creating the atmosphere which so affects the possibilities for economic growth.

II. Alternative Budget Policies

That controversy exists about appropriate budget policy is not surprising in view of its importance. There are three main alternatives which have vocal advocates.

One recommended course is a budget policy that provides that Government have the use of a large part of the savings of the country in all circumstances. Such a course means that the Government would direct the major part of the country's savings to such uses as Government officials believed best. This view rests upon the belief that under such a course incomes would be better maintained than otherwise, so that optimum savings would be made, that the savings would be better used, and that therefore optimum economic growth would result. This view usually is associated with advocacy of large Government expenditure and high taxation, often with severe antisaving features in the tax structure.

At the opposite extreme is the advocacy that Government should have an exactly balanced budget under all circumstances, and so use none of the country's savings—though an exception is usually made for wartime conditions. This view rests upon the belief that the

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private sector of the economy will maximize incomes, cause optimal savings, and use savings to the greatest advantage. This view usually is associated with advocacy of small Government expenditures and consequent low taxation.

The final alternative is for the Government and the private sector of the economy to operate in a collaborative manner to assure that income and savings are maximized and that the best use of savings is made under all conditions. Under this view a lower rather than a higher budget is aimed at, and conditions conducive to best functioning of the private economy are established. When the private sector is advantageously using savings and maximizing income under these conditions, the budget would so operate as to add to the volume of savings being done privately: i. e., it would be balanced and provide for a modest amount of debt repayment. When the economy is not operating to employ resources at a high level despite a favorable environment, Government would make use of some savings through a budget deficit.

This third alternative seems to me the wisest and most desirable; the two extreme views are unpromising. On the one hand, I have no faith that any set of Government officials of any administration or party have sufficient skill and wisdom to put the major part of the country's savings to the most efficient use or to bring about conditions in which the optimum amount of saving is done. This lack of faith is based upon no unfriendliness nor lack of acquaintance, for I have worked in and around a number of Government agencies over the past quarter of a century and know them customarily to be manned by hardworking, conscientious and able people. It arises rather from a conviction that this country and its farflung interest is much too complex an organization to be comprehended in any detail or operated with any real success even if every public office were at all times occupied by the very best fitted man in the world for the post.

On the other hand, I observe that on the record the private economy has not at all times brought about high employment or optimum saving, nor used the savings that occurred to the maximum efficiency. Whether this has resulted from inept governmental influence or deficiencies of the private sector is argued at length and sometimes with more heat than light. My own impression is that both sides could mend their ways considerably.

III. Meshing Public and Private Sectors

If the best budget policy is for the public and private sectors to be made to complement each other in helping to bring about maximum income, optimum volume of savings, and their most efficient use for economic growth, the question is how.

One way much discussed over the past two decades is for the Government budget policy to decide when and in what amount budgetary operation should utilize or add to the country's savings through incurring surpluses or deficits. This proposition has a certain amount of plausibility, which is enhanced when it is put into the persuasive form called the compensatory budget. Under this concept the budget provides for a sizable deficit to use saving and probably expand bank credit and the money supply when the country is having less than prosperous conditions, and conversely the budget is then more than

balanced so as to create savings and repay the previously incurred debt when prosperity again is achieved. Under this concept expenditures and taxes must be raised or lowered as economic forecasts are changed.

But, though plausible, this concept has proved unworkable. Its operation requires such continuous and accurate long-term forecasting of receipts and expenditures by the budget makers as to be beyond human performance. But more than that, its operation required action that neither the Congress nor the Executive is, on the record, willing to take. Deficits have been accepted during the past 20 years on the understanding that they will be offset by surpluses in good times. But good times have found little of surpluses except by accident. The current period has the greatest prosperity the country ever has known—and a deficit. Expenditures are more easily raised than lowered, so the system has become one leading to a rising expenditure trend. Congress and the administration have struggled to find revenues to meet high outlays and have been led to impose a disadvantageously high tax burden, containing some seriously antigrowth taxes. Evidently something more reliable than the compensating budget concept is needed.

The other way for budget policy to provide that the public and private sectors complement each other is to leave the decision to the private economy aided by the Federal Reserve System. Under this plan a low—rather a high—expenditure policy is adopted and the budget always would be prepared on the assumption that high prosperity will prevail during the time period which the budget is to cover. Tax rates would be set to provide revenues to cover estimated expenditures and provide a small surplus from personal and corporate incomes at high levels of prosperity. The private economy always desires prosperity and the Federal Reserve System always is working to aid in the achievement of that desire.

But if prosperity does not in fact prevail as the budget would contemplate, then receipts would fall below the level prosperity would provide and outlays (including trust funds) would rise as a result of the so-called built-in stabilizers—not due to changes in appropriations. A sizable deficit thus automatically occurs, and the necessary borrowing to cover it uses savings and expands credit. This system doesn't demand an omniscient crystal ball in the Budget Bureau nor in the Halls of Congress. I conclude that this is the only realistic concept available, and that it should be used.

IV. The Central Bank

I have placed great emphasis upon the Federal Reserve System and its role. The Federal Reserve System is well equipped to help the private economy toward prosperity. It can make its decisions upon facts of the moment. It can change direction very speedily as conditions change or even to correct its own errors if any be made. It can encourage or discourage savings, and it can encourage or discourage investment. It can determine the availability and cost of credit, and greatly influence and in most circumstances determine the money supply. It has long experience, and it is staffed with an extraordinarily skilled and competent organization of men. The Federal Reserve System is one of the most successful and commendable organizations the Congress has ever created.

The Reserve System has not in the past been given sufficient powers and freedom by Congress and the administration to operate most effectively. Its present position is much improved and its capabilities much enhanced. Congress and the administration would contribute to economic growth by being very responsive to any requests from the Federal Reserve for actions or legislation to enhance its effectiveness.

The best budget policy is that which encourages the Federal Reserve System to be the Government's primary instrument to aid the private economy to achieve and maintain prosperity, which creates conditions most conducive to the efforts of the economy assisted by the Federal Reserve, and then automatically and rapidly provides aid when aid demonstrably is needed. That is the policy here advocated.

V. But Wise Tax and Other Policies Also Are Essential

This statement is concentrated on budget policy for economic growth and it also deals with expenditure policy. But at the risk of belaboring the obvious, I want to emphasize that even the wisest budget policy cannot assure the realization of the objective. There are a number of other essentials if the most beneficent rate and type of economic growth is to be realized.

Next to the most important of all is the central matter with which your subcommittee is dealing: taxation. Most important is, of course, the combined matter of the maintenance of freedom and the avoidance of war. Next comes the manner in which the tax gatherer removes his necessarily large take from the economy. I should like to urgently recommend your attention to three aspects of taxation which seem to me to be of outstanding importance to economic growth.

1. Encouragement to American business operation and investment abroad, through special tax rates.

(*a*) *To help maintain peace.*—Foreign commercial operations can do more to sell the "American way" and to tie nations to us than can the necessarily limited staff of Government officials abroad.

(*b*) *To enlarge domestic economy.*—With a world market as big as the United States and potentially much bigger, foreign operations can vastly increase consumption of the goods we produce; and this is the psychologically and economically exact right time to expand our foreign business.

(*c*) *To assure sources for materials needed here.*—American development of natural resources abroad can mean that more materials will be available to us. And we need many now and will need more and more as time passes.

(*d*) *To produce increased tax income.*—Greatly increased United States earnings abroad, rising out of greater incentive to operate abroad, can, even with reduced tax rates, produce greater tax revenue. It's the old American system of making more money by taking a smaller markup. For example, if a cut in taxes by 15 percent gets earnings up 25 percent, both the tax collector and the investor will get more than now.

(*e*) *Reduce foreign-aid expenditures.*—Increasing private American investment abroad results in improving foreign economies and speeds the eventual elimination of United States Government direct aid.

Much study has been given this subject in the last several years and many proposals made, but so far not much has filtered into the taxing statute to activate them. These proposals are being reviewed in detail by another paper, and I will not list them here. However, I wish to particularly recommend the adoption of proposals which would tend to eliminate or minimize differences in the tax consequences of various legal forms of operating abroad and which would adopt the businessman's concept of the unitary nature of foreign operations.

2. Facilitation of most efficient corporate operation: This is important to economic growth because corporations are the chief economic instrumentalities of this society, and the welfare and efficient operation of the corporate population is essential to the welfare of the human population. The tax structure contains a number of impairments and obstacles to most efficient corporate operation, and these should be remedied. Among the impairments and obstacles to most efficient corporate operation, probably the most notable are the continued taxation of intercorporate dividends and the penalty on consolidated returns. The originally suggested need for the former (the prevention of evasion of a graduated tax on corporations) is, to the extent it may still exist, taken care of by other technical provisions in the law, but its onerous burden has increased through the years with the increased corporate rates. Both it and its companion, the consolidated return penalty, are almost universally recognized as being anomalies which should be eradicated.

3. Realization of the fundamental relation of saving and economic growth: This statement began and will now end with emphasis on the essentiality of savings to the process of economic growth. In view of this essentiality, the penalties on the saving process which have crept into the tax structure need urgently to be exorcised. Those who save (both persons and corporations) have already had to overcome the necessary obstacle of the payment of income tax, and they have had to undergo the penalty of foregoing the pleasure of current consumption of their income.

They benefit society by providing the wherewithal for economic growth, and, as they must overcome an obstacle and make a sacrifice in order to save, the imposition of taxes upon the resulting savings is a most unwise tax policy.

BUDGET POLICY AND ECONOMIC GROWTH

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The subject assigned is too broad for thorough treatment, and I have chosen to limit myself to its third subdivision, viz. criteria of budget policy for short-run economic stabilization and long-term economic growth and proposals for meeting both sets.[1]

As usual the problem begins with concepts. The common definition of economic growth runs in terms of rate of advance in gross national product and it is commonly held or implied that one of our major policy objectives should be to maintain this rate at a maximum—at any rate unless efforts to do so involve periodic recurrence of mass

[1] I am trusting others to find critical ratios of tax yield or rates of capital formation to income just beyond which lies disaster (for which they will find a wide range of choices in the literature), to expound balanced budget theorems, and to measure the effects of different mixes of taxation and spending at given levels of the latter.

unemployment. The intensity with which such a belief is held will influence attitudes toward tax levels and the division of tax burdens, the extent to which we can tolerate direct controls and State ownership that our creed generally regards as cramping, the wariness with which we should walk in trying to stabilize the system—and so on.

Obviously these other judgments must be made before we finally decide upon how much growth we want, and action to stimulate growth will sometimes be difficult to reconcile with them. Every tax has known and poorly known effects. In the usual case when the visible or superficial effects are arranged in a scale of values they turn into positive and negative purposes, and are thereupon transfigured with no improvement in our knowledge of ultimate effects. I have not observed any two economists agreeing precisely on either the mix of purposes that should be exalted or on the mix of taxes that would achieve it, and regard it as not unreasonable to assume that legislators, policymakers, and the public find themselves in like difficulty.

Among the effects and often among the purposes of taxes are equity, growth, stability, efficient allocation of economic resources, incentives to investment and effort, and tolerable allocation of revenue sources among Federal, State, and local taxing authorities in accordance with a logical division of duties that we don't have. Our grasp of the subject is so poor that in different countries people with generally comparable philosophies and morals move in many directions including the diametrically opposed. The final misery is that when honest technicians try to assess and allow for the secondary and tertiary effects of each kind of tax in putting together a package, by definition it can outrage others seeking the same ends but who don't know or disagree about secondary and tertiary effects.

The ground I choose is not to make expansion the decisive factor in shaping economic policies. For reasons given later I suspect that both equity and stabilization could be put a little ahead of it, paradoxically, without hurting it—that is, if anyone is willing to accept my ideas of what constitutes equity and stabilization. For example, if I were bound by a definition of stabilization that would exclude such amplitudes, lacking monetary cumulation, as those of 1949 and 1954 I would downgrade the goal as excessively damaging to other objectives.[2] This graduation in values supports rather than denies another necessary proposition; namely, that up to a point measures found desirable on other grounds may also promote growth. Much of the trouble arises at the margins, as from straining for perfection in one value at disproportionate cost to others. I am satisfied that sluggish progress is among the consequences of the kinds of disorder marking the British and French economies. But it seems to me that the major reasons for removing such disorder should override effects on the growth rate. Indeed, most of them would warrant elimination even if in process this rate fell off somewhat. The same thing holds for otherwise desirable changes at home that might have this effect.

The proper aim is to achieve what for lack of a better term I shall label "healthy growth." To me this means whatever degree of progress happened to attend operation of a well-arranged system in-

[2] The distinction is personalized merely as a part of the process of showing the exasperating dimensions of the problem, not to prove anything.

suring among other things, (1) only such Federal activity as is required to perform essential jobs that cannot be handled well by other agencies, and (2) equitable distribution of its tax cost. Granted that specifications have still to be written for these terms, whether or not the attendant annual rise in gross national product is 2.78 or 2.92 or 3.15 percent doesn't strike me as important.

For our purposes, the conception of budget policy is clear enough, involving action on both the tax and expenditure sides of the Federal cash budget. Its consideration, however, raises several problems. First, only selective treatment is possible in brief compass since virtually all elements on each side bear some relationship to growth and most have some connection with stabilization. Secondly, discussion of these items—or at least those in the field of taxation—poses a dilemma of sorts. Judgments with respect to appropriate tax structures are bound to be quite inconclusive in the absence of close estimates as to size and distribution of future income and the rate of Government outlays. On the other hand, projections of income and its incidence are time-consming and subject to wide error, while only arbitrary guesses can be made as to rates of Government spending more than a few years ahead. Here I have decided to sit on the first horn and suggest only general specifications for an ultimate goal.

So much for framework. The parts are closely interwoven. As indicated, the degree of stabilization achieved and the methods used to that end carry important implications for growth. In attempting to unravel the strands, it is best to consider first linkages between budget policy and long-term growth without reference to the bearing of stabilization on the outcome, and then to deal with the interrelationships.

Long-Run Growth

TAXATION

On the tax side, the major conditions of healthy growth seem to me to be nothing more or less than imposition of such a pattern of levies as will divert to the Government the revenue it needs to perform essential functions and do so with as little injustice (inequality in sacrifice) as possible. Equality of sacrifice involves progressivity.

This postulate seems weak in two ways. It principally shifts the focus of debate to one of definitions; and it refuses to stress the number and variety of criteria of tax policy (cited even at the outset of this statement), including the attainment of social or common good goals. No doubt some important ends could occasionally be best served through tax measures at the expense of equity—but not very often in America.[3] The messy system we now have is attributable in large part to imperfect awareness of the true effects of specific taxes, or of excesses and discord among the aims of a tax system, or of the availability of better ways to achieve many of the valid goals we are

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[3] Let me expand this a bit through comment on some of the "big games" so often played in this field—incentives versus equity, equity versus efficiency, or—to run ahead a bit—equity versus stability. In my judgment, most of these billings promote pseudo-contests. I concede that in limiting cases there may be serious conflict between equity and other desirable goals. To take the first instance listed above, I have no doubt that a policy which seeks to maximize incentives to invest would involve among other things a truly inequitable tax system. So too would one intended to induce as many people as possible to work for as long a time as possible. But extremes like these are hardly valid objectives of policy in this country. For us at least, I don't think that serious conflicts arise between maintenance of equity and legitimate preservation of incentives. I believe too that similar judgments are correct in the other cases listed above.

trying to attain through taxation. Largely in consequence, our tax structure is sadly inadequate not merely on its face but after account is taken of the gadgets hidden from "Everyman" that do so much to make the end result very different from what he thinks it is—at every point in the scale—high, low, and medium. Our basic law, to say nothing of its uneven enforcement, is now such a tangle that one can't tell whether on balance the interclass and intraclass inequities obviously present in the apparent pattern are heightened or diminished by the loopholes, but it is clear that very serious ones remain and that substantial revision is necessary to meet conditions of healthy growth. In our system of poorly related pretensions and tolerances, probably even sophisticates would be astonished to learn how much money and time is spent by taxpayers in doing unnatural things.

However, it is a long way from these considerations to specification of a particular tax structure. One reason is that, as already said, the character of the best system depends somewhat on the yield it must produce. And beyond that there is room for difference of opinion with respect to what is the best system. That is to say, for any given yield or diversion of resources there are likely to be several setups, each having about as good a claim to being best as the others, and choice among which, therefore, must be based on concomitant contributions to achievement of other desirable objectives. Since the first factor cannot be handled adequately without knowledge of the level of outlays required, and since in any case proper treatment of the second is impossible in the space available, I shall simply list the major changes in our existing setup that appear desirable (as properties of a basic system, not as a siphon for any given yield; see below) under most conceivable circumstances. They are:

1. Heavier reliance on the personal income and estate taxes, including, among other things, reduction of existing excises and integration of the corporate and personal income-tax levies. Conceptually integration would require limitation of the tax on corporate income to a low flat rate and retention of a substantial levy only on undistributed profits, from both of which some moderate part (say $25,000 to $50,000) would be exempt. The last proposal is not for revival of the misfit undistributed profits tax of 1936. The glaring weakness of the latter was not in its principle but in the failure to clean up the rest of the tax structure sufficiently to permit the principle to work. Failing adoption of associated proposals, plus current tolerances under section 102 for expected immediacy of reinvestment on the part of corporations lacking access to the money markets, I would oppose this one. Practically, despite the stimulus to dividend flow, need for revenue in the foreseeable future would not permit relinquishment of such an easy-to-tap source as aggregate corporation profits. A differential might be initiated, however, by dropping the rate on earnings distributed in the tax year by a few more notches than that on retained earnings under the conditions stated. Permitting closed corporations to file as partnerships under a rule forbidding reversion for X years would provide an approach to integration for most incorporated businesses.

2. Substantial changes in the personal income-tax setup, including:

(*a*) Withholding on dividends at the first-bracket income-tax rate;

(*b*) Introduction of a device for averaging personal incomes over the years for tax purposes; as a corollary, carryover of unused exemptions and deductions in justice to low-income and/or large families. It is recognized that in both cases administrative problems would be serious;

(*c*) Significant reduction in the high upper-bracket tax rates;

(*d*) In principle capital gains should be taxed more heavily than at present—perhaps not fully as income, lest the functioning of the exchange markets on a judgment basis, which is also a public need, be unduly constricted. This was not entirely an ethical question during the postwar years because adjustments to the depreciation of the dollar were so violent and diverse.[4] The immediate point, however, as in the case of retained earnings, is that it is academic to talk about taxing capital gains as income without liberal provision for averaging, over the years, full allowance for losses, less distorting progression in upper-bracket income rates, reduction of corporation tax rates, credits for the length of time property has been held, and some distinctions between trade and casual gains. With similar safeguards against inequity, arrangements should be made for constructive realization on capital gains at death;

(*e*) Narrowing of tax brackets, with corresponding narrowing of rate spreads.

3. Extension of the corporate tax carryback—say, to 5 years.
4. Closer study of the relation of capital depletion allowances to (*a*) the underlying physical phenomena and (*b*) needed incentive to exploration.
5. Development of means to accelerate tax refunds.
6. Modernization of State constitutions and laws now unduly cramping their borrowing and taxing powers; discovery by the Federal Government of more equitable ways of bearing predetermined portions of the carrying charges on State and municipal obligations.
7. Provision of funds to permit adequate enforcement of the law.

Full replacement of our present tax setup by any of those which meet the foregoing standards, involving as it probably would a substantial net fall in revenue at given levels of income, would be impossible over the next few years. The most productive would still not produce the yield and accompanying diversion of resources required. Nonetheless, the job could go ahead a lot more rapidly than might be thought offhand since the secular rise in taxable income should outrun growth in Federal spending, including that which some proposals made later would involve. I think it is possible to devise several patterns, any of which would, by 1955, permit diversion to the Government of sufficient command over resources to meet the latter's legitimate needs.

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[4] The dominant influence in that period was inflation flowing in part from inadequate taxation during the war and release of the resulting vast money potential more explosively than necessary, perhaps, by monetary policy. All groups of the population were struggling to recapture their original claims on goods and services. Those succeeding included the labor unions, property owners, farmers, and eventually holders of equities. Those failing included pensioners, savers, holders of life insurance policies, teachers, firemen and policemen, perhaps most white-collar workers. The cruelty of inflation in dispossessing large numbers of low to medium income citizens is notorious.

EXPENDITURES

Let us turn now to spending. What principle should govern the scope of Federal activity? In what spheres and degree does this dictate Federal outlays?

The answer to the first question seems fairly clear. Governments should not tackle any job which private agencies can handle adequately. For tasks that only governments are able to do, the Federal Government should not assume those which the States could perform, nor the States those which lower units can do satisfactorily. Moreover, even where smaller units are unable (or lack the will) to do so at a given point of time, great care must be taken to insure that the scale and method of assistance are so fixed as to encourage the beneficiaries to equip themselves to take over the job—if need be, even to the extent of stimulating development of intermediate agencies (e. g., metropolitan and regional authorities).

It is difficult to overstress the importance of adherence to this approach and of resolving doubts against intervention. The latter is often a cumulative business, initial action being taken in such ways as to reduce the initiative and capacity of the assisted, thus inviting extension of the higher agency's role. Perhaps the best recent example of how this kind of thing burgeons can be found in postwar British history,[5] but we don't need to go abroad to find the virus at work.

Admittedly, however—and I come now to the second question—the principle is much easier to state than to apply. There are of course a few exceptions to this judgment (e. g., national defense). But most of the areas in which the Federal Government is now financially active present real problems. In what follows, I propose to consider those fields in which the bulk of the important ones arise: Public construction; agriculture; and welfare.

PUBLIC CONSTRUCTION

The Federal Government undertakes itself a large amount of construction and assists lower governments in their building programs. These activities occur in many fields, of which the following nonfarm areas are related to insurance of healthy growth in the system closely enough to warrant separate mention: Slum clearance, urban redevelopment and public housing; highways; health facilities; and water and power development.

In my view, there is warrant for a substantial stepup in the slum clearance and urban redevelopment program, presently authorizing Federal loans to a grand total of $1 billion (and capital grants to a grand total of $500 million) to localities on projects that they initiate under enabling State legislation and approved by the National Government. Major changes should perhaps wait on fuller rationalization of intergovernmental relationships. In this context, I don't have much quarrel with the recommendations made last June by the Commission on Intergovernmental Relations, calling for more vigorous participation by the States, including establishment of metropolitan planning agencies and State provision of technical and financial assist-

[5] On this, see W. A. Robson's scathing indictment of what he labels "the centralizing mania which has seized hold of [the Labor Party] since 1945" (Labor and Local Government, political quarterly, January–March 1953, p. 51).

ance to localities, and offering as an incentive to such participation a shift from local to State basis of administration of Federal assistance in cases where the States provide by law comprehensive programs and give significant financial and technical assistance to lower governments.

I am not clear myself how far efforts should be made to complement the foregoing program by measures to accelerate the rate of public housebuilding, particularly low-rent units, but believe that however this may be, it is desirable to limit Federal participation to establishment of standards and provision of financial and technical assistance.

What about roadbuilding? Several points are clear: To promote healthy growth, it will be necessary to boost outlays terrifically and maintain the higher level for more than a decade. Moreover, the bulk of the program should be carried immediately or eventually by State and local groups, although significant Federal aid should continue to be supplied. With respect to financing, I would be inclined to retain the 60–40 setup for the interstate system and apportionment of Federal funds on the basis of State population and mileage. I am opposed to some existing and proposed standards as to collection and use of revenues.

As to existing conditions, I do not see much logic in rules requiring States to earmark specific percentages of particular levies for highway purposes. The linkages are inevitably narrower than the flow of services and preclude flexibility in the allocation of revenues among needs of different and shifting time-shape and urgency. If the principle were applied generally, the confusion would be vast. As to proposed standards, I am not persuaded that most of the Federal contribution should come from larger motor-fuel taxes. The benefits accruing to various segments of the population from better highways are related to relative income position as well as relative use of roads. Finally, I am not clear that our rate of construction should be limited to that which a pay-as-you-go system can support. The payoff to future generations in larger output potential from acceleration of the present program beyond pay-as-you-go limits seems likely to be great enough to warrant some forward shifting of the burden.

The grant-in-aid for construction of health facilities should be continued. There seems to be some doubt, however, as to the fairness of double weighting the relative average per capita income of the several States in applying the inverse allotment formula. Variations in requirements are of course a proper consideration, but the data on need for hospital beds among the States, compilation of which was financed by the Hospital Survey and Construction Act itself, are now available and should support a much simpler and probably more equitable allotment plan. Any present inequity is also aggravated by the graduation of State matching percentages to average per capita income. Conformance of grants to economic needs should hardly now require a double, and under the squaring formula, a triple exploitation of the spreads in per capita income among the States.

With respect to power and water development, I believe that much is to be said for the proposal of the first Hoover Commission's task force on natural resources to establish within a department of natural resources a water-development service to which would be transferred (1) the functions of the Bureau of Reclamation and the river, harbor,

and flood-control functions of the Army Corps of Engineers; (2) major responsibility for the conduct of river-basin and power-market surveys, now shared by several agencies; (3) authority to decide what power installations should be made at Federal dams; and (4) the right to certify to the Federal Power Commission such private projects as would serve best to promote resource development. Coupled with establishment of a consistent water policy, involving among other things participation of the States and localities in the planning, execution, and financing of projects and a rule-of-thumb that to the extent feasible and equitable costs be paid by beneficiaries, such a setup would make the contribution to healthy overall growth to which we are entitled from this sphere. However, it appears quixotic to expect this kind of reconstruction. For a while we shall probably have to settle for more modest results. I would recommend the following:

1. Extension to all federally sponsored projects of the requirement specified in flood-control legislation that the National Government take account of the views of lower governments prior to authorization of projects.
2. Institution of the policy of equitable division among governments of the capital costs of multipurpose, basinwide developments, in line with incidence of benefits, capacity to pay, etc.
3. Establishment of a board of coordination and review to advise the President and the Congress on steps necessary to assure proper coordination of natural resources policy within and among governments.

AGRICULTURE

What about agriculture? Budgetwise the biggest element in the picture is the system of support prices and related activities. The position here, however, is too painful to elaborate. As a result of work done by many agricultural economists over the past 15 years, we have been given persuasive ideas as to the ingredients of a sensible setup in this respect. This is a big question and from the average citizen to points of decision opinions will continue to differ. The Congress has been preoccupied with it for years. A half century ago a political leader remarked caustically of the maiden address of a young legislator, "What he said that was good wasn't new and what was new wasn't good," and on this issue at least I will avoid straining your courtesy.

In discussing budgets for growth, however, I am obliged to reveal my position on 1 or 2 technical matters.

To improve the position of marginal farmers, the proximate ends to be sought are generally recognized: Farms need to be substantially larger, mechanization much heavier, resort to complementary productivity-increasing measures (pest control, conservation practices, and fertilizers) much greater, and both financial management and marketing practices much better. Efforts to achieve any of these goals being likely to yield small returns failing concomitant action toward the others, a multipronged attack appears necessary. At least two major steps merit close consideration:

1. Arrangements to provide substantial capital loans to low-income farmers meeting certain standards of competence, subject to approval of the general program for their use and willingness

of borrowers to accept the supervisory and technical assistance of the lending agency or its delegatees.

2. Adaptation of existing facilities—notably the Farmers' Home Administration and the apparatus it has created at lower levels—to supply such assistance.

An integrated policy to promote outmovement from farms is likewise necessary and would involve three kinds of action, namely—

1. Arrangement and financing of job-training programs, complemented by vocational guidance and counseling.

2. Provision of informational services supplying data on nonfarm job opportunities and on living costs and conditions in the areas where these exist.

3. Financial assistance in migration.

In view of the amount of interstate movement which would doubtless occur, the third action might best be taken by the Federal Government. The second could be handled through extension of existing State and Federal employment services and some widening of their functions. The first presents problems. In view of the basic objective and the financial status of most of the affected States, there is much to be said for substantial Federal participation. Grant-aided vocational-training programs are already in existence. Teacher training apart, however, these are geared to prepare nonfarmers for nonfarm jobs and farm youths for farm jobs and the setup calls for a 50-50 division of costs between the National Government and the States. A substantial ad hoc program to train farm youths for nonfarm work and providing for a larger ratio of Federal-to-State funds—perhaps 75-25—would seem defensible. I up the Federal share reluctantly, but am afraid that otherwise the job wouldn't be done.

WELFARE

The problems confronting efforts to channel growth along healthy lines are nowhere more difficult than in the field of exconstruction) welfare activities, including public health, which now receive more than half of the grand total of Federal grants-in-aid. Here, too, it is easy enough to specify the broad aims of budget policy. Practically all would agree that Federal financial assistance should be designed to effect "equalization" of fiscal burden among lower governments. But the problems of just what this involves in practice and whether and to what extent the Federal Government should set standards and seek to stimulate activity present real headaches. Indeed, the literature is almost a cafeteria-service proposition. The choices range all the way from proposals for unconditional block grants, reflecting belief that although much of the necessary diversion of resources via taxation is best effected by the Federal Government, decision as to their use should be completely a matter for lower governments to make, to a host of earmarked grant-in-aid setups that, if adopted en masse, would yield a rather tight federally controlled system.

Lack of space precludes extensive comment on the pros and cons of various proposals, but I can set forth my own position briefly:

1. With respect to general assistance, it is probably better, during periods of general prosperity or mild recession, to stick to the present procedure of leaving the full financial burden with

lower governments. (Significant recession is another matter, dealt with below.)

2. Continuance of the present classes of "welfare" assistance on an open-end basis is desirable, but changes in their scope and in the degree and character of Federal aid seem appropriate. As to the former, child-welfare grants should be made generally in urban areas as well as farm communities as at present. As to the latter, I believe there is a case for replacing present formulas by setups involving Federal provision of the difference between some average national payment per recipient and what would be the average payment per recipient in each State if it spent the equivalent of some prespecified (uniform) percentage of State income payments. Both the national minimum and the appropriate percentage would be chosen on the basis of various relevant criteria and altered only if real costs per recipient dictated.[6] Under such arrangements, Federal aid would grow during downswings since the margin between the national minimum and average outlays required from the States would then widen. While throughout this discussion of Federal aid I have avoided administrative questions as not lying within either my assignment or my competence, I should state my belief that for old-age assistance, provided as it is on an open-end basis, the States should comply with eligibility standards set by the Federal Government.

3. I have no proposals to make about changes in the number or detailed content of specific health programs receiving grants-in-aid. With respect to the basic ends to be sought and machinery to be used in their attainment, however, the position taken by the President's Commission on Intergovernmental Relations strikes me as quite reasonable.

Short-Run Economic Stabilization

How far is this essential to insurance of healthy growth in the system? How far, if at all, in conflict therewith? Does budget policy have an important part to play in a stabilization program? If so, does the degree of consistency between attainment of the objective of growth and that of stabilization depend on the kind as well as scale of budget policy followed?

My own general answers to these questions can be given quickly: (1) it is correct to regard as adequately stabilized a system in which unemployment is kept generally within a range of 3 to 7 percent of the labor force and prices never decline cumulatively or rise more than a small amount (say, 1 to 2 percent) per year; (2) adequate stabilization of activity is not only a necessary condition of healthy growth but itself a major element therein; (3) although a stabilized environment can be insured in ways that militate against growth, means can be found that are conducive not only to healthy growth but to maximum physical growth; (4) and it is well within our power to pursue policies that will serve well all these objectives.

Limitations of space compel me to support only the last of these judgments. Before undertaking to do so, however, I should like to

[6] This is a modified version of the approach advocated by Prof. James A. Maxwell, Federal Government and the Business Cycle (National Bureau of Economic Research, New York, 1952, pp. 59–71).

offer a few comments on the second and third since they do not command unanimous support by any means. There is a school of thought which advocates "full employment at whatever cost," to use Viner's apt phrase. These analysts consider "full employment" (close to 100 percent employment of the labor force) to be so desirable in itself as to warrant acceptance of any socioeconomic straitjackets its maintenance might entail. They would regard as representing healthy growth whatever rate of progress occurs in such a world, but tend to expect that more likely than not this rate would represent maximum growth, too. Another group goes to the other extreme, arguing that the rate of advance during past decades could not have been so great in the absence of conditions—notably a credit-mechanism enabling innovators to set a more rapid pace—that tend to produce cyclical fluctuations and are likely to do so in greater degree the more favorable they are to secular expansion. In their view, the issue is, in D. H. Robertson's words, "progress against stability." Unlike their opponents, members of this group seem willing to accept stabilization in my sense as the goal toward which policy should aim, but are convinced even so that the resulting rate of growth would fall well short of maximum.

I cannot quite accept the validity of either of these views. As to the former, I suspect that the loss of dynamism in continuous adjustment will reduce the rate of growth more than it would be increased through greater increase, if any, in the yearly addition to labor force (and slowdown, if any, in the secular decrease in hours worked per year). As to the latter, I see no reason why all of the progress achieved in the past could not have happened in a world less frequently and badly stricken with fluctuations; and suspect that the kind of instability occurring in the last 75 years preceding World War II cost us more in the way of retarded growth during depressions than it gave us in the way of accelerated progress in booms, with the result that progress has been less historically than it would have been if the system had always been kept "stable" in my sense. Indeed, I suspect that such a system would contain close to the optimal degree of stability from the standpoint of physical progress.

So much for the second and third points. Turning to the fourth, one runs into the problem that there are many ways to hold swings in activity around trend within tolerable bounds. The requirements of healthy growth, however, limit the real possibilities. And choice is further restricted by political factors. In light of existing constraints, what role ought budget policy to play in the stabilization act? And what form should its participation take?

About the role of budget policy, the main thing to stress is that our arsenals of weapons include some that are extrabudgetary—notably those that fall in the monetary and debt management fields. The degree of reliance on such measures should probably be greater when our aim is to check inflation than when we are dealing with recession, but in either case they appear well fitted to handle a substantial part of any load compensatory policy would be called upon to bear. Since, however, exploration of the subject lies outside the terms of my assignment, the only suggestion I would make here is that the manner of handling surpluses and financing deficits be such as to reinforce their direct effects. (For this the prime reason is that the task of devising compensatory fiscal measures which will not have sour by-

product effects becomes progressively more difficult the larger is the necessary scale of such measures; hence there is need through monetary action and debt management to get the most out of a given amount of direct action.)

Now for budget policy. In attempting to insure that this plays its proper role, how far should we seek to rely on improvement in the system's so-called automatic flexibility? To what extend should efforts be made to buttress automatic stabilizers by so-called formula flexibility, which would trigger off prearranged reenforcing actions whenever activity fell below predetermined levels on selected indexes? How much should we depend on discretionary action as an alternative or supplement to these built-in counterforces? And if and insofar as action of each kind appears desirable, what specific measures should be taken?

Let me consider first automatic flexibility. Roughly speaking, this consists in the degree to which any departure from high-level employment at stable prices automatically sets in motion changes in revenue and spending which work against cumulation of the unwanted trend. The system already contains, especially against recession, a resistance of this sort that is very large absolutely and much larger relatively than in prewar days. Some analysts, however, appear to feel that the residual danger of serious fluctuations is so strong and difficulties of increasing the use of ad hoc compensatory measures of the proper scale and mix at the proper time so great as to warrant strong efforts to heighten automaticity even at sacrifice of other major objectives.

On this point, my position can be put briefly. In itself, I would welcome addition to the system's automatic flexibility. In all cases where ways to achieve a certain end are otherwise equally acceptable, I would urge choice of that which raises flexibility. The same holds in determining the priority of changes to serve different ends, all of which are equally desirable. All that is easy. In fact, on balance the structural changes suggested above would increase substantially the budget's stabilizing potential—although all were proposed because of their desirability on other grounds. But I do not believe that at present the effect on stabilization should enter more than peripherally itno decisions as to what to do about tax structure, etc. Owing in good part to the degree of flexibility now existing, the range of variations in cyclic movements to which the system seems likely to be subject appears well within the capacity of special measures to handle where necessary.

Formula flexibility presents more complex considerations. In my view, judgment with respect to this device turns largely on whether it seeks to provide general counterforces to changes in overall activity—being geared to movement in one or more of the big variables such as personal income or unemployment and relying on measures designed to have widespread direct effects—or whether we are trying to choke off undesirable developments in specific fields. Of these, general counteraction is superficially more attractive in that, if feasible, it would enable us to achieve a large increase in automatic flexibility while holding on most of the time to policies and structures that have been tested and found good basically—which would not be true if automatic flexibility were maximized directly. However, a survey of the literature and a fair amount of work on my own leads me to discount the possibilities. These investigations suggest that any formula able

to provide good insurance against bad timing of action and still prevent any substantial fluctuation in activity or unfavorable byproducts would be so complicated as to be unacceptable to the Congress. Indeed, from my own experiments I am persuaded that it would be risky to give much of a role to formulas under which widespread action would be set off by changes in big variables or indexes. Perhaps the most that we could afford would be a cut of a few billions in personal income or OASI tax yield if and when unemployment runs 6 percent or more for a 3-month period.

Selective formula flexibility is a somewhat different matter. Almost every kind of area or industry arrangement imaginable has found a sponsor at one time or another. Many of these don't withstand close examination and there is the additional consideration that creation of a profusion of devices might in net effect expose us to the same risks attaching to politically salable global formulas. I believe, however, that there are several areas in which contracyclical setups may judiciously be built into the system. Specifically, the following merit separate mention and discussion:

1. So long as seasonally adjusted unemployment exceeds 7 percent of the labor force, interest-free loans by the Federal Government to any State to preclude exhaustion of UC reserves, repayable at prespecified rates during years in which such unemployment averages 4 percent or less. I would not advocate fancy formulas arrangements to extend duration or raise the size of benefits.

2. Although opposed to Federal grants-in-aid for general assistance as a regular thing, I believe that a good case can be made for resort to them in recession. Formula arrangements involving its provision on some supplementary basis after overall unemployment (seasonally adjusted) in the system averaged 6 percent or more for 3 months and withdrawal once this drops to an average of 4 percent or less for the same period warrant consideration.

As to the kind of aid, I would favor open-end and relatively unconditional grants. It seems to me that the National Government could commit itself to grants for additional recipients at unchanged rates once the basic condition was met. Under this scheme States and localities would receive the sums necessary to cover growth in their payments for general assistance, obviating penny pinching on an essential need (or, alternately, diversion of funds from other essential uses) as happened so often in the past. To provide moderate incentive to screen cases properly perhaps the State and localities should pay a portion, say 15 to 25 percent, of the cost of general assistance to these additional recipients. The stabilizing effect of this setup would be quick and strong.

3. Finally, and most important, I believe that, in the case of downward movements propelled in substantial part by falloffs in private construction, it is both possible and desirable to place heavy reliance on compensatory public works' programs. No doubt circumstances are conceivable in which this would be rash. I don't have any quarrel in principle with the impressive list of pitfalls on which opponents of the approach laid so much stress in the late forties: the danger that acceleration of public building, even though it moderated swings in overall building, might do so by way of starting new subcycles in the field or (since the inputs required for different kinds of building often differ sharply) in the building materials' lines; the technological and

other difficulties hindering the step-up and reduction of outlays in accordance with need; the fact that action which tends via "spot spending" to forestall desirable shifts in use of resources or which yields useless product is more likely with this device than with other measures; the difficulties that might arise in resolving jurisdictional problems and inducing lower governments to permit projects to lie fallow until recession hit, thus precluding development of a large shelf of projects; and the risk that Federal participation in financing would have injurious long-term effects on State and local independence.

But these are all relative matters. Their strength depends much on the scale of the job to be done, size and mix of the natural backlog of projects, degree of planning undertaken and status of planning techniques. Review of the literature—also lack of fear of any big setbacks—suggests that, for any load that public works' programs might be called upon to carry in the constructional trades for a good while, an acceptable program can be put together. The planning techniques are known, enough experience in their use has been acquired, suitable standards for determining timing and scale of action already devised, and means of financing without risk of compromising chances of healthy long-term growth are abundant. The prime need now is institution of legislative and administrative measures necessary to develop and maintain the desired shelf of projects and allow withdrawal as appropriate. Specifically, I would urge the following:

(*a*) Action to develop a shelf of projects adequate (i) to support expansion of public works by $5 billion to $8 billion annual rate and (ii) through replacement of withdrawals, to sustain outlays at the rate selected indefinitely. I believe that such step-ups could be achieved without prejudice to healthy growth in the economy.[7]

Grants-in-aid for planning purposes and arrangements to assist in financing of projects either through grants or interest-free loans—in the latter case with suspension of amortization charges until total building (or general activity) returns to some prespecified rate—should serve.

(*b*) Establishment of a schedule relating the amount of compensatory outlays to variations in demand. It seems to me that a program (i) going into effect when seasonally adjusted unemployment has run 6 percent or over and the real volume of contract awards has averaged 15 percent or more below prerecesssion level for 3 months, (ii) aiming to restore half of the falloff for a while and (iii) undertaking to offset as much as three-quarters of it if, despite the offset, construction runs 7½ percent below peak for more than a year merits serious consideration.[8]

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[7] On this subject, see Robinson Newcomb's instructive article, Public Works and Economic Stabilization (in Problems in Antirecession Policy, Committee for Economic Development, New York, 1954.

[8] Changes in the building field itself as well as in total activity are proposed owing to danger of inverse correlation between swings in construction and those in general demand. Establishment of what may appear to be too low a floor at which to begin action and too moderate a degree of compensation of falloff stems from fear that more precipitate moves would prevent strongly desirable shakedowns in the building trades. The rule that the degree of compensation be raised from one-half to three-quarters in the event of a long valley reflects judgment that the degree of desirable adjustment in construction will be a function not only of its magnitude but of its length. And contract awards rather than actual outlays have been chosen to minimize the lag between need of action and its initiation. The proper mix of action depends on too many variables to admit of broad specification in advance, but it seems clear that a substantial portion of any program should and can be composed of short-length projects, permitting efficiently rapid expansion and contraction in its scale.

The foregoing apparatus should as a rule enable us to cope rather well with such instability as the system might display despite the amount of built-in flexibility it would then contain. This confidence is heightened by the probability that movements which do not affect building activity enough to bring into operation compensatory works programs would be mild and short lived—inventory cycles or their equivalent. Nonetheless, it is only prudent to assume that we shall often be called upon to forestall intolerably large residual fluctuations. It is implicit in what was said above that, if so, reliance should be placed upon discretionary measures. What should be done and what sort of advance preparation is in order?

As to advance preparation—to take the second point first—so far as concerns the timing and scale of contracyclical measures, I hesitate to rely on any substitute for detailed examination of events leading to any particular setback, the actual position at the time action is contemplated, and what analysis thereof coupled with expectations data suggests with respect to short-term prospects. Decisions about the kind of action to be taken are another matter. These should be made beforehand. To postpone debate as to what to do until after recognition of need for support is a good way to insure ill-timed and otherwise ill-devised action.

As to what should be done, it appears to me that so far as concerns budget policy the position is asymmetrical. Against inflation, my inclination is that budgetwise it is undesirable (and perhaps politically impossible) to plan supplementation of automatic flexibility, and the kind of formula flexibility suggested above, except in conditions (e. g., another Korea) so obviously exceptional as to call for strong countervailing action on many fronts. The appropriate tools are extrabudgetary, lying largely in the field of monetary policy. In case of recession, on the other hand, occasions may well arise in which reinforcement of monetary action through demand supporting budgetary measures are highly desirable. The planning job here is to insure that the steps taken do not compromise basic efforts to preserve conditions of healthy growth.

In my view, the most promising candidates for manipulation are OASI and personal income taxes—the latter especially if the proposed arrangements for expediting refunds are put into effect. There is, however, room for argument as to the form adjustments should take. On this point, it seems to me that the criterion for action to stabilize the system is quite different from that which would be appropriate when the issue concerns changes to match secular or long-term decline in need for revenue (or to forestall any rise in revenue relative to expenditures that maintenance of a given tax structure would involve). In the case of downward secular trends, cuts should presumably be made in ways that maintain equality of sacrifice or benefits. But for phenomena like recessions which not only cause the whole community to suffer but result from flexibilities of the system that everybody regards as too costly in terms of other objectives to suppress, we need another criterion. I am aware of proposals for a social dividend, payable on a per capita basis and in effect involving a negative income tax for those not liable at all for tax or whose liability was smaller than the desired dividend. This kind of thing is probably unsalable. Abuses would eventually be great, and I don't think it is for us. But the notion that the proper approach involves some approximation of

uniform aid seems quite tenable. I believe that as the primary discretionary tool budgetwise, close consideration should be given to reductions in personal tax load per taxpayer, spread evenly in dollar terms so far as individual tax liabilities were large enough to permit this treatment. Through resort to such means to reinforce other stabilizing elements, it should be possible to contain downswings within narrow limits, securing what would represent practically speaking continuous high-level employment, without substantial violation of any of the conditions of healthy growth.

FEDERAL TAXATION AND ECONOMIC STABILIZATION

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The Federal revenue system in its present form counteracts fluctuations in business activity in various ways, and could be used to do so in other ways. Built into the Federal revenue system are a number of features which tend automatically to reduce the magnitude of any swing in the level of employment or prices. This effect is exerted through variation in the level of tax liabilities as employment and income fluctuate. In addition to this built-in stabilizing power of the Federal revenue system, tax rates and other provisions of tax laws could be changed during a depression so as to raise the level of economic activity and could be changed during an inflationary boom to combat the rise in prices. In the first section of my paper I shall discuss the automatic impact of the present revenue system on cyclical swings, in the second section, ways of improving that impact, and in the third section, proposals for changes in revenue rates during cyclical swing to counteract those swings. In the fourth I shall note very briefly the relationship to long-run growth of measures for short-run stabilization.

In an appendix I discuss the involved question of the relative countercyclical effects of the various tax laws which make up the present revenue system. For lack of space I shall not discuss except in passing the relationship of revenue measures to other types of stabilizing action.

I. The Built-In Stabilizing Power of the Revenue System

The revenue system exerts a strong stabilizing influence on the economy. Various influences cause minor variations in the level of output in our economic system. Business firms may decrease the level of their inventories; installment plan sales of consumer durables may fall, and so on. If, when such a reduction in production and employment occurs, the spendable income of consumers fell as much as the value of output, even a relatively small initial recession in economic activity might cause a serious depression. (I use the term "spendable income" of consumers to refer to their income remaining after meeting their tax liabilities.) For their expenditures would fall by almost as much as the fall in their spendable income. This reduction in consumer purchases would cause an equal additional fall in output and income, this would cause a further fall in expenditures, and so on; and the snowballing effect could cause a minor swing in business activity to become a major one.

Fortunately, however, for each $1 billion fall in output, the spendable income of consumers does not fall by nearly as much, because of three influences. First, part of the fall in income is absorbed by corporations. Their profits fall sharply, but they tend nevertheless to maintain their dividends for some considerable time. Between the second quarter of 1953 and the first quarter of 1954, corporate profits after tax fell by $2.1 billion (annual rate) or 11 percent. Dividends, however, rose from $9.2 billion to $9.7 billion (annual rate). Between 1929 and 1932, corporate profits after tax fell from $8.3 billion to −$3.4 billion, that is, to a loss of $3.4 billion. But dividends fell only from $5.8 billion to $2.6 billion. This continued payment of dividends helps to sustain consumer spendable income and, to a lesser extent, consumer expenditures.

A second influence, not present in the 1930's but present now, is unemployment compensation payments. In the second quarter of 1953, these totaled $227 million. In the second quarter of 1954, after a fairly small decline in output and employment, they totaled $577 million. This increase of $350 million per quarter is equivalent to an increase of $1.4 billion per year, a considerable help in sustaining the income and also the expenditure of low-income groups. If output had fallen further, the rise in unemployment benefits would have been greater.

The third factor preventing consumer and business spendable income from falling as much as the value of output is the reduction of tax liabilities when output and income fall. This is the influence to be discussed at greater length in this paper.

The helpful influence of reductions in tax liabilities in sustaining consumer income and expenditures when output and employment fall, is considerably greater than that of either corporate dividends or unemployment benefits. As this is written, the gross national product is running at a rate of about $390 billion per year. At present tax rates, individual income tax liabilities at this level of GNP are perhaps $33 billion per year, excise tax liabilities between $9 and $9.5 billion, and employment taxes about $7 billion. If GNP were to fall by $25 billion, or to $365 billion, Federal individual income tax liabilities would fall by say $3 billion per year, excise tax liabilities by perhaps $1 billion, and employment taxes by some $750 million. These are not precise figures. The exact amount of each of these reductions would depend on the timing and exact nature of the reduction in GNP and estimates of the reductions in tax liabilities differ. But for a typical recession, these estimates are probably reasonably good. The total reduction would be about $4,750 million. Thus the reduction in these tax liabilities would equal almost one-fifth of the fall in GNP. Not all of the benefit would accrue to consumers; some would accrue to corporation profits. They would be somewhat higher—possibly $500 million to $550 million higher—at a GNP of $360 billion, than if aggregate liabilities under these three taxes had remained at their prosperity level.[1] But the great bulk of reduction of liabilities under these three taxes would accrue to individuals. Consumer spendable income would remain, I estimate, well over $4 billion higher and consumer spending about $3.5 billion higher than if aggregate tax liabilities had remained at their prosperity level.

[1] These estimates assume that corporations would absorb one-third of the additional excise taxes and one-fourth of the additional employment taxes.

If this "cushion" did not exist, so that consumer spending fell by an extra $3.5 billion, output, employment, and consumer incomes would also fall further, expenditures would fall still further, and so on in a spiral which would greatly aggravate the recession. How far such an effect might carry depends on many circumstances. But it is a fair estimate that if the rates of these three types of taxes were really pushed up sufficiently to yield the same revenue at gross national product of $365 billion as they had previously yielded at $390 billion, and then were pushed up again as the first increase depressed gross national production further and reduced tax revenues again, the final effect in a typical situation would probably be to carry gross national product down another $10 billion—i. e., almost half again as far, purely because of the cumulative reduction in consumer expenditures. The extra inventory unloading which would occur might carry the downswing much further. If a failure of confidence occurred because of this rather drastic fall in output and income, the effects might of course be still more serious. And if corporation income tax rates were also increased progressively as the depression deepened this would add to the dismal effects.

Of course, no one would conceive of thus raising the rates of all taxes as income and economic activity fell. But this brief sketch of the results may be useful as a reminder of the virtues of the fact that Federal tax liabilities do fall as output, employment, and income fall. Federal revenues have always fluctuated with fluctuations in business conditions, but the effect in sustaining income and expenditures has never in earlier decades been as great as at present, mainly because the magnitude of Federal tax revenues has never been as great.

The stabilizing power built into the Federal revenue system also operates during an inflationary period. As prices rise, money incomes and corporate profits rise. Liabilities under the individual income tax and the corporation income tax therefore increase, and the increased taxpayments siphon off income and check spending. Liabilities under those excise taxes which are on ad valorem base also rise, with a corresponding helpful effect. However, liabilities under excise taxes which are levied on a per unit basis do not rise, and employment tax liabilities rise little. For these reasons, the counterinflationary effect of the Federal revenue system as a whole is somewhat less than its counterdepressionary effect.

The reduction in tax liabilities as output and income fall, which cushions the recession, also creates a budget deficit. The reduction and the budget deficit which it creates are desirable because they do mitigate the recession. A deficit which creates an inflationary level of demand during a boom does so by injecting into the economy an excessive addition to income (and to the money supply). But a deficit during a recession or depression merely supplies needed income (and money), not an excessive amount. The additional money which it injects into the economic system is almost certainly less than would have been injected by private business activity if full prosperity had continued.

II. Improving the Built-In Stabilizing Power

A. THE RELATIVE MERIT OF VARIOUS TAXES

It is my judgment that employment taxes and the individual income tax are of approximately equal effectiveness in combating cyclical fluctuations in employment, and that the present selective excise taxes as a group are less effective. The same would be true of a general excise or sales tax. The individual income tax is the most effective of the four in combating inflation. The cyclical impact of the corporation tax is highly uncertain. It is not certain whether it is less or more effective in combating fluctuations than the employment and individual income taxes.

Because the considerations leading to these conclusions are somewhat involved, they are presented in an appendix.

B. EFFECTS OF 1954 TAX CHANGES

Among the changes in revenue legislation enacted in 1954, only one in my judgment may alter to any appreciable degree the countercyclical effect built into the revenue system. This provision is that permitting somewhat accelerated amortization of most of the cost of new plant and equipment for tax purposes. Because of this provision, a firm investing will know that its liability for corporation income tax during the first years of a new venture will be less than otherwise, assuming that it has any profits to be taxed. This will stimulate investment, if profits during the first years are anticipated. Early profits are more probable in full prosperity than in recession or depression. Hence the stimulus in prosperity may be greater than in recession or depression, and the net effect will probably be to shift investment from depression or recession to full prosperity, and thus make cyclical swings worse. However, the magnitude of this effect is probably not large.

C. TAX CHANGES WHICH WOULD INCREASE THE STABILIZING EFFECT

Certain changes in present tax laws would somewhat increase their stabilizing effect, but no changes which left tax rates constant during cycles would bring a very large improvement.

Introduction of a carryback provision into the corporation-income tax would improve its cyclical effectiveness in two ways. Both effects would result from the fact that any corporate loss during recession or depression would create an immediate claim for a tax refund.

First, a carryback would give the corporation more cash during the depression. This would enable it either to continue dividends at a higher rate than otherwise, while maintaining a prudent cash position, or to carry out investment plans. Either course of action would help to raise the level of spending, hence of employment and income.

Secondly, a carryback would increase the prospects that advantage could be taken of accelerated depreciation during a depression or recession. For even if a new venture carried out by an existing enterprise showed no profit, so that there was no tax liability, carryback would permit a loss registered through accelerated depreciation to be charged against any profits in recent years. The destabilizing effects of accelerated depreciation would thus be mitigated.

Both of these advantages would accrue, however, only if the Treasury Department set up administrative machinery which made possible prompt handling of claims for tax refunds.

A carryforward, it should be noted, would not have these advantages. It does not yield any benefit during the depression, but merely creates a situation in which the corporation will be able to reduce its taxpayments in more prosperous future times (precisely when a reduction is not necessary).

The effects on investment of introduction of a carryback should not be exaggerated. They are small. In a minor recession few corporations would have losses to carry back, and in a major depression other circumstances would have great influence on investment decisions.

The countercyclical effect of the present selective excise taxes would be increased by changing the specific rates which exist for some commodities and services to ad valorem rates. This would not only reduce the tax burden in depression if prices of the items were reduced; it would also increase the tax burden during an inflationary rise in prices, thus helping to check the inflation.

Increase in the flexibility of employment taxes could be achieved by increasing the maximum salary liable to tax. In many cases the tax does not vary even though wage or salary falls during depression, because the wage or salary does not fall below the rate of $4,200 per year, the maximum subject to tax. If it were desired to raise the ceiling salary without increasing the burden of the tax, present rates could be adjusted downward so as to leave aggregate revenues unchanged.

In the individual-income tax, altering the progression of tax rates in any moderate degree would not greatly alter the cyclical flexibility of tax yields, for only a minor part of the cyclical variation in the revenue yield of the tax is caused by the movement of incomes down or up the scale of surtax rates. The major part of the cyclical variation is caused by the fact that in recession or depression an increasing share of incomes drop below the level at which they pay tax at all. In other words, it is the bracket change from 20 percent to zero, not the smaller bracket changes above 20 percent, which is the major influence. Changing the magnitude of exemptions moderately would probably not greatly alter the countercyclical effect.

III. FORMULA FLEXIBILITY

Valuable though the built-in flexibility of the Federal Revenue System is, its operation is limited. It can only prevent a recession or depression from going as far as it otherwise would, but can never act independently to reverse the fall of employment and income during a depression. In inflation, it will similarly act only to prevent an inflationary surge from proceeding as rapidly or as far as it otherwise would, but it can never inject an independent counterinflationary force. For countercyclical forces that reverse a swing, either "formula flexibility" or discretionary action is necessary.

The term "formula flexibility" refers to arrangements by which changes in the provisions of revenue, expenditure, or monetary and banking measures are put into effect automatically when certain economic changes occur. Discretionary action refers to changes adopted

at the desired time through action of the Congress or the Executive, rather than by formula.

Formula flexibility would, of course, require legislation specifying the change in tax provisions and the circumstances in which it will take effect. An example of formula flexibility would be a provision that the first-bracket rate of the individual-income tax should be reduced from 20 percent to, say, 10 percent, by announcement by the President, if the Bureau of the Census Monthly Report on the Labor Force had indicated unemployment of more than 4,500,000 for 3 consecutive months, and that the 20-percent rate should be restored when either of the following occurred: (*a*) The Monthly Report on the Labor Force showed unemployment of less than 2 million for 3 consecutive months, or (*b*) the Monthly Report on the Labor Force showed unemployment of less than 2,500,000 for 3 consecutive months and, in addition, the Bureau of Labor Statistics Consumer Price Index showed a rise of one-half of 1 percent in prices within the period.

Some other economic change could be used as a signal for the tax change, instead of these two indicators. And, of course, the provisions of taxes other than the individual-income tax could be altered. For example, excise rates or the rate of the corporation-income tax might be cut by a specified amount. But the latter two sorts of changes run into certain difficulties. Business planning is affected by corporation-income-tax rates. Uncertainty concerning them would hamper it. It would also lead to stock-market speculation based on the likelihood of change. Moreover, a temporary reduction in corporation-income-tax rates is not very effective in stimulating economic activity. It does extremely little to stimulate investment, precisely because it is only temporary. Granting credit against corporation-income-tax liability for investment during depression would serve as a stimulus, but this rather complicated and controversial proposal would certainly be less attractive as a means of formula flexibility than a simpler measure. Reduction and later restoration in excise-tax rates, if sizable in amount, would also hamper business planning, in this case the planning of retailers as well as of manufacturers. It would cause repeated difficulty concerning floor stocks, and could lead to speculative deals in the commodities. While these difficulties concerning these two types of taxes are by no means insurmountable objections, change by formula in individual-income-tax rates seems both most feasible and economically preferable.

Formula flexibility can save a great amount of time, compared with that which would elapse if after an economic downturn Congress met and went through the process of deciding whether the situation warranted tax action and, if so, what action was preferable. Deciding in advance on the action and its timing would leave only the mechanical steps to be taken after the need for action had arisen. Nevertheless, there would necessarily be some delay after a change in economic conditions before a formula change, for example, a change in the income-tax rate, could take effect. First, there would be a lag between the time when the change in the level of economic activity occurred and the time when statistics reflecting it were recorded. Then, after the statistics gave the signal for a change in tax rates, business firms throughout the country would have to be notified, and time

allowed for them to change their withholding procedures.[3] This might require say 2 months, at a minium. Several additional months will elapse before the increased monetary flow released by the reduction in withholding rates begins to have its full effect on employment, output, and prices. Thus a minimum of about 6 months would elapse from the time the trigger was pulled until the tax reduction began to have its full effect on economic conditions.

This course of events assumes that by prior legislation the Congress has authorized the executive branch to institute the change in tax provisions when unemployment had reached the indicated level (if that was the signal specified in the legislation). A change provided in prior legislation might be triggered off in other ways. When the specified level of unemployment had been reached, Congress might trigger off the change by a joint resolution. This is the method recommended by the Committee for Economic Development in Jobs and Markets. Or, Congress might provide for administrative discretion, with the provision that a proposed change must be submitted to Congress for possible congressional veto. Finally, full administrative discretion might be granted to alter tax rates within specified limits as economic conditions seemed to warrant.

All of these methods except the last, which Congress would probably be reluctant to enact, would require more time than a simple automatic trigger.

There is a danger which should be guarded against in any formula flexibility. It is that if a cyclical fluctuation turns out to be a short-lived one, the change in tax provision might come into play just in time to have a perverse effect. The 1953–54 dip in business activity provides an example of this possibility. Output began to fall in the third quarter of 1953, and unemployment began to rise in November. Unemployment reached its highest level, some 3.7 million, in March 1954, hovered at 3.3 or 3.4 million through July, and then fell (except for a seasonal rise above 3.3 million in January–March 1955). Output and income began to climb in the last months of 1954, and by mid-1955 the Board of Governors began to take steps to check an inflationary level of spending. If a reduction in taxes had been instituted some time during the second quarter of 1954, it would have begun to have its full effect in stimulating spending along toward the end of the year, when it was unnecessary, and would have played its part in considerably increasing the threat of rising prices in mid-1955.

Conversely, if tighter tax measures to check spending are instituted just when a short-lived upswing in prices has in fact spent its force, they may aid in creating unemployment, rather than in countering the price rise.

Yet if the downswing in output, income, and employment had gone farther in 1954, formula flexibility in individual-income-tax rates could have been of great help in checking the downswing and turning it up again. Quick action in such a circumstance might prevent a cumulative downswing due to loss of confidence in future markets and profit prospects.

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[3] New tax forms and instructions woud also have to be prepared and printed; this could not be done in advance, for the change in tax liability for the year would depend on the month when the change took effect.

These considerations lead to the following recommendations:

1. No attempt should be made by formula flexibility to keep minor economic fluctuations within too narrow limits. If this is attempted, the danger of perverse action is too great. Perhaps even the range of fluctuation suggested in the example cited is too narrow. Certainly no narrower one should be specified.

The danger of perverse effects exist not only because of the possibility of a quick turnaround in economic trends under certain conditions, but also because of the margin of error in our economic statistics. As the Census Bureau would be the first to admit, the Monthly Report on the Labor Force estimates of unemployment are by no means perfect, both because financial limitations limit the size of the sample and also (and more important) because of the margin of error in the responses of individuals to interviewers. The Consumer Price Index is not only subject to some margin of error, but also is computed only some time after the date to which it applies. Considerably more money would be required to execute a procedure which would permit more speedy computation.

2. To check cumulative developments, prompt action should be provided for if unemployment or prices go beyond the indicated limits. The trigger should either be provision for the Executive to alter tax rates when the specified condition existed, or provision for triggering by a joint resolution by Congress, when the specified condition exists. Such a provision should provide for a request to the President to call a special session of Congress, if it is not in session at the time.

3. Considerably increased amounts of money should be appropriated by the Congress for the collection and processing of economic statistics, in order to reduce the time involved and increase the accuracy of the statistics.

4. The sort of indicators recommended above (MRLF and CPI) are those commonly recommended by economists to trigger formula flexibility. However, to prevent perverse action because of quick turnarounds in economic conditions, I recommend investigation of another type of indicator as well, based on the difference in nature between short economic fluctuations and others.

Except where there are exceptional and obvious new factors impinging on the economic system, a quick economic dip and recovery is caused by, or at least has associated with it, an inventory swing. When manufacturers and traders feel that their inventories are ample, any small dip in business—or even the fact that rising sales cease to rise—may cause them to reduce inventories. Their curtailment in their orders is occasionally enough to cause a sharp drop in output and employment, increasing unemployment by 1 or 2 million. But if no other fundamental factor is involved in the downturn, when firms have reduced their inventories and begin to buy as much as they are selling, this in itself will bring an upturn, and the upturn will cause them to rest'ck inventories. Therefore, when a quick downturn is primarily due to inventory disinvestment, a quick turnaround is apt to occur and tax reductions as a countermeasure is dangerous.

On the other hand, if the total of investment by business firms in fixed capital (plant and equipment) plus housing construction is declining significantly, not only is a quick turnaround much less likely, but the danger of a cumulative downward spiral is far greater. (A

decline in the share of their income which consumers spend may in certain circumstances have effects similar to those of a decline in fixed investment.) Tax reduction in these cases is not only safer but much more necessary. I therefore suggest that the Congress should investigate the possibility of obtaining adequate data concerning the two types of business expenditure promptly enough so that these data, together with data on employment, might be used as a signal to trigger off tax changes, no change being made in case of a recession due primarily to inventory decumulation.

It should be noted that tax changes have marked advantages over Federal expenditure changes as measures of formula flexibility. It is difficult to store up worthwhile expenditure programs during prosperity, and save them for recession or depression. Furthermore, few expenditure programs can be put into effect as rapidly as a tax change. Finally, there are a number of administrative difficulties and economic disadvantages to abrupt changes in expenditure programs. Changes in the individual income tax, on the other hand, can be initiated promptly, and they exert their effects smoothly throughout the economic system, in accordance with the spending decisions of the millions of individuals whose tax liabilities are reduced. It seems desirable to reserve expenditure action for any major emergency, and to enact formula flexibility in revenue legislation toward the end that the major emergency may be prevented from ever arriving.

IV. Short-Run Stabilization and Long-Run Growth

One of the important requirements for long-term growth in the economy is a steadily increasing level of demand. When output falls for lack of demand, incentives to continued growth are lessened. Another of the conditions for long-term growth is adaptability of the economy to meet internal changes—growth in some industries, relative decline in others. Fiscal measures which cushion and counteract short-run economic fluctuations help to provide both of these needed conditions. They are therefore not only consistent with long-term growth; they are essential supports of it.

Appendix: The Relative Stabilizing Power of Various Taxes

To increase the stabilizing power of the revenue system, which type of tax should be emphasized? Which type should be increased and which reduced, if the only criterion were their relative effectiveness in helping to sustain consumer and business spending and income in a recession, and in helping to restrain spending in an inflationary period? There are, of course, many other criteria which must be applied in deciding the relative desirability of alternative taxes, but only this one is appropriate for discussion here.

The choice to be made would be between, say, a $2 billion reduction in one tax or another, or perhaps whether to reduce an inferior tax by some such amount and increase a superior one. The criterion, therefore, is not the total amount by which each tax varies between prosperity and recession. The criterion is how much countercyclical impact each billion dollars of each tax has.

It was indicated above that with a fall in gross national product of $25 billion, annual individual income-tax liabilities would fall from $33 billion to $30 billion; excise-tax liabilities from some $9 billion to $8 billion; and employment-tax liabilities from $7 billion to $6,250 million. In the same circumstances corporation income-tax liabilities would fall from some $21 billion to 17–18 billion dollars. Of each billion dollars of revenue from the corporation income tax at the present level of gross national product, 14–19 percent or 140–190 million dollars per year would be lost if gross national product dropped by $25 billion; of each billion dollars of excise-tax revenues, some 11 percent or $110 million would be lost; of each billion dollars of employment-tax revenue, somewhat less than 11 percent or $110 million, and of each billion dollars of individual income-tax revenue, some 9 percent or $90 million. Estimates such as these, as noted earlier, can be only approximate. But they are accurate enough to permit evaluation of the different taxes.

Not all of the reduction in excise and employment tax liabilities benefits consumers. Consumers do not bear the full burden of these taxes in prosperity, and hence are not relieved by the full amount of decline in the taxes, when a decline occurs. Perhaps, as a rough estimate, two-thirds of the burden of selective excise taxes and three-fourths of the burden of employment taxes fall on consumers. When these fractions of the reductions in these taxes are computed, it is seen that, per billion dollars of tax, the influence of employment and individual income taxes in sustaining consumer income in recession or depression is about equal, and that of excise taxes considerably less.[3] This is true of the present selective excise taxes. It would also be true of a general excise or sales tax, whose flexibility would be no greater than that of the selective excises.

The corporation income tax exerts an impact on consumer spendable income in three ways. Decline in corporation income tax liability helps to sustain dividends, but by no means dollar for dollar; probably except in a prolonged depression not more than one-third of the decline in corporation income tax liability is reflected in dividends. Further, the dividends, being on the whole paid to higher income groups, are subject to a high rate of individual income tax, so that the share remaining as spendable income is reduced. The bracket rate of individual income tax applicable to the dividends probably averages at least 50 percent.[4] Hence the contribution to spendable income is probably not more than one-sixth of the decline in tax liability itself, or 23 to 32 million dollars per each billion dollars of tax.

A second effect on consumer spendable income arises from the incidence of the corporation income tax. Not all of the tax burden is borne by corporations; some part is passed on to purchasers in the form of higher prices or passed back to workers or suppliers in the form of lower wages or prices; in either case the burden is shifted to consumers. As corporation income tax liability declines in recession or depression, this burden on consumers declines; this effect reduces

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[3] All of the reduction in the individual income tax liabilities, o $90 million, benefits consumers; three-fourths of the reduction in employment tax liabilities, or $87.5 million, two-thirds of the decline in excise tax liabilities, or $73 million.

[4] If dividends were not maintained, individual income tax revenues would fall further in depression than they do. Conversely, the individual income tax prevents the maintenance of dividends from sustaining consumer spendable income as much as it otherwise would.

the decline in spendable income.[5] If as much as one-third of the burden of the corporation income tax is passed to consumers, then one-third of the decline in tax liability, or 46 to 64 million dollars per billion dollars of tax, helps to sustain their incomes. Thus through this effect plus the effect via dividends, the sustaining effect may be as great as 69 to 96 million dollars, or as great as that of employment taxes and the individual income tax.

The tax has a third effect which must be considered. Through its impact on profits it probably affects the volume of business investment in depression, which in turn affects the level of employment and income.

The effect of the tax on investment is not certain. It should be noted that the problem is not whether the corporation income tax reduces investment in prosperity and depression combined. The problem considered here is whether the existence of the tax increases or decreases the fall in investment from full prosperity to recession or depression. Reduction in the rate of the tax would increase profits after tax in depression. But it would increase profits after tax in prosperity even more, in absolute terms. Hence the added stimulus in prosperity would probably be greater than that in depression, and the net result might be to shift some investment from depression to prosperity, so that when a depression came it would be deeper than otherwise. Insofar as this occurs, the higher the corporation income tax rate, the more stabilizing the effect.

It is probable that the existence of the corporation income tax reduces the amount of cash available for investment during a recession or depression. Even this, however, is not certain. If corporation income tax rates were reduced, profits after tax would be larger during full prosperity, and dividend rates during full prosperity would accordingly be greater. When a depression or recession occurred, the fall in the dollar level of profits would be greater, hence the cut in dividends, internally financed investment, or accumulation of cash would have to be greater than at present. Because the pressure for maintenance of dividends is great, it may be the retention of cash for investment or accumulation which would give way in favor of dividends. However, a corporation that was able to resist this pressure could have a greater absolute amount of cash available in depression than is now the case.

On balance, it is my judgment that considering the incentive effect and the availability of cash effect combined, the corporation income tax evens out the cyclical flow of investment somewhat, rather than accentuates cycles. The question, however, is complex and the answer uncertain.

Because of the uncertainty of these various effects of the corporation income tax, it is impossible to know with certainty whether its stabilizing effect is greater or less than that of the individual income tax and of employment taxes. My judgment is that the stabilizing effect of the corporation income tax is greater, but this judgment is subject to a wide margin of uncertainty.

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[5] The tax widens the margin between the sales price of a commodity or service in prosperity and the income which flows to the individuals who helped to produce it. That is, because of the tax a smaller share of each sales dollar goes into consumer income. Therefore, when sales and output fall by $1, consumer income falls by less than it otherwise would. Excise taxes have a similar effect.

I would like to emphasize that these comments concerning the relative stabilizing effects of various taxes are not intended to express judgments concerning the overall desirability of the various taxes. They fail to consider the entire question of equity, as well as the economic effects of alternative taxes other than the countercyclical effect (for example, the relative impact on different industries). The considerations discussed here, those which relate to stabilizing total output and employment, are only one group among a number of important factors which must be evaluated in judging the relative desirability of alternative taxes.

II. IMPACT OF FEDERAL TAXATION ON THE DISTRIBUTION OF REAL INCOME AND LEVELS OF CONSUMPTION

THE IMPACT OF MODERATE INFLATION ON INCOMES AND ASSETS OF ECONOMIC GROUPS

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Most of the papers submitted to this subcommittee deal with the effects of taxes. My task is to consider briefly the effects of no taxes—of permitting inflation to occur instead of raising taxes (or reducing Government spending) when aggregate demand rises above aggregate supply at the then-existing price level. Only by comparing the effects of different taxes with the consequences of not enacting taxes can we reach a fully considered decision as to what taxes, if any, ought to be levied when, and how heavily.

The major purpose of this paper, therefore, is to provide a background and standard of comparison for assessing the comparative impacts of the many tax policies that will be discussed before the committee.

Little disagreement remains on the broad outlines of sound tax policy in periods of either mass unemployment or drastic inflation. In the former, tax reductions are surely in order, and in the latter sharp tax increases. But more difficult decision problems arise when the situation is less clearcut, when the problem is: Shall we try to get from reasonably full to full employment, at the risk of helping to generate moderate inflation—or, alternatively, how drastically shall we impose taxes to resist relatively mild inflationary pressures?

This analysis, therefore, considers the impact of relatively mild inflation on different economic groups when a situation of relatively full employment prevails. Such situations are apt to pose especially puzzling dilemmas for overall tax policy in the American economy over the foreseeable future.

By inflation, I shall mean simply a rise in a broad-based commodity price index (such as the Bureau of Labor Statistics Index of Consumer Prices). This simple definition includes price rises when less than full employment exists, because this may be part of the situation we wish to consider. The definition does not lead us into the ultimate causes of the general price increase, since this would go beyond the scope of this brief exploration.

By "relatively mild inflation" I shall mean inflation roughly up to the severity of the inflation in the American economy between 1939 and 1952. This eliminates from consideration here "hyperinflation" and the type of rapid, persistent inflation found in several European countries since World War II where economic behavior was widely adjusted to the expectation of continuing inflation. Most of the em-

pirical evidence used here deals with recent inflation (since 1939) in the United States. Thus, it must be recognized that the findings may not apply equally to other inflations and other settings. Still, this is probably the best factual evidence we have for considering likely events in the United States in the years immediately ahead.

By "relatively full employment" I shall mean situations where unemployment does not exceed 5 to 6 percent of the civilian labor force.

All these definitions are arbitrary. They are taken merely to delimit the problem posed for this particular analysis.

Summary of Conclusions

Inflation is often said to reduce the Nation's standard of living, to impoverish the average man, to aid the rich against the poor, to benefit the profit receiver at the expense of the wage earner, and to impoverish creditors by wiping out the real value of their claims on debtors. Objective investigation supports some of the commonly held beliefs about inflation, but fails to support many others.

The economic effects of inflation may be conveniently analyzed here by asking what is the effect of inflation on (*a*) society's total real output (e. g., gross national product), (*b*) the distribution of that real output among economic groups, and (*c*) the distribution of ownership of society's wealth. Briefly, this analysis, considering only the type of inflation defined above, suggests tentatively that—

(1) There is little evidence that relatively mild inflation of the sort considered here reduces the current real output of society, through weakening faith in the value of the dollar, impairing the incentive to work, or any other of the often claimed channels. (Even in the hyperinflations of central Europe, total output did not decline until late in the hyperinflation periods.)

(2) Neither is there substantial evidence that relatively mild inflation (i. e., rising prices per se) significantly stimulates increased total real output, although strong total demand clearly does stimulate total output.

(3) The impact of relatively mild inflation in redistributing current income among major economic groups is apparently less than is often claimed.

(4) Inflation's income redistributional effects, at least during the 1939–52 period, did not correspond closely to several commonly held beliefs about inflation. For example, there is little evidence that inflation significantly changed the size distribution of income between rich and poor, though it may have helped to decrease income inequality somewhat. During the 1939–52 inflation, and during 2 of the 3 separate bursts of inflation within the 13-year period, the share of wages and salaries in the national income rose significantly; that of unincorporated businesses (both farm and nonfarm) fell; that of corporate dividends and of dividends plus undistributed profits fell slightly, though that of corporate profits before taxes rose; that of rent receivers remained substantially unchanged; and that of interest receivers fell sharply during World War II but rose slightly thereafter. These changes, of course, reflect many forces, not merely inflation, but they indicate that the redistributional force of inflation was either in line with

these results or, if different, was not strong enough to dominate the results.

(5) Within these maor economic groups, individuals and subgroups were affected very diversely. Persons and institutions on annuities and other fixed income arrangements, for example, suffered drastic relative and absolute losses.

(6) Inflation's effect in redistributing control over wealth is substantial. Between 1939 and 1952, roughly $500 billion of purchasing power of creditors was wiped out by inflation.

(7) In transferring purchasing power from net creditors to net debtors, inflation in the modern American economy transfers purchasing power mainly from the "household" sector (which is a heavy net creditor, in spite of its substantial debts) to the Federal Government (which is a heavy net debtor). It also transfers purchasing power on a smaller scale from unincorporated businesses (which are slight net creditors) to incorporated businesses (which are modest debtors). But the Government is only an intermediate institution. When the Federal Government benefits as a net debtor, the gain accrues in part proportionately to all taxpayers (whose future real tax burden to meet interest and principal claims of debtholders is reduced). But if the debt is continually refunded rather than paid off by taxes, the gain accrues mainly to all spenders in the economy, as bondholders' real purchasing power over current output is decreased, thereby correspondingly increasing the claim that can be exercised by all others with their rising money incomes.

(8) Nearly all major groups of households (families and individuals living alone) are net creditors, as their holdings of money, Government bonds, life insurance, and pension reserves substantially exceed the debts they owe. Only very poor families and those in the early years of establishing households (especially under age 25) are net debtors as groups, though farm families are only small net creditors. Conversely, high income, wealthy families and older families are heavy net creditors, highly susceptible to loss from inflation. Within all these major household groups, however, there is a wide diversity among individual households.

(9) There is little evidence that the once pronounced lag of major costs, especially wages, behind business selling prices in inflation any longer exists as a major factor (see 3 and 4). Depreciation and inventory accounting tend to understate costs in inflation, long-term rental and interest costs lag somewhat, and corporations gain somewhat in inflation as moderate net debtors. But these factors appear to have been substantially overcome by other forces determining current business costs in relation to selling prices in inflation. Investigation of individual firms' inflation-period experiences suggests that net debtor or creditor status is secondary to current income and cost factors (which vary widely from firm to firm) in determining which firms gain and which lose relatively during relatively mild inflation. Thus, inflation such as we had over the 1939–52 period apparently no longer significantly shifts income from workers to profits. This finding weakens the argument that inflation per se is an important stimulant to increased total output and employment.

THE EVIDENCE

The above tentative conclusions rest partly on a priori reasoning (theory), but mainly on analysis of the American economy during the recent major three-stage inflation of 1939–52. Theorizing about the effects of inflation is never completely satisfactory as a foundation for policy thinking because we are never sure that our basic assumptions will accurately describe the world of tomorrow, even though they reflect past facts. Analysis of historical experience is similarly limited, both because we never know that yesterday's experience will be repeated tomorrow and because we seldom really know what caused what, looking backward. Thus, all the summary conclusions above should be considered only rough suggestions of what may happen in relatively mild inflations during the years ahead. Nevertheless, they are probably better bases for forecasts than hunch or casual impression that must serve in the absence of more careful investigation.

The following paragraphs present briefly some of the reasoning and evidence underlying the summary conclusions. But the brief scope of this statement precludes presentation of more than a small part of the relevant data, and the following sections make no pretense of doing more than to suggest the main lines of reasoning and the broadest supporting data.[1]

EFFECTS ON TOTAL REAL OUTPUT (CONCLUSIONS 1 AND 2)

The likelihood that relatively mild inflation will reduce the economy's current real output finds little support in a priori reasoning; individuals or businesses stand to gain little from reducing their willingness to work or output, respectively, merely because commodity prices are rising. Moreover, the historical evidence shows output generally rising in inflation periods. During the entire 1939–52 inflationary period, and during each of the 3 intensive bursts of inflation within these 13 years (World War II, the 1946–48 price upswing, and the Korean war), real gross national product rose. This fact does not prove that inflation did not exert a downward pressure on real output which was overcome by other expansionary forces, but it does suggest that any possible output-depressive forces in the inflation were, at most, relatively weak. This American experience appears to be similar to that in other relatively mild inflations here and in other countries.

The evidence that inflation per se probably does not significantly stimulate real output is considerably less clear cut. In the kind of situation considered here, where relatively full employment already exists, clearly increases in total output are sharply limited unless somehow (as by involvement in war) the available labor force is substantially increased. Moreover, experience suggests that reducing unemployment becomes increasingly difficult as the unemployed margin becomes smaller and smaller. If inflation is to increase total output in such circumstances, it must probably act primarily through three channels: increasing the willingness of individuals to work; expanding the labor force; or increasing efficiency of productive processes, consumer demand for goods and services, or increasing business' desire to invest (in inventories, buildings, and equipment).[2]

[1] More detailed information and analyses are included in a paper to be published elsewhere.
[2] This omits from consideration international effects.

Satisfactory evidence is not available on any of these two channels. The belief that inflation stimulates increased total output has rested primarily on the argument that wages lag behind rising prices, thereby increasing business profits; this increases businessmen's incentive to invest and to increase output, and perhaps induces individuals to work harder to replace their lost real income. But modern evidence fails to support a substantial lag of wage rates or wage incomes behind rising prices except very temporarily. Some costs clearly do lag (depreciation charges and inventory costs as shown by accounting records, interest, and rent), but there is little evidence that these lags are dominant enough to lead to significantly increased investment, except for inventory investment. Secondly, it has been argued that in inflation the expectation of further price increases leads to increased consumer and business spending. Evidence of such behavior in the business world is plentiful, especially in the purchase of raw materials. But evidence concerning business spending on major investments and concerning consumer spending is mixed. In any case, this expectation effect relies on the expectation by consumers and businesses of continuing inflation, rather than on the existence of inflation as such. Expectations of further price rises in inflationary periods appear to have been volatile and are, as yet at least, unpredictable. Overall, the evidence on the impact of inflation on total output is mixed and inconclusive, with no clear presumption that inflation will significantly stimulate increased total output during periods of relatively full employment.

Effects on the Distribution of Current Income (Conclusions 3, 4, and 5)

With any given level of total real output, in inflation those whose money incomes rise more rapidly gain at the expense of those whose incomes rise less rapidly.[3] Since total real income is unchanged, inflation merely causes a redistribution of that income. The crucial determinant is not whether any individual is a wage earner or profit receiver, rich or poor, old or young—but whether his money income rises more or less rapidly than the average. Insofar as inflation is widely anticipated, a corresponding adjustment is likely to be made in the income claims and economic bargains made by individuals, businesses, and other groups, such as unions.

Table I shows the change in the percentage share of the Nation's total personal income received as different income shares during the entire 1939–52 inflation period and during each of the three subperiods containing the major inflationary bursts making up the total inflation. It is important to remember that during World War II inflation was intermingled with a strong recovery from mass unemployment, while the two postwar inflations began from positions of very modest unemployment.

[3] This section leaves aside temporarily the effects arising because different groups have different balance sheet positions, some having more accumulated debts or assets than others. This factor is considered in the next section.

TABLE I.—*Change in share of total personal income, 1939–52*[1] *(as percent of total)*

	1939–52	1939–46	1946–49	1949–52
1. Total labor income	+6	0	+3	+3
2. Unincorporated businesses	−1	+4	−4	−1
Nonfarm	0	+2	−2	0
Farm	−1	+2	−2	−1
3. Rental income	0	0	0	0
4. Interest income	−4	−4	+1	−1
5. Corporate profits after tax[2]	−1	+1	−1	−1
(a) Dividends only	−2	−2	0	0
6. Corporate profits before tax[2]	+3	+4	−1	0

[1] Data from U. S. Department of Commerce.
[2] This line not strictly comparable, since "personal income" does not include corporate profits except for distributed dividends. Gains and losses do not balance, for this reason and because other items are omitted. However, calculations are substantially in keeping with the way the data are prepared.

Table I shows that labor income rose substantially as a share of total personal income during the long inflation period (from 64 percent in 1939 to 70 percent in 1952), and that about half of this 6-point gain occurred during each of the 2 postwar inflationary bursts. The unincorporated business share gained rapidly during World War II, but then fell back continuously during the postwar inflations. Corporate dividends and total profits after taxes fell by 2 and 1 points, respectively, during the entire inflation period, although corporate profits before income and profits taxes rose by 3 points, the spread reflecting the large increases in Federal corporations taxes during World War II. If we consider movements within the three subperiods, the wage and salary share appears to have grown least rapidly, or even have fallen slightly, during the months when prices were rising most rapidly. Unfortunately, the roughness of the data and the absence of a clear-cut lead-lag theoretical model make such detailed analyses of the exact timing of price and relative share changes of doubtful significance. Thus the emphasis here is only on the broad picture of "before and after" positions for the major periods. Table I presents the data separately for the 3 inflationary periods, to indicate the substantial differences between the World War II inflation, which was part and parcel of a huge recovery from mass unemployment, and the 2 postwar inflations which began from positions of relatively full employment, as defined above.

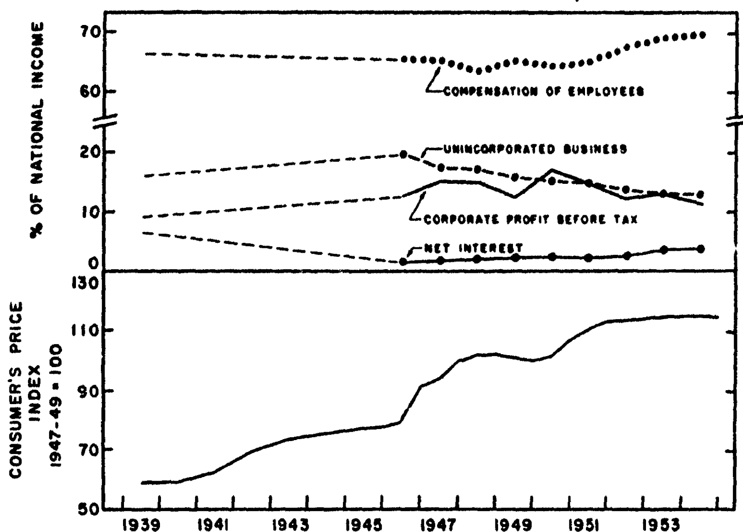
These figures, while indicating substantial changes in relative income shares during the inflation and sharp reduction in the already small interest share during World War II, do not show drastic changes overall. Nor are the changes in the three subperiods all the same in direction or in magnitude. The large increase in the labor share during the two postwar inflations, after removal of most wage and price controls, is the most striking result, counter to many statements that wage earners lose in inflation. The decline in the shares of unincorporated businesses and of corporate profits after tax also conflict with some commonly stated propositions about inflation.

Slightly different results are obtained if the Department of Commerce national income data are used instead of the personal income data above; the main difference is that the national income data report incomes before transfer payments such as social security and dividend payments. Figure 1 shows the four major income shares, as percent of total national income, from 1939 to 1952; annual data are

used after 1946 but are omitted during World War II when annual shifts were influenced heavily by special war developments such as intermittent changes in legal controls over wages and different prices. The BLS Consumer Price Index is also plotted to facilitate comparison with the timing of price-level changes. The picture shown by the national income data differs mainly in that the rise in the labor share is less striking than with the personal income data. Otherwise, the results are similar. (In fig. 1, relative income shares are plotted at the midpoint of each year, after 1945; the Consumer Price Index is plotted semiannually.)

FIGURE I

SHARES OF NATIONAL INCOME IN INFLATION, 1939-54



In both table I and figure 1, it is important to remember that types of income are shown, not the incomes of particular or typical individuals. Although most individuals receive the bulk of their incomes from 1 source, usually wages or salary, many receive income from 2 or more of the sources shown. Thus neither table I nor figure 1 necessarily represents what happened to particular individuals during the inflationary periods shown. Nor is there any necessary connection between source and size of income; wage and salary recipients are not necessarily poor men, nor rent receivers rich men.

Two further special warnings concerning these figures are in order. First, they picture what did happen to the different income shares during inflation, but they do not necessarily mean that inflation caused the changes shown. Many forces are at work simultaneously in such periods, and possibly inflation alone would have produced quite different income shares. But the data do tell us that any inflation-produced forces counter to the results shown were at least relatively weak, since they were overcome by other forces at work.

Second, the income shares shown are by large groupings. They obscure the vast differences between different individual income re-

cipients within the totals. Wage rates in different industries and different occupations rose at very different rates during the inflation. Individual interest and pension receivers lost far more drastically than the table suggests when their incomes were completely fixed; over the period roughly half the purchasing power of their current income was wiped out. Dividends on some stocks rose very rapidly while those on others vanished. Figure 1 and table I provide only overall, global data.

The relatively stable distribution of income except for the strongly growing labor share during more than a decade of pronounced inflation may be attributable partly to the fact that inflation was anticipated to about the same degree by the major economic groups concerned, and hence the income status of each was largely protected in the economic contracts reached. There is considerable evidence that inflation played an important role in such bargaining, especially in wage-contract talks and in product-pricing practices, at least as a stated justification for price increases. But there is surprisingly little evidence in consumer spending and asset-management behavior of adjustment to long-continued inflation. Nearly all household groups continued to be heavy net creditors, and the Federal Reserve-Michigan Survey Research Center field surveys repeatedly found little evidence that consumer spending and saving behavior was heavily influenced by the likelihood of continued inflation, perhaps because many consumers were uncertain as to how long inflation would continue. The short Korean war buying spree may be an exception, but this appears to have been more war-scare than inflation-scare dominated.

There is no clear evidence that inflation as such significantly affects the size distribution of income. Since the crucial factor in inflation-period current income gain or loss is relative flexibility of income, there is no general presumption as to the effect of inflation on the size distribution of income. It is commonly said that inflation helps the high income groups, possibly because profits are said to gain in inflation relative to wages and profits accrue mainly to the high income groups. But this reasoning is not supported by the data above. Moreover, the upper income groups are the major recipients of interest, which share dropped substantially in the World War II inflation. Available data show considerable stability in the size distribution by income (before taxes), with a small decline in the share of the top 5 percent. But there is no evidence that even this moderate change was caused by the inflations during the change over the last quarter century. Sufficient evidence is not available to warrant any general conclusion on the impact of inflation on the size distribution of income, though it seems very unlikely that the 1939–52 inflation exerted a significant income redistributional force against the lower income groups.

Effect on Ownership of Assests (Conclusions 6, 7, and 8)

Inflation transfers real purchasing power from debtors to creditors, since debtors repay dollars of less purchasing power than they borrowed. A rough estimate of the total loss to creditors during the 1939–52 inflation can be calculated by taking the $321 billion total of monetary assets (i. e., assets representing fixed dollar claims on debtors) held in the economy in 1939, and calculating the loss result-

ing from the 91-percent rise since then in the BLS consumer price index (as a rough guide to the decline in purchasing power of the dollar). Making a similar calculation for the additional monetary assets accumulated each year, and converting all the resulting losses to 1952 prices, the total loss of purchasing power to creditors through the 1939–52 inflation was (very roughly) around $500 billion.[4]

Who are the debtors and creditors affected by such transfers of purchasing power in inflation? Table II gives a broad picture, by major sectors of the economy? This table shows the net creditor or debtor position, for selected years, of each of the major sectors of the economy. Households are clearly the main net creditor, while government (primarily the Federal Government) is the major offsetting net debtor. Unincorporated businesses and financial corporations were by 1949 slight net creditors, while nonfinancial corporations were moderate net debtors. While ultimately we are interested in the individuals or households behind such groups as businesses or governments, it is useful to view the economy first as divided into these major sectors. In all cases, debtor-creditor status is calculated by taking the difference between total monetary assets (credits fixed in dollar terms) and monetary debts for the sector concerned. While satisfactory data are not available for later years, there does not appear to have been a drastic change in the relative positions of the different sectors.

TABLE II.—*Net debtor and creditor status of major economic sectors, 1939–49*[1]

[In billions of dollars]

	1939	1945	1949
Households	+87.0	+230.2	+249.2
Unincorporated businesses	+2 5	+19.0	+15.7
Financial corporations	−2 9	+10.1	+16.9
Nonfinancial corporations	−25 3	−6.4	−17.4
Government	−64.2	−244.2	−236.6

[1] Data from Raymond Goldsmith, A Study of Saving in the United States, vol. III, tables W–14, 15, and 16. Positive figure shows net creditor status, negative figure net debtor status.

Inflation clearly transfers purchasing power heavily from households to the Federal Government. Bondholders lose potential purchasing power as prices rise. But who is the Government? Who ultimately gains through the Government from inflation? The answer depends largely on whether we assume that the Federal debt will be paid off through taxes or more or less continually refunded.

If the Federal debt is to be paid off through taxes, it is the taxpayers who gain from the Government's heavy debtor status when inflation hits. If we assume the taxes used to retire the debt would be in proportion to those now in force, all taxpayers would gain proportionately as debtors through the Government. If, however, the Federal debt is to be continually refunded, taxpayers gain as debtors only to the extent the real burden of annual interest charges is reduced. As the debt is refunded, the new bond buyer pays current value dollars for a fixed-dollar-value bond, so he reaps no corresponding debtor's gain. The debtor's gain in this case is spread throughout the population roughly in proportion to the amounts they spend. The bond-

[4] Calculations are based largely on data provided by Raymond Goldsmith, A Study of Saving in the United States (Princeton University Press, 1955), tables W–14, 15, and 16.

holders' real purchasing power has been reduced because the dollars they receive will buy less; the claims they can exercise in buying current output or assets are correspondingly reduced. This means that with any given incomes and monetary assets everyone else in the economy finds it relatively easier to buy goods, services, and assets without bidding up prices. The net debtor gain is widely diffused. If, following the inflation, lack of adequate purchasing power and unemployment occur, the reduced real purchasing power of inflation-hit bondholders may reduce the likelihood of recovery.

Nearly all major groups of householders are substantial net creditors. Table III shows the total assets of households classified by several characteristics, the debts of each group, its monetary assets, and its variable price assets, all as percent of total assets to facilitate intergroup comparison. Monetary assets are those which represent fixed dollar amount claims on debtors (primarily bank deposits, Government bonds, and insurance and pension reserve funds). Variable price assets are those whose dollar prices may vary during inflation, such as houses, farms, common stocks, ownership of unincorporated businesses, and automobiles. Table III thus provides relatively detailed information on which types of households stand to lose most from inflation because of their net creditor status, or in rare cases to gain because they are net debtors. When monetary assets exceed debts, the household is a net creditor. Even here, however, it is important to remember that individual households' positions vary widely, and the data shown provide only a general picture for different types of households, rather than a true picture of any particular household.

TABLE III.—*Assets and debts of households, early 1950* [1]

	Percent of all household	Total assets (billions of dollars)	As percent of total assets		
			Monetary assets	Variable price assets	Debts
All households	100	613	24	76	11
By 1949 money income before taxes:					
Under $1,000	14	39	19	81	12
$1,000 to $2,999	40	119	26	74	13
$3,000 to $4,999	29	150	27	73	16
$5,000 to $7,499	11	107	25	75	12
$7,500 and over	5	188	19	81	5
By occupation:					
Professional and semiprofessional	7	61	32	68	10
Managerial	4	40	27	73	12
Self-employed	8	155	16	84	6
Clerical and skilled	41	136	29	71	18
Unskilled	12	23	31	69	14
Farm operator	9	97	13	87	12
Retired	5	55	31	69	2
All other	14	46	28	72	8
By net worth in 1950:					
Negative net worth	5	2	30	70	490
$0 to $1,900	33	17	46	54	33
$2,000 to $9,900	34	117	29	71	20
$10,000 to $24,900	18	162	24	76	9
$25,000 to $59,900	7	135	22	78	6
$60,000 and over	3	180	17	83	3
By age of head of household:					
18 to 24	10	9	23	77	20
25 to 34	23	69	22	78	27
35 to 54	40	285	24	76	12
55 and over	26	244	23	77	4

[1] Data from Goldsmith, op. cit., tables W–46, 47, 48, 49, based in turn primarily on Federal Reserve-Michigan Survey Research Center survey of consumers finances for early 1950. Total households columns may not add to totals because of minor unascertained items and rounding.

EFFECTS ON BUSINESS FIRMS (CONCLUSION 9)

Table I and figure 1 indicate that unincorporated and corporate profits fell slightly as a share of national income during the post-World War II inflations. This is contrary to the common belief that business profits rise relative to other income shares in inflation, both because business costs (especially wages) lag behind selling prices and becaue businesses are net debtors, gaining thereby from inflation.

During the recent American inflation, neither wages and salaries as a share of total income nor hourly wage rates lagged behind rising commodity prices on the average. Raw materials, another major cost for many firms, varied widely in rate of price increase, but in general rose more rapidly than finished commodity prices. Under prevailing accounting practices, both depreciation charges and inventory costs tend to be understated in inflation, and long-term interest and rent charges lag behind selling prices. But on balance, the rapidly rising costs appear to have overweighed the lagging costs for the two postwar inflation periods studied.

Nonfinancial corporations are substantial net debtors as a group (table II) and gained appreciably thereby from inflation. The unincorporated businesses and financial corporations are more than offsetting net creditors. Thus, businesses as a whole are net creditors to a moderate extent (according to latest available estimates), and during inflation suffer relative to debtor sectors of the economy on this account.

Debtor-creditor status appears clearly to be subordinate for nonfinancial corporations as a group and for most individual companies to current operating factors as a determinant of relative gain or loss during inflation periods. Detailed analysis of a random sample of some 50 nonfinancial corporations listed in Moody's indicates that—

(1) The net creditor companies outperformed the net debtor companies by a small margin during the entire 1939-52 inflation period, and during the three subperiods of 1939-46, 1946-49, and 1949-52, using increase in rate of return on investment as the measure of performance for each period.[5]

(2) The net creditor companies outperformed the net debtors during 2 of the 3 subperiods, but not in the third, using increase in the market price of the company's common stock as the measure of performance.

(3) Net debtor or creditor status was far less important in determining individual company performance, as judged by the two measures indicated in (1) and (2), than was the company's increase in sales volume. It was also apparently less important than the particular cost-price lead-lag relationships for the company, through this relationship could not be tested directly.[6]

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[5] A net creditor company is defined as one whose monetary assets (assets fixed in dollar value, such as cash, receivables, and Government securities) exceed its monetary liabilities (liabilities fixed in dollar terms, such as notes and accounts payable, bonds, and accrued taxes).

[6] The significance of debtor-creditor status in determining company performance was tested by computing rank correlations relating the rank of different companies in the sample in debtor-creditor status to their rank on the two different performance tests. Similar rank correlation tests were applied to assess the relative importance of increase in sales volume and other income statement factors in explaining varying economic performance during inflation.

(4) While nonfinancial corporations as a whole are net debtors, possibly as many as one-third of the total are net creditors, and many companies shift from one status to the other quite frequently.

While this sample may not represent accurately the performance of all nonfinancial corporations during the recent American inflation, it strongly suggests that such corporations are not necessarily large gainers from inflation because of being net debtors, and that in any case net debtor or creditor status is considerably less important in determining overall economic performance than are current income account factors, even during substantial, continued inflation.

EFFECT OF TAXATION ON WORKERS

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It might be said that the effect of taxation on workers is the same sense of irritation and frustration that overcomes anyone who finds that money to which he would otherwise be entitled has to be transferred to a seemingly remote outsider, the Government.

Yet, despite this feeling of irritation that the word "taxes" arouses in every individual, there is every evidence that workers and workers' organizations have displayed an interest in tax policies and a recognition of tax needs that rises above the frailties of human nature.

Naturally enough, the average worker's interest in taxation starts from the question, How much do I have to pay? In a very real way, changes in tax rates have just as important a bearing on the worker's standard of living as changes in his rate of pay. When the individual income-tax rates were increased in November 1951 to meet the cost of the Korean war, this was equivalent at that time to a 1- to 3-cent per hour wage cut to the average factory worker (the impact varying with the number of dependents).

The steady rise in taxes paid by the average worker has served to stimulate his interest in tax questions. This does not mean, however, that workers have fought indiscriminately for tax reduction or that their primary emphasis has been to reduce their tax burden to a minimum.

Rather, the opposite is closer to the truth. On the whole, workers and the American people in general have accepted the responsibility of contributing to the cost of Government. They have recognized that payments to Government represent payments for services rendered. If Government, in turn, is efficient in spending the tax revenues, few complaints are made about having to meet required tax payments.

It has become commonplace to point out that today's Government has assumed an increasing role in our society. This increasing Government responsibility has naturally required an increase in revenues to finance these added expenditures. In general, workers have recognized that any specific Federal program which they support will require increased funds and, by the same token, increased taxes. There is a genuine recognition that not only the function of Government which directly redound to the benefit of workers but, in addition such

important functions as the task of a national defense, cannot be performed without adequate funds.

This attitude toward Government finances is illustrated by organized labor's views on budget and fiscal policy. For example, the American Federation of Labor has never favored or argued for a perpetually unbalanced budget, although it does not feel that the solvency of Government is endangered if a particular year's budget is not in balance. Generally, labor organizations believe that over the period of a business cycle the budget should roughly be in balance, with any sharply unbalanced budgets confined to years of low economic activity when expenditures for needed Government activities may far exceed available revenues.

Moreover, in supporting any new Government program, labor organizations have always been willing to answer the question: Where is the money coming from? This has been an issue, for example in such diverse matters as the initiation of a program of Federal aid to education and the development of an improved system of interstate highways. In general, labor organizations have felt that these new programs should be financed through the regular budgetary sources of revenue (with the attendant possibility that additional tax revenues might be required) rather than special types of Government bond issues which might circumvent the budgetary processes.

Nowhere has this point of view on fiscal policy been more sharply expressed than with regard to specific decisions involving the status of the trust fund created under the old-age and survivors insurance program. In proposing at various times substantial increases in benefits to be paid under the OASI program, organized labor could easily have suggested that the substantial surplus in the trust fund be utilized to finance these added benefits without any increase in the employer or employee contributions. For example, in 1954 the surplus of the trust fund amounted to over $19 billion, an amount that could easily have financed for some time the higher benefit payments Congress voted in that year. Yet in appearances before congressional committees discussing this issue, both the A. F. of L. and the CIO strongly favored an increase in the employer and employee contribution rate because they recognized that the burden of paying the additional benefits would jeopardize the long-term actuarial soundness of the OASI trust fund.

These examples are cited not in any attempt to indicate that labor organizations have completely embraced orthodox financial views, but merely to demonstrate the degree of thoughtfulness and responsibility with which workers and their organizations have approached problems of taxation and fiscal policy.

The workers' special stake in tax policy stems from the fact that they pay most of the taxes. This fact is difficult to substantiate statistically because income and tax figures cannot be isolated for particular groups in the economy. However, the most recently available data from the Treasury Department's Statistics of Income show that in 195[illegible] wage and salary payments amounted to over 80 percent of the total income reported on all Federal income-tax returns. The extent to [illegible] workers pay other types of taxes, including taxes to State and [illegible] governments, is impossible to estimate accurately, but upon refl[illegible] seems clear that the bulk of the revenue received by all

government units comes directly from wage earners and their families.

With such a high stake in tax policy, workers want to make certain that the burden of taxation in the United States is distributed equitably throughout the country and among all groups in the population. This principle of equity is the one factor to which workers look first in discussing matters of tax policy. They are mindful, however, of the various other criteria that any tax system should meet. They recognize, for example, the close relation between taxes and the functioning of our economic system and the necessity for tax policy to contribute to an expanding productive economy.

First, and foremost, however, come considerations of equity. This is, of course, a difficult concept to define and even more difficult to write into law. Nevertheless, it can be said that the American people have generally accepted the view that the most important factors by which to judge an individual's capacity to pay taxes are his income and his family status. From this has come the commonly accepted belief that the most equitable type of a tax is a progressive tax on all income received after deductions based on family status. A tax system which places primary reliance on the progressive income tax provides the only basis for making certain that taxes will fall at least roughly in relation to an individual or a family's ability to pay.

Unfortunately, the tax structure in the United States today, considering the State and local as well as the Federal system, can hardly be termed a model of equity. A carefully documented study analyzing the impact of 1948 taxes on families at all income levels concludes that for families with income below $7,500, there is little if any progressive character to the United States tax structure.[1] This is a source of real concern not only for workers alone, but for all individuals interested in an equitable tax structure.

In today's tax structure, each type of tax carries with it a different impact—or incidence—on families in different income groups. The Federal individual income tax retains its progressive character although a number of provisions adopted in recent years have the effect of benefiting only the higher income groups. Taxes on consumption, like the Federal excises and the various State sales taxes, fall most heavily on families at the lower end of the income scale. There is considerable uncertainty concerning the incidence of the tax on corporate income although undoubtedly part of this tax is passed on to consumers in the form of higher prices.

A nation's tax system normally includes different types of taxes levied for different purposes and falling with varying impact on different groups in society. No one expects every single tax imposed by the Federal, State, and local governments to meet the same standards of equity as the progressive income tax. For example, the Federal payroll tax of 2 percent on all wages covered by the OASI program is clearly regressive, but workers accept it as such because they are willing to pay this price as the cost of maintaining a contributory system of social security.

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[1] R. A. Musgrave and others, Distribution of Tax Payments by Income Groups, National Tax Journal, March 1951, p. 1. See also Further Considerations of the Distribution of the Tax Burden, National Tax Journal, March 1952, particularly table 2, p. 19.

The important question is whether, on balance, a particular tax system is equitable to all sections of society. On this point, there is every reason to believe that the tax structure in the United States today can and should be modified to make it more equitable.

In the remaining part of this article, attention is called to a number of tax issues concerning which measures could be taken to eliminate current inequities. No attempt has been made to include all pertinent points of today's tax program. Rather, the attempt has been to single out those features which have special interest for workers and regarding which unions have made specific recommendations. Obviously, for reasons of space, each of these questions is given only summary treatment.

INDIVIDUAL INCOME-TAX RATES

The most equitable aspect of today's tax structure is the system of rates promulgated by Congress for the individual income tax. Starting at 20 percent, the rates increase gradually to the top bracket rate of 91 percent for all taxable income over $300,000.

To the casual observer these rates appear almost a model of progressivity. However, the rates themselves may be misleading. Many of the rates in the higher brackets are seldom utilized because many individuals with such high incomes can so manage their financial affairs that a significant portion of their income is brought within the purview of other sections of law which do not call for such high rates. By the use of provisions concerning family trusts, capital gains, and income splitting, individuals with high incomes can substantially reduce their tax liability. It would seem desirable for Congress to consider the extent to which these special provisions have in effect nullified the progressive character of the Federal income tax.

At the lower end of the tax schedule, a serious question arises concerning the validity of the initial 20-percent rate. In effect, any income above $800 earned by an individual is taxed at this rate while any married man with a family of 4 is similarly taxed for all income over $2,700.

For some time the American Federation of Labor has felt that any additional tax reductions in the income-tax field should be taken by splitting the first bracket rate and establishing a lower rate on at least part of this income. One specific proposal that has been made is to tax the first $500 at a 10-percent rate and the remaining $1,500 of the first income tax bracket at the standard 20-percent rate. A move of this type would introduce a greater degree of progressivity into the income-tax structure.

INCOME SPLITTING

The split-income provision was enacted in 1948. It allows all married couples to be taxed as though their combined income had been equally divided between the two.

The effect of the 1948 change has been a substantial reduction in tax liability for all married persons in the upper income brackets. For example, the resulting tax reduction (outside the community property States) is $5,220 for a husband with $40,000 taxable income; for a $100,000 taxable income, the saving is $13,680 while for $200,000 income, it is $22,180.

At the time of its adoption, this change was defended as necessary in order to correct an inequity between married couples in the original eight community property States who could by law split their income and those in the rest of the country who could not. It is true that the change in the law does remedy this difficulty but only at the cost of considerable revenue and a critical loss in the progressive character of the income tax.

Workers receiving the benefits of the split-income provision enjoy this special tax advantage as much as anyone else. However, only those workers whose income reaches beyond the first bracket rate are able to gain any advantage from this particular section of the law.

To correct this inequity, it would not be necessary to return to the former system under which income splitting was permitted in some States and not in others. A far more practical solution which could be applied uniformly across the country would simply be to develop a separate and higher tax table for married couples. In this way, income splitting would be permitted in all States, but the tax rate that would be applied on such split income (after the normal deductions) could be the same effective rates that would be applied to the taxable income of a single person. The result would be a far more equitable system of taxation.

Taxation of Dividends

The 1954 tax revision law introduced many changes into the Nation's tax system. By far the most inequitable from the point of view of the worker were the special provisions adopted concerning dividend income.

These provide that taxpayers may exclude from gross income the first $50 of dividend income received. In addition, a credit of 4 percent of total dividends is permitted against the individual's income tax liability.

Workers generally do not own stock and do not receive dividends. In fact, careful research has disclosed the fact that only 8 percent of United States families (spending units) own publicly issued common or preferred stock in American corporations. Additional findings of this study make it clear that stock ownership is concentrated in the higher income brackets.[2]

An examination of the Treasury Department data shows clearly how the dividend credit works almost entirely to the benefit of the higher income groups. Of the 42.6 million taxpayers filing returns in 1951 only 3.5 million or 8 taxpayers out of each 100 list dividends as a source of income. For the 8 million taxpayers with total income of between $600 to $2,000, only 3 taxpayers out of each 100 received dividends. By contrast, in the income groups above $25,000, from 72 to 96 taxpayers out of each 100 taxpayers listed dividend income.[3]

Equally significant is the fact that the taxpayers with income below $4,000 who do own stock save only a limited amount under the dividend relief provision, while those in the income groups above $10,000 will save amounts ranging on the average from $105 at the $10,000 in-

[2] 96 percent of all spending units with 1954 income below $3,000 did not own any stock. This percentage declines with increases in income; only 65 percent of all spending units with income over $10,000 did not own stock. 1955 Survey of Consumer Finances: The Financial Position of Consumers, Federal Reserve Bulletin, July 1955, p. 622.

[3] Statistics of Income for 1951, pt. I, U. S. Treasury Department.

come level to $36,555 in the group with income over $1 million. Larger savings for each stockholder and a higher percentage of stockholders in the upper income groups therefore will combine to give these taxpayers a disproportionately large share of the tax reduction on dividend income.

COSTS OF DOING BUSINESS VERSUS EXPENSES OF EARNING A LIVING

A farmer or an individual owning his own business is naturally entitled to deduct from his gross income the regular expenses of conducting his business.

The wage earner has certain comparable costs but only a few of these can be deducted for income-tax purposes. Dues to labor unions or professional societies and the cost of workers' uniforms are a few of the specific occupational costs that can be deducted from an individual worker's income.

One problem that arises in this regard involves the cost of taking special training or educational courses. If these are borne by the employer, their cost can be deducted as a regular business expense, but the individual worker seeking to improve his skills by enrolling for such courses finds that no comparable deduction is permitted.

Another problem involves the cost of traveling to and from work. The wage earner is not permitted any deduction for this traveling expense. Neither presumably is any other taxpayer.

However, anyone utilizing his car in his own business is entitled to claim auto expenses as a regular business deduction. For him, the difficulties of isolating allowable automobile expenses are almost insuperable. The net result is that without ever intending to claim additional mileage expense, the individual who is self-employed gains a tax advantage over the wage earner.

These items are not cited in any attempt to draw an invidious comparison between the tax burden of workers and other groups in society. It is important, however, to make clear that some aspects of our tax laws have the effect of favoring the individual in business for himself without granting similar advantage to the wage or salary worker.

DEPLETION ALLOWANCE

Under the current revenue laws, the extractive industries (oil, natural gas, coal, together with various minerals and metals) occupy a unique position. They alone are entitled to the coveted depletion allowance.

The defense for this special allowance becomes weaker each year. In early days the privilege of calculating the special allowance was allowed for only the oil and natural-gas industries. It was claimed that such an allowance was necessary to encourage expansion and additional production of these important sources of energy. As years have passed, Congress has added more and more industries to the list of those entitled to this privilege, so that today all industries that extract any type of useful material from the ground can claim the allowance, whether or not the item is in short supply. Among the commodities in danger of depletion for which this special allowance is given are sand, gravel, stone, and salt.

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Workers do recognize that business firms are entitled to deduct as a legitimate expense the cost of wear and tear on their machinery, plant, and equipment. Congress has set forth specific ways in which this wear and tear or depreciation is to be calculated for income-tax purposes. In fact, a completely new and far more generous method of calculation was included in the 1954 income-tax law. It should be noted, however, that in the case of the extractive industries the depletion allowance is calculated not as a percentage of the cost of the machinery or equipment, but as a percentage deducted from the gross income of the enterprise. Moreover, depletion allowance continues to be deductible even after the owner of the property has recovered, tax free, 100 percent of his invested capital.

The results of this special favoritism for the extractive industries may not have been clear at the time the depletion allowance was first adopted. By now, though, it seems obvious that by this device these industries are simply not paying their full share of taxes. The depletion-allowance industries have become a haven for all individuals seeking a tax-favorable outlet for their accumulated capital.

Whatever special circumstances might have been warranted at one time no longer prevail. Particularly with the very generous depreciation provisions in the 1954 law, there is no further reason for continuing these excessive depletion allowances. As former President Harry Truman stated in his 1950 tax message:

> I know of no loophole in the tax laws so inequitable as the excessive depletion exemptions now enjoyed by oil and mining interests.[4]

CAPITAL GAINS

To the worker this appears to be a most peculiar and puzzling tax. To him it seems clear that the income acquired from selling a capital asset at a profit has as much buying power as any income earned through wages or salaries. Yet the tax treatment of the two types of income is vastly different. It is difficult to explain to the average worker why, under our tax system, only half the income from selling a capital asset (assuming it has been held for over 6 months) is taxable and that the maximum rate at which the total gain can be taxed is 25 percent.

The present tax treatment of capital gains provides a special advantage for those individuals who can so manage their affairs that much of their income is accrued in the form of capital gains. It is unfortunate but true that recent legislation has encouraged this trend by extending capital-gains treatment to additional types of income. No such advantage is open to the ordinary wage earner, with his limited financial resources. Steps should be taken to close this wide gap in the treatment of these two types of income. Certainly the 6 months' period which encourages speculation should be extended to 1 year, and the 25-percent rate should be raised substantially.

COLLECTION OF TAXES

In the last analysis the details of tax legislation tell only part of the story of how the burden of taxation is distributed. Another important aspect concerns the extent to which these tax laws are en-

[4] Message from the President, January 23, 1950. H. Doc. 451, 81st Cong., 2d sess.

forced, the extent to which tax collections equal the full amount of tax liability under the law. A taxpayer not reporting his full income in effect is not contributing his full share of taxes.

This problem, of course, will arise even under the most equitable tax system. Individuals cannot be expected to demonstrate much enthusiasm for paying taxes. The Treasury Department insists it does not want any taxpayer to pay any more than his lowest legal tax, and there will always be those who will take positive steps to avoid contributing even this amount.

If evasion is only a problem involving particular individuals, an alert enforcement staff can do much to keep tax avoidance at a minimum. The problem becomes more serious, however, if certain groups of citizens or certain types of income are more susceptible to tax evasion. This seems to be the situation today in the United States.

Workers are particularly concerned with this question because, through the withholding system, Uncle Sam makes certain that taxes levied on wage and salary income are automatically collected. This is not true for other types of income.

However, it is difficult to obtain accurate information on the extent to which tax collections are equivalent to tax liability. There is little current data on this problem. The Joint Committee on the Economic Report might find it desirable to urge the Treasury Department to develop additional statistics on this subject.

Some work, however, has been done in this field. The data that have gained the most general acceptance are the result of a special analysis of 1944–46 income-tax returns. In this study, a comparison was drawn for various types of income between the total reported in the income-tax returns and the aggregate amount of such income as determined by the personal income series of the Commerce Department. In summary, the following table shows the major results of this study for the year 1946:

Consumer money income, 1946 [1]

[Millions of dollars]

Type of income	Personal income series adjusted for comparability with tax returns	Reported according to tax returns	Percent reported
Civilian wages and salaries	$102,640	$97,409	95
Nonfarm entrepreneurial income	20,816	23,136	71
Farm entrepreneurial income	11,929		
Interest	2,989	1,105	37
Dividends	4,933	3,730	76
Fiduciary income to individuals	1,120	1,108	99
Rent	4,013	1,799	45

[1] Goldsmith, Selma, Appraisal of Basic Data Available for Constructing Income Size Distributions, pt. VI. Studies in Income and Wealth, vol. 13, National Bureau of Economic Research, 1951, New York.

Estate and Gift Taxes

This has been a most neglected field of taxation. No major review of estate and gift tax policy has been made in recent years.

There is a serious question whether the Federal Government is receiving sufficient tax revenue from this source. The fact is that in this, the wealthiest nation of the world, revenue from estate and gift

taxes comprises only slightly more than 1 percent of the total Federal revenue. It would seem that there is substantial room for additional taxation in this field without involving any possibility of confiscating wealth or unduly limiting financial gifts.

Among the proposals that have been made to correct this inequity are a revision of the rate schedule, lowering of exemption, and greater integration of the gift and estate tax provisions.

State and Local Taxation

The emphasis in these hearings naturally is on Federal taxation. However, many of the most critical problems in the tax field have risen at the State and local level.

Since World War II, the Nation's growing and more mobile population has placed a greater strain on the traditional activities of State and local governments in such fields as education, law and order, highways, and sanitation facilities. As a result, sharply increased expenditures have been required which have strained the limits of the State and local tax systems.

In far too many instances, State and local governments have allowed their tax systems to deteriorate and become obsolescent. When in recent years these governments have finally awakened to the need for drastically overhauling their tax systems and obtaining additional revenue, too often they have looked for quick and easy answers to their tax problems.

At the State level, the simple solution to the quest for more revenue has been the regressive sales tax. Sales or gross-receipts taxes now form part of the tax systems of more than two-thirds of the States. Revenue from this tax amounts to 33 percent of the total tax revenue derived by these States. In 1954, 11 States derived more than 35 percent of their revenue from this source.[5]

When these taxes are added to other types of taxes on consumers, the figures show that a growing number of States obtain the bulk of their revenue by taxes on consumers.

Wide variants are found in the structure of various State tax systems. Some States include in their tax structure an effective revenue-producing income tax, both on individuals and corporations. In a number of cases, States which place such reliance on income taxes are thriving competitors of neighboring States which rely most sharply on consumer taxes. Opponents of the State income tax contend that it throttles business expansion but the fact remains that a number of State governments have developed a healthy industrial system within their borders and at the same time have obtained sufficient revenue without relying excessively on regressive consumer-type taxes.

At the local level, too few city and county governments have accepted the responsibility for maintaining an up-to-date tax system. This applies particularly with respect to the mainstay of local revenue systems, the real-estate taxes. In many jurisdictions, increasing inequities develop as improvements are overlooked, industrial and commercial property undervalued, and reassessments not conducted at regular intervals.

These constitute only a few of the State and local issues that must be met to develop a more equitable tax system.

[5] Bureau of the Census, Department of Commerce, 1955. Statistical Abstract, p. 408.

This brief summary serves to highlight major tax issues of concern to workers. It is to be hoped that the coming session of Congress will give major attention to these questions. Action is needed to eliminate serious inequities in the Nation's tax structure and to revitalize the principle that taxation be based on ability to pay.

EFFECTS OF FEDERAL TAXATION ON AGRICULTURE

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There are three Federal taxes that have a fairly significant direct impact upon agriculture. These are the personal income tax, the social-security tax, and the excise taxes on gasoline, lubricating oils, automobiles, trucks, and tires and tubes. What I shall discuss is the differential impact of these taxes on agriculture, since if the taxes had the same impact upon agriculture as on other sectors of the economy no special effects could be recognized.

THE PERSONAL INCOME TAX

The personal income tax has two differential effects upon income-tax payers who derive their major source of income from farming. First, an important element of the income of farm families is not defined as income for purposes of calculating the personal income tax. Included in this category are the incomes derived from home-produced food, home-produced fuel, and rented or owned housing. A related factor is that certain costs, such as some automobile expenses, can be charged as business expenses, though this is also true of other producer groups in our economy. Second, the personal income tax does not provide for averaging of income over a period of years. There is, however, a provision for a carryback of losses for 2 years and a carryforward of the remaining losses for a 5-year period. Since farm incomes fluctuate a great deal from year to year, many farmers with unstable incomes have to pay somewhat more in income taxes than do persons with a stable income.

These two factors operate, of course, in opposite directions. The first tends to reduce the income-tax liability of farm people compared, say, to an urban wage or salary worker with the same real or economic income, while the second increases the income-tax liability.

In an effort to try to evaluate the significance of these two factors, the position of farm families will be compared to that of wage or salary workers who have stable incomes from year to year.

I would first like to show certain hypothetical examples and then present some actual farm income data. In all of the hypothetical cases it is assumed that each family includes 4 persons and that the standard 10-percent deduction is taken. In the case of farm families, it is assumed that the value of nonmoney income is $900, of which $400 represents the value of housing. Table 1 shows the effect of the exemption of nonmoney income upon the income taxes paid by 4 types of families. One farm family is a renter, while the other is a farm owner. The one urban family rents a house or an apartment, while the other owns a house. The total income, money plus the value of nonmoney income, is assumed to be $5,000 for each of the

families. It is assumed that joint returns are filed. The value of the nonmoney income for the urban owner is assumed to be $100, which would represent a 1 percent return on a $10,000 house.

The last column of table 1 indicates that the two farm families each pay $258 in taxes, while the urban homeowner pays $318 and the urban renter pays $120. Under the assumptions made, the farm renter and owner remain in the same after tax position. This is because the farm renter is able to deduct as a business expense the rent paid on his house, since the house rent is not separated from the rent on the farm as a whole. However, the urban renter is in an inferior position, since he pays rent out of taxable income.

The purpose of table 2 is to illustrate the effect of fluctuating income, such as may occur on farms, on the total tax paid over a period of 2 years. The first part of the table illustrates an extreme case of zero net money income in 1 year and a net money income of $10,000 in the other year. For the moment, it is assumed that all income is taxable and a comparison is made to another taxpayer who receives $5,000 each year. The farmer with variable income (or any other person with variable income) would pay a total tax of $1,316, compared to $840 for the person with stable income. This is a very substantial difference, but, as noted, represents an extreme case.

Most of the difference in taxes in this comparison arises not because of variations in the marginal tax rates, but because the family loses the personal exemptions of $2,400 (for 4 persons) for the year that income is zero. If the net money income were $2,400 in the 1 year and $7,600 in the other, the income tax total would be $892.40. The difference that remains is due to the failure to realize the 10 percent standard deduction for the first year. If the income in the first year were $2,700 and $7,300 in the second year, the tax bill would be $841.70, or only $1.70 more than with stable income.

Table 3 is included to illustrate the combined effects of the exclusion of nonmoney income from taxable income and the fluctuating nature of farm income. Three degrees of variability are shown and the comparison is with an urban homeowner and an urban renter.

The results of the calculations in table 3 show about what we would expect from the discussion above. Whether the exemption of nonmoney income offsets the effect of income variability depends on how great the variability is. In example A the variation of income is sufficiently large as to more than offset the exclusion of nonmoney income from taxable income, while in example B the farmer would pay more tax than the urban homeowner but less than the urban renter. In example C the farmer pays less tax than either of the other two.

Table 4 presents information on the income of 10 farms for a period of 6 years. These farms have participated in farm business associations affiliated with a land-grant institution. Two income figures are given. In part I of the table the income data are the annual net incomes, including the value of nonmoney income. Food and related items have been priced at the prices farmers would receive for the items if sold, while the value of housing has been included at rather low figures averaging between $190 and $325 for the various years. In part II of the table the data refer to annual net money income, which is assumed to be the figure which would be reported for income-tax purposes. The average difference between the two income figures for the 10 farms for the 6 years is $762.

In table 5, I have estimated the annual average income tax, using 1955 tax rates, for these farms on the basis of 3 assumptions. The second column indicates what the tax would have been if all the income had been earned as money and the income each year had equaled the average for the 6 years. The third column presents the estimates of income tax for the net money income, assuming a steady annual income flow. The last column is an estimate of the actual tax paid by this group of farmers. In every case it was assumed that there were 4 exemptions and that the standard deduction for allowable expenses was taken (10 percent or $1,000, whichever was the smaller).

For the farms studied the variations in income resulted in only a relatively small increase in income tax. Farmer 9 had the biggest absolute increase (compare the last two columns) of $71. The largest relative increase was for farm 1 with an increase of 25 percent.

The fact that nonmoney income is not taxed is of some importance in reducing the income tax payments by farmers. Of course, many nonfarm people have nonmoney income, such as the urban homeowner or the family with its garden in a town or village. The comparison made here implies an urban worker who does not own his own home.

I was somewhat surprised to learn that variability of income may be more important for farm families with incomes averaging $3,000 to $4,000 than for those earning $10,000 to $15,000. The reason for this is that the family with the lower income may have an income in 1 year that is less than the value of the personal exemptions. This explains the situation of the first farm in table 5. In 1 year this family had a net money income of only $720. Thus $1,620 of personal exemptions went to waste, so to speak, since personal exemptions not used in 1 year can't be carried forward or backward.

It is not implied that the sample of 10 farms that I have presented is representative of American agriculture. The value of food and fuel that comprise the nonmoney income is about the same as the average for United States farmers that pay any income tax, namely between $450 and $500. The value of housing is probably less but by not more than $100. The annual variability of income for this sample is probably less than for some groups of farmers, particularly farmers in the Great Plains States.

The effects of the Federal personal income tax upon resource allocation are of two major kinds. First, the exemption of nonmoney incomes from the income tax means that individuals can afford to remain on farms for a smaller total or real income before tax than they could afford to accept for nonfarm employment, if that employment requires moving to an urban area. However, the tax may encourage part-time farming since part-time farmers produce about as much for home consumption as do full-time farmers. Thus the tax probably induces some people to remain in agriculture or on farms who would move to urban areas if all income, nonmoney as well as money, were taxed.

Second, those areas of agriculture that have large variations in income from year to year are taxed more heavily than other farm areas with less variability but the same average level of income over time. Allowing farmers to average their income over a period of years would make it somewhat easier for farm families in high risk areas to make more appropriate consumption and investment plans.

SOCIAL-SECURITY TAX

Many farmers are affected by the social-security tax in two ways. First, the farmer as an employer must withhold the tax on any employee's wages, where the employee meets the criterion for inclusion, and must pay the employer's contribution to the tax. Second, farmers must pay as earners of self-employment income a tax of 3 percent on the amounts so earned up to $4,200 per annum.

An examination of the social-security taxes indicates that farmers are treated like other similarly situated groups in the economy. While the combined tax paid as an earner is less than the amount paid jointly by an employer and employee, it is the same amount paid by other self-employed workers who participate in the social-security program.

EXCISE TAXES

Farmers, both as consumers and producers, buy certain items on which Federal excise taxes have been levied. The principal items are gasoline, diesel fuel, lubricating oils, automobiles, trucks, tires, and innertubes. It is not possible to indicate the overall incidence of these taxes. However, if all of these taxes were borne by the purchasers of the items taxed, farmers would probably pay a somewhat larger share of these taxes relative to their incomes than consumers and producers in the rest of the economy. All of these taxes are related to transportation in one way or another and the nature of agriculture requires relatively large amounts of transportation of both persons and products.

One aspect of the calculation of business expenses by many farms in the determination of income-tax liability may partially offset the effect of these taxes. Many farmers deduct about half of their automobile expense as a business expense. Since relatively fixed costs of operating automobiles—depreciation, insurance, and various fees—constitute a rather large share of total costs, charging part of these fixed costs as a business expense lowers the income-tax liability. Many other workers find owning a car to be desirable, but cannot deduct expenses of the car as a business expense if the car is used for going to and from work.

SUMMARY

The conclusion of this brief note may be stated as follows: The Federal tax structure does not place a disadvantage upon agriculture; it is probable that farm families gain relative to many other earners from certain provisions of the income-tax laws. The personal income tax does not apply to nonmoney income and farm families have much greater nonmoney income relative to money income than do people with other kinds of employment.

While the effect of income variability upon the total income tax paid for the farms included in my small sample was not very great, I think that it would be wise to allow income averaging over a period of 3 to 5 years. There is no reason why this provision should be restricted to self-employed groups. Many wage workers who suffer periods of unemployment may incur greater income-tax liability than they would if their incomes were stable.

TABLE 1.—*Federal personal income tax liability of farm and nonfarm persons: Hypothetical examples*

Taxpayer	Net income	Net money income	Taxable income [1]	Income tax [2]
Farm renter	$5,000	[3] $4,100	$1,200	$258
Farm owner	5,000	[3] 4,100	1,200	258
Urban renter	5,000	5,000	2,100	420
Urban owner	5,000	[4] 4,600	1,740	348

[1] Assuming 4 dependents and 10 percent standard deduction on net money income.
[2] Joint return filed by husband and wife. 1955 tax rates used.
[3] $500 from farm-produced items (food and fuel) and $400 as value of house.
[4] $400 as value of house.

TABLE 2.—*Effect of annual variations in net money income upon Federal personal income tax liability: Hypothetical examples*

Taxpayer	Year net money income	Taxable income [1]	Income tax [1]
Variable income:			
I	0	0	0
II	$10,000	$6,600	$1,340
Total	10,000	6,600	1,340
Stable income:			
I	5,000	2,100	420
II	5,000	2,100	420
Total	10,000	4,200	840

[1] See footnotes to table 1.

TABLE 3.—*Effects of exclusion of nonmoney income and variability of income upon Federal personal income tax liability: Hypothetical example*

Taxpayer	Net year income	Net money income	Taxable income	Income tax
Farmer A:				
1	$900	0	0	0
2	9,100	$8,200	$4,980	$1,006
Total	10,000	8,200	4,980	1,006
Farmer B:				
1	2,500	1,600	0	0
2	7,500	6,600	3,660	732
Total	10,000	8,200	3,660	732
Farmer C:				
1	3,300	2,400	0	0
2	6,700	5,800	2,820	564
Total	10,000	8,200	2,820	564
Urban renter:				
1	5,000	5,000	2,100	420
2	5,000	5,000	2,100	420
Total	10,000	10,000	4,200	840
Urban owner:				
1	5,000	4,600	1,740	348
2	5,000	4,600	1,740	348
Total	10,000	9,200	3,480	696

TABLE 4.—*Annual net income, including nonmoney income, and annual net money income, for 10 farms for 6 years*

I. ANNUAL NET INCOME, INCLUDING NONMONEY INCOME

Farm No.	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Average
1	$3,431	$5,036	$5,399	$1,197	$4,002	$7,975	$4,707
2	5,004	3,787	4,023	3,061	4,925	7,599	4,743
3	7,098	13,240	7,773	3,809	7,987	9,020	8,353
4	8,065	9,402	9,389	5,193	7,708	8,806	8,105
5	5,557	6,405	4,557	4,994	5,350	5,420	5,381
6	7,322	11,006	5,987	2,370	7,155	6,738	6,805
7	7,392	7,009	5,003	4,213	4,539	7,049	5,868
8	4,852	7,095	3,265	3,177	3,991	3,587	4,314
9	14,222	16,976	18,016	5,102	16,909	14,034	14,322
10	6,088	13,119	5,590	3,280	5,883	10,080	7,335

II. ANNUAL NET MONEY INCOME

Farm No.	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Average
1	$2,904	$5,045	$4,235	$720	$1,770	$7,096	$3,961
2	4,597	3,392	3,463	2,598	4,235	6,815	4,184
3	7,156	12,726	7,015	3,205	7,408	8,972	7,769
4	6,980	8,357	8,531	4,331	6,075	7,903	7,181
5	4,837	5,583	3,690	4,220	5,003	4,848	4,698
6	6,419	10,581	4,918	1,129	6,170	5,797	5,836
7	6,696	5,936	4,416	3,476	3,810	6,123	5,077
8	4,044	6,504	2,388	2,551	3,258	3,078	3,637
9	13,517	15,905	17,669	4,299	16,077	13,097	13,430
10	5,460	12,519	4,810	2,021	4,990	9,165	6,595

TABLE 5.—*Estimated average annual income tax under 3 assumptions: (1) stable net income; (2) stable net money income; (3) actual annual net money income*

Farm	Stable net income	Stable net money income	Actual annual net money income
1	$367	$233	$291
2	372	273	276
3	1,023	924	946
4	968	814	818
5	489	307	367
6	786	671	621
7	576	434	434
8	297	175	187
9	2,342	2,128	2,199
10	842	707	735
Average	806	663	697

THE INCIDENCE OF THE TAX STRUCTURE AND ITS EFFECTS ON CONSUMPTION

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The incidence of taxation and the effects of taxation on consumption are closely related. In order to appraise the latter, we must know something about the former. At the same time, they pose distinct policy problems. The determination of who should pay the taxes and the equitable distribution of the tax bill is one important

[1] I am indebted to the faculty research fund of the Horace H. Rackham School of Graduate Studies of the University of Michigan for a grant which permitted a revision of our 1948 tax-burden study, the results of which are here presented. Also, I am indebted to Mr. H. Runyon, of the department of economics of the University of Michigan, for assistance in carrying through this project.

consideration of tax policy. The choice between taxes which fall on consumption and taxes which do not is another consideration, involving a quite different set of factors. In some cases, the two will support each other, and in others they will conflict.

WHO PAYS THE TAXES?

I begin with my first topic, who pays the taxes. We have prepared in this connection a revision of our earlier estimates of tax burden distribution for the year 1948. While there have been no drastic changes in tax structure, the great increase in income since that time has rendered the earlier figures of little use for present purposes. The methods followed are more or less similar to those of the earlier study. While the calculations were made in less detail, some of the criticisms of the earlier study were taken into account.[2]

TABLE 1.—*Estimated distribution of tax payments for 1954*

[Percent of total yield contributed by income brackets [1]]

	Spending unit income brackets (thousands of dollars)							
	0-$2,000	$2,000-$3,000	$3,000-$4,000	$4,000-$5,000	$5,000-$7,500	$7,500-$10,000	Over $10,000	Total
FEDERAL TAXES								
(1) Personal income tax	1.6	3.7	8.0	10.2	28.3	13.9	34.3	100
(2) Estate and gift taxes					-		100.0	100
(3) Corporate profits tax	3.3	4.5	6.3	6.8	15.0	6.9	57.1	100
(4) Excises	8.2	9.8	14.4	14.8	28.2	10.3	14.3	100
(5) Customs	8.2	9.8	14.4	14.8	28.2	10.3	14.3	100
(6) Social-insurance contribution	0.8	10.3	17.9	18.5	28.6	8.6	9.1	100
(7) Total	3.7	5.6	9.7	10.9	24.4	10.7	35.0	100
(8) Without social-insurance contribution	3.2	4.9	8.5	9.8	23.9	11.0	38.7	100
STATE AND LOCAL TAXES								
(9) Personal income tax	.2	2.3	6.0	7.2	22.0	12.7	49.5	100
(10) Inheritance and gift taxes	-	-	-	-	-		100.0	100
(11) Corporate profits tax	3.3	4.6	6.4	6.8	15.0	6.9	56.9	100
(12) Excise and sales taxes	8.2	9.8	14.4	14.8	28.2	10.3	14.3	100
(13) Property	7.0	8.4	13.0	13.9	25.7	10.0	22.1	100
(14) Social-insurance contribution	4.7	8.8	13.2	18.8	30.8	11.5	12.1	100
(15) Total	6.9	8.5	13.0	13.9	26.3	10.1	21.3	100
(16) Without social-insurance contribution	7.0	8.5	12.9	13.6	26.0	10.0	21.9	100
ALL LEVELS OF GOVERNMENT								
(17) Total	4.6	6.4	10.6	11.8	25.0	10.5	31.2	100
(18) Without social-insurance contribution	4.3	6.0	9.8	10.9	24.5	10.7	33.8	100

[1] Based on appendix table A4.

[2] See R. A. Musgrave, J. J. Carroll, L. D. Cook, and L. Frane, Distribution of Tax Payments by Income Groups: A Case Study for 1948, National Tax Journal, March 1951; and R. A. Musgrave and L. Frane, Rejoinder to Dr. Tucker, National Tax Journal, March 1952. These will be referred to below as "1948 Study" and "Rejoinder," respectively.

TABLE 2.—*Estimated effective rates of tax for 1954*

[Tax as percent of income [1]]

	Spending unit income brackets (thousands of dollars)							
	0-$2,000	$2,000-$3,000	$3,000-$4,000	$4,000-$5,000	$5,000-$7,500	$7,500-$10,000	Over $10,000	Total
FEDERAL TAXES								
(1) Personal income tax	3.1	5.3	7.1	8.4	11.5	14.2	14.6	10.7
(2) Estate and gift taxes	...	...	...	...	...	...	1.4	.3
(3) Corporate profits tax	3.7	3.8	3.3	3.2	3.6	4.1	14.1	6.2
(4) Excises	5.0	4.5	4.1	3.9	3.6	3.3	1.9	3.4
(5) Customs	2.3	.3	.2	.2	.2	.2	.1	.2
(6) Social-insurance contribution	3.6	4.1	4.4	4.2	3.2	2.4	1.1	3.0
(7) Total	15.7	17.0	19.1	20.0	22.2	24.2	33.2	23.8
(8) Without social-insurance contribution	12.1	13.8	14.7	15.8	19.0	21.8	32.1	20.9
STATE AND LOCAL TAXES								
(9) Personal income tax	.01	.1	.2	.2	.4	.5	.8	.4
(10) Inheritance and gift taxes	...	...	...	...	...	...	.4	.1
(11) Corporate profits tax	.2	.2	.1	.1	.2	.2	.6	.3
(12) Excise and sales taxes	5.7	5.1	4.6	4.4	4.2	3.8	2.2	3.9
(13) Property	4.8	4.3	4.1	4.1	3.8	3.6	3.4	3.8
(14) Social-insurance contribution	.5	.7	.7	.9	.7	.6	.3	.6
(15) Total	11.2	10.4	9.8	9.8	9.1	8.8	7.7	9.1
(16) Without social-insurance contribution	10.7	9.7	9.1	8.9	8.4	8.1	7.4	8.5
ALL LEVELS OF GOVERNMENT								
(17) Total	26.9	28.3	28.9	29.8	31.3	33.0	40.9	32.9
(18) Without social-insurance contribution	22.8	23.5	23.8	24.7	27.4	29.9	39.5	29.4

[1] Ratio of tax allocations shown in table A4 to adjusted money income shown in appendix table A2 line (6).

TABLE 3.—*Effective rates using broader income concept* [1]

[Tax as percent of income]

	Spending unit income brackets (thousands of dollars)							
	0-$2,000	$2,000-$3,000	$3,000-$4,000	$4,000-$5,000	$5,000-$7,500	$7,500-$10,000	Over $10,000	Total
FEDERAL TAXES								
(1) Personal income tax	2.7	4.7	6.4	7.6	10.6	13.2	14.0	9.9
(2) Estate and gift taxes	...	...	...	...	...	...	1.3	.3
(3) Corporation profits tax	3.2	3.4	3.0	2.9	3.3	3.8	13.5	5.7
(4) Excises	4.4	4.0	3.7	3.5	3.4	3.1	1.9	3.1
(5) Customs	.3	.3	.2	.2	.2	.2	.1	.2
(6) Social-insurance contribution	3.1	3.7	4.0	3.8	3.0	2.3	1.0	2.7
(7) Total	13.7	16.1	17.3	18.0	20.5	22.6	31.8	22.0
(8) Without social-insurance contribution	10.5	12.4	13.3	14.2	17.5	20.3	30.8	19.3
STATE AND LOCAL TAXES								
(9) Personal income tax	.01	.1	.2	.2	.3	.5	.8	.4
(10) Inheritance and gift taxes	...	...	...	...	...	...	.4	.1
(11) Corporation profits tax	.1	.2	.1	.1	.1	.2	.6	.3
(12) Excise and sales taxes	5.0	4.6	4.2	4.0	3.9	3.5	2.1	3.6
(13) Property	4.2	3.9	3.8	3.7	3.5	3.4	3.2	3.5
(14) Social-insurance contribution	.4	.6	.6	.8	.6	.6	.3	.5
(15) Total	9.8	9.4	8.9	8.8	8.4	8.2	7.4	8.4
(16) Without social-insurance contribution	9.3	8.7	8.3	8.0	7.8	7.6	7.1	7.9
ALL LEVELS OF GOVERNMENT								
(17) Total	23.4	25.5	26.2	26.8	28.9	30.8	39.2	30.4
(18) Without social-insurance contribution	19.9	21.1	21.6	22.2	25.3	27.9	37.9	27.1

[1] Ratio of tax allocations shown in table A4 to broader income concept shown in appendix table A2, line (4).

RESULTS OF STUDY

1. Overall picture

A brief summary of the methods and the underlying data will be found in the appendix. The results are summarized in table 1 which shows the percentage distribution of taxpayments by spending unit income brackets. The data are for 1954 and both the Federal and the State and local tax structures are covered. In table 2 we show the so-called effective rates of tax, that is, the ratio of taxpayments to income received for the various income brackets. It is this ratio which we look upon to determine whether the tax structure is regressive or progressive, and by how much.

The estimated incidence of the total tax structure, including all levels of government and all taxes, is shown in line (17). We find that the incidence is progressive throughout the scale, although the degree of progression appears to be quite moderate over the lower and middle income ranges.[3] The picture for the Federal tax structure alone is more distinctly progressive as shown in line (7). That for State and local taxes is regressive as shown in line (15).

The general picture may be qualified in two ways. For one thing some people feel that social insurance contributions (all or in part) ought not to be counted since they go to purchase special benefits which are not included in the picture. While I don't quite subscribe to this view, those who do will find the overall picture excluding social-security taxes in lines (8), (16), and (18). As shown in line (8) this makes for a more progressive picture, especially at the lower end of the scale.

A second qualification arises from the definition of income. It will be noted that the distribution of taxpayments shown in table 1 is essentially independent of the income concept used. But the pattern of effective rates shown in table 2 reflects both the distribution of taxpayments and the distribution of income; and the distribution of income in turn depends on the particular income concept that is used. The pattern of effective rates shown in table 2 is based on a concept of adjusted money income, including outright money income as defined by the Survey Research Center[4] plus imputations for (a) capital gains and fiduciary incomes, and (b) retained earnings of corporations and the unshifted part of the corporation tax. The items under (b) must be included in the concept of income in order to permit a fair computation of effective rates because the entire unshifted part of the corporation tax is imputed to the shareholder.[5] Now it might be argued that this is too narrow a concept, that allowance should be made also for other items of imputed income such as rental value of residences, food consumed on farms, employer contributions to pension funds, and so forth. In table 3 we repeat the results of table 2, using such a broader income concept. Since the imputed income thus added is distributed more equally than money income, a somewhat larger fraction of total income comes to be allocated to the lower groups. Since

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[3] Note that incomes under $2,000 have been combined into one bracket, in place of the two $1,000 brackets shown in the 1948 study. This eliminates regressivity at the lower end for line (17). Combination of the two first $1,000 brackets is perhaps the safer procedure because the composition of spending units in these brackets poses some peculiar problems.

[4] Survey Research Center of the University of Michigan (hereafter referred to as SRC), the data of which provide the primary basis for this study.

[5] For a discussion of this point see 1948 Study, p. 10, and Rejoinder, p. 18.

the distribution of taxpayments remains the same, the pattern of effective rates becomes slightly more progressive for the case of the Federal and slightly less regressive for the case of the State and local tax system.

In appraising the total picture, we are thus left with four patterns, shown in lines (17) and (18) of tables 2 and 3. Which of these is the most meaningful pattern is essentially a matter of judgment. While I see good reasons for thinking in terms of lines (17) and (18) of table 2, some readers may wish to operate with the broader income concept; and others may wish to use an even broader base including, say, an imputed income for the services performed by housewives.

2. Particular taxes

We now turn to the role of particular taxes in bringing about this overall pattern of incidence.

Personal income tax.—Turning again to table 2, we find that the Federal personal income tax is the most distinctly progressive element in the tax structure. As shown in line (1), this feature does not only apply to the middle and higher income ranges but also at the lower end of the scale.[6] This, I think, is a factor of paramount importance for Federal tax policy and a strong reason for placing primary emphasis on the personal income tax. The progressivity of State income taxes is more moderate, as shown in line (9). In estimating the incidence of these taxes, we assume in both cases that income-tax payments stay put with the taxpayer.

Estate and gift tax.—The estate and gift tax is a highly progressive part of the tax structure. If we assume that the tax falls on the donor, we will not be far off if we allocate the total amount to the top income bracket. If we assume it to fall on the recipient, some of the burden might accrue to the lower brackets, but the amount will be small. While the estate and gift tax is a highly progressive element in the tax structure, its weight in the total picture is very slight.

Corporation income tax.—The estimated incidence of the corporation income tax, as shown in lines (3) and (11), follows a U-shaped pattern. It is more or less proportional or even regressive over the lower to middle range of the income scale and becomes progressive only in the higher brackets. This somewhat surprising result reflects two factors which enter the analysis. One factor is the assumption that two-thirds of the corporation tax is borne by the shareholder while one-third is passed on to the consumer. Thus one-third of the corporation tax is in fact treated as a sales tax, with a correspondingly heavier burden on the lower income groups. While I am not in a position to prove that this is the true ratio, I believe that theoretical reasoning as well as empirical observation renders this a much more defensible assumption than the standard textbook proposition that the corporation tax cannot be shifted except through its effects on capital formation.[7] A second factor is that the ratio of dividend to other

[6] Progressivity at the upper end of the scale appears more modest in our table than it actually is because all income above $10,000 is here combined into one open-end bracket. Also, note that the underlying concept of income imputes retained earnings to the shareholder, a procedure which increases income and reduces progressivity in effective rates for the top bracket.

[7] Also, there is a distinct possibility that part of the tax will be reflected in the wage bargain. The distributional implications of such "backward" shifting are more or less similar to those of "forward" shifting to the consumer. Thus the result would be changed but slightly if part of the one-third was shifted backward.

income is higher in the lower than in the middle income brackets, reflecting the importance of retirement income in the low brackets. To the extent that the corporation tax falls on the shareholder, the lower income brackets thus assume a proportionately larger burden than may be expected. Certain other methodological problems of the corporation tax case (in particular, the treatment of retained earnings and tax thereon) were discussed at length in the 1948 study and need not be repeated here.[8]

These results as well as certain other considerations[9] suggest that the corporation tax is not as progressive an element of the tax structure as some people believe it to be. Indeed, the popularity (insofar as taxes can be popular) of the corporation tax may well be due to the fact that its friends consider it to be highly progressive, while those who prefer it to the personal income tax suspect that in fact it is pretty much in the nature of a sales tax. Both can't be right at the same time. The incidence of the corporation tax, unnecessarily to say, is of crucial importance to tax policy. It has immediate bearing on the problem of integration and to me implies a strong argument in favor of the dividend credit (at the corporate level) approach. Also, it is of evident importance to the choice between taxes on consumption and taxes on investment.

Excises and customs.—The estimated incidence of excise and custom duties, shown in lines (4), (5), and (12) of table 2, is distinctly regressive throughout the income scale. This result is based on the assumption that such taxes are paid for by the consumer and reflects the familiar fact that consumption expenditures decline as a percent of income when moving up the income scale. The assumption that such taxes are paid by the consumer is not beyond dispute, but I believe that it is a rather sensible one.[10]

Property tax.—The estimated incidence of the property tax, shown in line (13), is again regressive, though less so at the upper end of the scale than that of excise and sales taxes. The general principle, in estimating the incidence of this tax is that the part assessed on owner-occupied residences rests on the owner, the part assessed on the improvement component in business property (including rental housing) rests on the consumer, and the part assessed on the rent component of business property rests on the owner. Farm real estate is treated as business property and a more detailed statement of our procedure is given in the appendix.

Social insurance contributions.—The estimated incidence of social insurance contributions, shown in lines (6) and (14) is progressive up to the $4,000 income range and becomes regressive thereafter. In arriving at this result, it was assumed that the employee contribution

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[8] See reference in note 5, above.

[9] I refer to the fact that the corporation tax burden per dollar of dividend income is less for a dividend recipient in a high surtax bracket than in a low surtax bracket. This is the case because the corporation tax reduces dividends, the reduction in dividends reduces personal income-tax liabilities, and the saving in personal income tax per dollar of dividend lost is the greater the higher is the surtax bracket of the dividend recipient. Thus the net burden per dollar of dividends is less for the wealthier shareholder. This factor is not allowed for in the above estimates of the corporation tax but is reflected in the distribution of the personal income tax.

[10] For a defense of the view that excise taxes (if general) are similar to a proportional income tax see Earl Rolph, Fiscal Economics, ch. 6, 7. For a critique thereof see my paper, On Incidence, Journal of Political Economy, August 1953.

and one-half of the employer contribution fall upon the employee; and that one-half of the employer contribution is passed on to the consumer.

CONCLUSIONS

It goes without saying that the above estimates of tax incidence must be used with reservation. They do not constitute the results of laboratory experiments which unfortunately are not at the economist's disposal. Nor do they involve as exhaustive a statistical analysis as might be undertaken. All sorts of theoretical and methodological qualifications apply which were discussed in connection with the 1948 study and which need not be repeated here.

In spite of these reservations some such information is needed for intelligent policymaking, and the picture here presented should give a fair approximation to the distribution of taxpayments. The primary conclusion, as I read it, remains that the overall tax structure in the United States is but moderately progressive over the crucial range of middle incomes, extending from, say, $2,000 to $10,000 and including nearly three-quarters of all spending units. Whether this is good or bad from the point of view of equity is not for the economist to say, but it is a factor to be kept in mind in future tax legislation. Secondly, let me draw your attention to the sharp distinction in the incidence of the Federal and the State-local tax package, and what this implies for future trends in our fiscal structure. Finally, there is the distinction in the incidence pattern of particular taxes, and the somewhat surprising role of the corporation tax.

Impact on Consumption

I now turn to the second part of my problem, which is the impact of various taxes on consumption.

WHY IS THIS A PROBLEM?

As a starter, let us consider briefly why this is something to worry about. Are taxes which fall on consumption good or bad, and for what reason?

I begin with the familiar view that taxes which fall on consumption are bad because they reduce demand, shrink markets, and make for depression. Taxes which fall on saving, by the same token, are good because they do not do these things. This involves two propositions: (1) That taxes which weigh heavily on private demand are bad taxes; and (2) that taxes which fall on consumption depress demand more than do other taxes.

Under conditions of potential depression these points have merit. Consider a situation where a substantial budget deficit is needed to maintain an adequate level of demand and employment. The deficit needed to do the job will be smaller if the remaining taxes weigh but lightly on the level of private demand. If we wish to do the job with as small a deficit as possible, we will do well to choose "light" taxes and avoid those which have a heavily deflationary effect. This much for the first proposition. The second point also tends to hold under such conditions. This is the case because expenditures on capital formation will be at a low level and relatively insensitive to tax changes.

There will be no scarcity of liquid funds and anticipated profits will be low, with or without profits taxes. Thus taxes which fall on saving will be reflected in a reduction in idle balances; only taxes which fall on consumption will reduce demand. Putting the two points together, it may be argued that consumption taxes are bad taxes.

But the situation will be quite different in a highly buoyant economy. Here neither of these propositions holds. If existing taxes are ineffective in holding down demand, more taxes will be needed to check inflationary pressures. More likely than not, it will be difficult enough to maintain an adequate level of taxation of any type, even if highly deflationary taxes are used. This being the case, "heavy" taxes may be all to the good. In other words, proposition (1) tends to be reversed. Nor does proposition (2) apply. It cannot be argued in this setting that "heavy" taxes are necessarily taxes on consumption. Under buoyant conditions, investable funds will be scarce and taxes which fall on saving may be reflected promptly in reduced expenditures on capital formation. Moreover, capital formation may be retarded by profit taxation. Thus demand may be checked in the buoyant economy either by raising taxes which fall on consumption or by raising taxes which fall on capital formation. The choice in this case must be made on grounds other than effectiveness as a deflationary device.[11]

In view of all this, what type of cuts will be in order if and when the happy time for tax reduction arrives? The answer depends on the circumstances which will give rise to such a reduction. Suppose first that international conditions improve so as to permit a substantial cut in defense outlays. As Government expenditures are reduced, a corresponding increase in private demand will be in order, and a tax reduction must be made to call forth such an increase. If the economy is buoyant, this offsetting increase may be achieved either by reducing taxes which fall on consumption or by reducing taxes which fall on capital formation. While the response per dollar of tax reduction may not be quite the same in both cases, either approach will be possible. The choice then must again be made on other grounds. Now suppose that the budget does not change but that tax reduction is required because a recession or depression threatens and private demand falls off. In this case, it will be more difficult to deal with the problem by attempting to raise capital formation. If the contraction is sufficiently severe, a reduction in taxes which fall on consumption may be the only type of tax reduction that will help. In a less severe situation some choice between the two approaches will remain. But the amount of tax reduction that is needed may be considerably greater unless it is in taxes which fall on consumption.

TAX EFFECTS ON CONSUMPTION

1. Income effects

However this may be, let us now turn to the comparative effects of various taxes on consumption. Here a distinction must be drawn between the so-called income effect and the so-called substitution effect. The income effect relates to the change in consumption which results because taxes reduce (or tax removal increases) a taxpayer's

[11] These other grounds involve (1) a choice between present consumption and future growth and (2) distributional characteristics of the two types of taxes.

income. The substitution effect relates to the change in consumption which results because taxes may affect the desire to consume or to save out of a given level of income.

If people pay more taxes, they have less money left to use for other purposes. This means that they will spend less on consumption and/or set aside less for saving. The extent to which the tax dollar is reflected in reduced consumption or reduced saving will depend on who pays it. Now we know from statistical observation that the percentage of income consumed typically declines as we move up the income scale. This suggests that a tax dollar taken from the higher incomes will depress consumption less than a tax dollar taken from the lower incomes. In other words, a more progressive tax structure will tend to depress consumption less (with any given yield) than a less progressive or regressive one. Similarly, reduction in taxes paid by people in the lower income brackets will raise consumption more than an equal yield reduction of taxes contributed by people in the higher income brackets.

This general principle is correct, but its quantitative significance is less than may be expected. The ratio of total consumption to total income (the so-called average propensity to consume) differs substantially as between low and high incomes, but this is not what matters here. Rather, our concern is with differences in the ratio of change in consumption to change in income (the so called marginal propensity to consume) and differences in this ratio are relatively slight. Such at least appears to be the case on the basis of available data on saving and consumption by size groups of income.

Putting the problem on an aggregative scale, let us compare the increase in consumption which might result from a $1 billion reduction in income tax, secured by (1) a flat 3-percent cut in all bracket rates and (2) a cut in rates so as to give tax relief similar to that provided by a reduction in sales tax. The first pattern of tax reduction accrues more largely to the higher income groups and may be expected to release less in consumption expenditure than the second pattern. Using such data as are available, we estimate the increase in consumption to be about $750 million in the first and $825 million in the second case. In other words, substitution of the second for the first type of tax reduction would increase consumption by about $75 million.[12]

Suppose now that the second reduction is not in income taxes but directly in excise taxes. Provided that the excise reduction is passed on to the consumer in lower prices, he will find that his real income is increased. If he is aware of this, he may be expected to react in the same way as under the second type of income tax cut (distributed like a sales tax) and the gain in consumption will again equal $825 million. This we would expect to be the case provided that the relation of consumption to income is defined in real terms. If, however, the consumer disregards the fall in prices and continues consumer expenditures at the previous dollar level, consumption expenditures in real terms will be increased by $1 billion. If so, the difference in consumption impact between the across-the-board percentage cut in income tax and the cut in excises would be raised to $250 million. This, however, would seem to be an outside figure. Consumers are not likely

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[12] These figures relate to the initial impact on consumption prior to multiplier effects.

to wholly disregard the price change, and there is no assurance that the entire excise change will be passed on in lower prices.

All this suggests that the relationship between the degree of progressivity of the tax structure and the degree of consumption impact is not as potent as might be expected. There is, however, one feature of the tax structure which is of considerable importance in this connection. I refer here to the role of the corporation tax. This tax may be passed on to the consumer and/or the wage earner, or it may fall on profits. To the extent that it falls on profits, it may be absorbed in retained earnings; and to the extent that it is absorbed in retained earnings, there will be no immediate reduction (or, in the case of corporation tax cut, no immediate increase) in consumption. Retaining our earlier assumption that one-third of the corporation tax is shifted and assuming the remainder to be divided equally between dividends and retained earnings, we may estimate the consumption impact of a $1 billion change in corporation tax at $500 million, which is considerably less than in the earlier cases. To the extent that the corporation tax is not shifted, its weight may prove a more important factor in determining the consumption impact of the tax structure than does the degree of progression.

2. Substitution effects

I now turn to substitution effects, that is, tax induced changes in the allocation of a given income between consumption and saving. Without going into the details of the matter, I think it fair to say that the substitution effects between total consumption and saving (though not between types of consumption) are of minor importance where our standard taxes are concerned. In other words, the previously considered income effects are much the major factor in dealing with taxation effects on consumption. I am not so sure that the same holds for taxation effects on investment. Investment may be deterred not only by reduction in available funds, but also by reduced willingness to invest such funds as are available.

At the same time, taxes might be devised which carry a drastic substitution effect on total consumption. Thus, consumption might be reduced sharply by imposition of a spending tax or high excises during temporary conditions of war finance. Under such conditions, and above all in view of the expectation that such taxes are temporary, the consumer will find it highly profitable to postpone consumption. The consumption reducing effect of the tax accordingly may be much in excess of the actual yield. Such, however, is a temporary expedient of war finance and not available or desirable under ordinary conditions.

CONCLUSIONS

One conclusion to be drawn from the preceding discussion is that the relationship between progressivity and consumption impact of various taxes is less close than might be expected. The consumption impact of excises may be considerably greater than that of income taxes if consumers disregard price-level changes, but not otherwise; and the consumption impact of the corporation tax will be considerably less to the extent that the tax is absorbed in a curtailment of retained earnings.

A second conclusion is that the consumption impact of any one tax is not necessarily the same thing as its total deflationary impact. Under conditions of severe depression, it may be argued that only taxes falling on consumption have a deflationary effect; but this is not the case in a buoyant economy where taxes may go to reduce capital formation as well as consumption.

The proposition that taxes which fall on consumption are bad taxes thus holds for conditions of depression only, and even then with some qualification. In the buoyant economy, taxes which are highly deflationary are not necessarily bad taxes; indeed, a high degree of deflationary effectiveness may be an advantage rather than a disadvantage. But deflationary effectiveness can be had in taxes which curtail capital formation no less than in taxes which curtail consumption, so that the choice between the two must be made on other grounds.

First, these involve the choice between more rapid growth and more current consumption, a choice which (apart from considerations of national security) is essentially a matter of social value judgment. Secondly, the choice between these two policies carries distributional implications, which, though limited, cannot be disregarded. In all, a good case can be made for placing primary emphasis on the construction of an equitable tax structure and on meeting the requirements of compensatory finance by changes in the overall level of taxation. Such a policy is apt to be more satisfactory than stabilization through changes in emphasis between consumption taxes and other taxes.

Appendix

In the following pages we present the data and procedures underlying the estimates of tax distribution given in text tables 1 to 3. By the nature of the data this information is needed to understand and appraise the results. For lack of space no attempt is made to justify our procedures in detail, and the reader is referred to the 1948 study for such a discussion.

1. BASIC SERIES

In table A1 we present the basic series used in our tax allocations as explained below. The series are derived as follows:

TABLE A-1.—*Basic distributions for tax allocation*

	Spending unit income brackets (thousands of dollars)							
	0-$2,000	$2,000-$3,000	$3,000-$4,000	$4,000-$5,000	$5,000-$7,500	$7,500-$10,000	Over $10,000	Total
(1) SRC money income, 1954	6.0	8.0	13.0	14.0	28.0	11.0	20.0	100.0
(2) SRC distribution of spending units, 1954	23.0	14.0	17.0	14.0	21.0	6.0	5.0	100.0
(3) Adjusted money income	5.5	7.5	12.1	13.0	26.2	10.5	25.1	100.0
(4) Income, broader concept	5.9	7.7	12.3	13.3	26.2	10.4	24.2	100.0
(5) Consumer expenditures	8.2	9.8	14.4	14.8	28.2	10.3	14.3	100.0
(6) Housing expenditures	6.9	8.2	14.5	15.7	28.9	10.4	15.4	100.0
(7) Dividends	.9	1.9	2.3	2.8	8.4	5.2	78.4	100.0
(8) Capital gains income	.8	1.6	2.9	3.8	9.2	6.5	75.2	100.0
(9) Wages and salaries, inclusive	4.7	8.8	13.2	18.8	30.8	11.5	12.1	100.0
(10) Wages covered by payroll tax	6.7	12.4	18.6	23.7	27.9	6.3	4.3	100.0
(11) Rental income	5.7	5.3	8.9	9.2	15.6	8.0	44.1	100.0
(12) Liquid assets holdings	11.0	9.5	11.0	12.0	20.0	10.5	26.0	100.0

Line (1): Federal Reserve Bulletin, June 1955, page 609.
Line (2): Federal Reserve Bulletin, May 1955, page 472.
Lines (3) and (4): See lines 6 and 14, table A2 and explanation thereto.
Line (5): No Survey Research Center (SRC) information is available on the distribution of consumer expenditures for years later than 1950. The SRC distribution of consumer savings for 1950 is used as the basis for estimating the distribution of 1954 consumer expenditures. From the basic decile distribution of money income and using the 1950 SRC totals of $183 billion money income and $14 billion consumer savings, savings as a percent of decile income is computed. Applying these percentages to money income by deciles, the amount of consumer spending by deciles is computed. A percentage distribution of consumer spending by deciles is calculated from these dollar amounts. It is assumed for the purposes of this investigation that this decile distribution for 1950 remains unchanged in 1954, while the dollar limits of the decile intervals move upward. The consumption-income relationship which follows from the SRC data for 1950 shows a generally declining ratio of consumption to income when moving up the income scale. However, this tendency is interrupted by irregularities not usually found in data of this sort. These irregularities have been smoothed out in obtaining the series shown in line (5).
Line (6): The housing expenditure series is derived from SRC data which give housing payments in relation to disposable income, grouped by money income brackets (Federal Reserve Bulletin, July 1954, p. 705). The payments are given in terms of specific percentages of disposable income, according to percent of spending units in that income bracket making this percentage expenditure. To obtain a series giving dollar amounts of housing expenditures in each bracket, the product of each specific percentage of disposable income expressed in dollars and the number of spending units making that dollar amount of housing outlay is taken. Aggregating these terms for each money income bracket and taking the total, the interbracket distribution of housing expenditures is obtained. Housing payments include rent, mortgage, and property tax payments.

This series applies to 1954 payments as a percentage of 1953 money income. It is assumed that the same relationship holds for 1954 money income and housing expenditures.

Line (7): No direct information on dividend distribution by spending unit income brackets is available. Line (7) is estimated from the distribution of dividend payments by tax return for 1952 (Preliminary Report, Statistics of Income, pt. 1, 1952), it being assumed that the distribution by spending unit income brackets is the same as the distribution by tax returns. The distribution by tax return for 1952 is raised to 1954 levels by (1) increasing bracket limits by the estimated percentage increase in dividends and (2) raising dividend income by the same ratio. (Reported dividends on personal returns for 1952 equal $5.6 billion and those for 1954 are estimated at $6.7 billion.) From this raised distribution, the percentage distribution of dividend income by spending unit income brackets for 1954 is estimated by interpolation. This procedure would be highly unsatisfactory if a breakdown of higher incomes were attempted but should give a reasonable approximation for breakdowns under $10,000.

Line (8): The distribution of capital gains income is estimated on the basis of the 1952 distribution by tax returns of net capital gains (Preliminary Report, Statistics of Income, pt. 1, 1952), raised to allow for the increase in capital gains income. Total capital gains income for 1954 was estimated at $5 billion as against $3 billion for 1952, and the 1952 amounts of capital gains income by brackets were raised by this ratio. Bracket limits were raised by the same ratio as used in the dividend case.

Line (9): The wage income series for 1954 is estimated on the basis of the 1952 distribution of wage and salary income by tax returns (Preliminary Report, Statistics of Income, pt. 1, 1952). As in the case of dividend income, the distribution is raised by the percentage increase in wage and salary income and the 1954 distribution by spending unit income brackets is estimated by interpolation.

Line (10): Obtained by adjustment of line (9). In the brackets below $4,000 all wages are considered covered wages due to the present almost general coverage of the social-security program. For brackets above $4,000, the first $4,200 of wage income is considered to be covered wages. To obtain covered wages in these brackets, the number of tax returns for wage and salary income in each bracket (Preliminary Report, Statistics of Income, pt. 1, 1952) is multiplied by $4,200.

Line (11): Rental income is estimated on the basis of the distribution by tax returns of net rent and royalty income for 1952 (Preliminary Report, Statistics of Income, 1952). Brackets were not raised as rental income fell off slightly from 1952 to 1954.

Line (12): The distribution of liquid asset holdings by money income brackets is obtained by interpolation from the SRC distribution of liquid asset holdings by deciles (Federal Reserve Bulletin, June 1955, p. 618).

2. THE DISTRIBUTION OF INCOME

The derivation of the distribution of money income underlying text tables 2 and 3 is shown in appendix table A2.

TABLE A 2.—*Derivation of income series*

[Millions of dollars]

	Spending unit income brackets (thousands of dollars)							
	0-$2,000	$2,000-$3,000	$3,000-$4,000	$4,000-$5,000	$5,000-$7,500	$7,500-$10,000	Over $10,000	Total
(1) SRC money income	14,320	19,004	31,028	33,416	66,830	26,255	47,736	238,680
(2) Retained earnings	63	139	160	195	581	362	5,456	6,952
(3) Unshifted corporate profits tax	102	210	262	319	958	592	8,938	11,388
(4) Capital gains income	40	90	115	190	470	325	3,760	5,000
(5) Fiduciary income	154	133	154	168	290	147	364	1,400
(6) Total adjusted money income	14,679	19,655	31,748	34,287	69,112	27,681	66,254	263,420
(7) Domestics' and nurses' lodging and food	24	40	69	98	160	60	63	520
(8) Net rent and taxes on owner-occupied dwellings	663	788	1,393	1,609	2,777	990	1,480	9,610
(9) Services furnished without payment by financial intermediaries	332	279	323	352	587	308	763	2,934
(10) Food and fuel consumed on farms	689	231	177	143	284	181	158	1,861
(11) Accrued interest on savings bonds	68	60	58	63	105	55	136	525
(12) Employer contributions to pension funds	440	814	1,223	1,557	1,832	414	282	6,566
(13) Total nonmoney income	2,196	2,208	3,241	3,722	5,747	2,017	2,884	22,016
(14) Total income, broader concept (6 plus 13)	16,875	21,863	34,989	38,008	74,864	29,698	69,138	285,436

Adjusted money income

The derivation of our distribution of adjusted money income, underlying text table 2 is shown in lines (1) *to* (6). We begin with the SRC distribution of money income, shown in line (1). To this we add retained earnings of corporations and the two-thirds of the corporation tax which is assumed to fall on profits. These additions to money income are necessary in computing an effective rate of corporation tax since the entire part of the corporation tax which falls on profits is imputed to the dividend recipient.[13] Also, capital gains income and fiduciary income are added since they are not included in the SRC concept but are included in the taxable income.

Line (1): The total money income according to the SRC definition is obtained by multiplying the mean income of $4,420 (FRB, June 1955, table 1, p. 609) by the total number of spending units, 54 million (FRB, May 1955, p. 472). The total SRC money income is distributed by income brackets according to the SRC percentage distribution of money income (FRB, June 1955, table 1, p. 609).

Line (2): The total for retained earnings $6.952 billion (Survey of Current Business, July 1955, table 1, p. 8) is distributed according to the pattern of dividend payments, line 7, table A1.

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[13] For an alternative procedure and a discussion of this method see our original study (National Tax Journal, March 1951, p. 16) and its further discussion (National Tax Journal, March 1952, p. 18).

Line (3): It is assumed that two-thirds of the corporation income tax (both Federal and State) total of $17.082 billion is not shifted and falls upon shareholders. This total, $11.388 billion, is distributed according to the pattern of dividend payments.

Line (4): The estimated total of $5 billion is distributed according to line 8, table A1.

Line (5): The estimated total of $1.4 billion is distributed according to line 12 of table A1.

Money income, broader concept

Lines (7) to (11) show the distribution of various components of imputed and other income which are included in the Department of Commerce concept of personal income, but not in the SRC concept of money income. While an even broader income concept may be constructed, the above additions will suffice to indicate the nature of the problem.

The totals for lines (7) to (10) are from Survey of Current Business, July 1955, page 21, table 39. The total for line (12) is from table 34, same source. The total for line (11) is from Treasury Bulletin, table on derivation of cash withdrawals. The allocation patterns are table A1 line (9) for line (7); table A1 line (6) for line (8); table A1 line (12) for line (9); table A1 line (12) for line (11); and table A1 line (10) for line (12). Line (11) is allocated according to the distribution pattern of Rejoinder (see text note 1 above), page 33, appendix table 1, line 7.

3. TAXES TO BE ALLOCATED

Tax receipts for calendar year 1954 by levels of government are shown in table A3.

TABLE A3.—*1954 tax receipts*[1]

		Millions
	FEDERAL TAXES	
(1)	Personal income tax	$28,153
(2)	Estate and gift taxes	921
(3)	Corporation income tax	16,360
(4)	Excises[2]	8,960
(5)	Customs	565
(6)	Social insurance contributions[3]	7,831
(7)	Total	62,790
	STATE AND LOCAL TAXES	
(8)	Personal income tax	1,098
(9)	Inheritance and gift	265
(10)	Corporation income tax	722
(11)	Excises and sales taxes	10,230
(12)	Property	10,110
(13)	Social insurance contributions	1,567
	Total	23,998
	Total, all levels	86,788

[1] Nontaxes excluded.
[2] Excludes refunds.
[3] Excludes tax payments by self-employed.

Source: Survey of Current Business, July 1955, table 8, p. 12.

4. TAX ALLOCATIONS

The estimated distribution of these payments by spending unit income brackets is shown in table A4. The estimates given in table A4 were obtained as follows:

TABLE A-4.—*Distribution of tax payments by income groups*[1]

[Millions of dollars]

	Spending unit income brackets (thousands of dollars)							
	0–$2,000	$2,000–$3,000	$3,000–$4,000	$4,000–$5,000	$5,000–$7,500	$7,500–$10,000	Over $10,000	Total
FEDERAL TAXES								
(1) Personal income tax	451	1,037	2,247	2,882	7,962	3,920	9,655	28,153
(2) Estate and gift taxes							921	921
(3) Corporate profits tax	545	741	1,037	1,113	2,456	1,130	9,338	16,360
(4) Excises [2]	735	878	1,290	1,326	2,527	923	1,281	8,960
(5) Customs	46	55	81	84	159	58	81	565
(6) Social-insurance contribution	530	810	1,405	1,451	2,241	677	714	[3] 7,831
(7) Total	2,307	3,521	6,060	6,856	15,345	6,708	21,990	62,790
(8) Without social insurance contribution	1,777	2,711	4,655	5,405	13,104	6,031	21,276	54,959
STATE AND LOCAL TAXES								
(9) Personal income tax	2	25	66	79	242	139	544	1,098
(10) Inheritance and gift taxes							265	265
(11) Corporate profits tax	24	33	46	49	108	50	411	722
(12) Excise and sales taxes	840	1,003	1,474	1,515	2,887	1,054	1,464	10,236
(13) Property	707	848	1,315	1,409	2,594	1,009	2,232	10,110
(14) Social insurance contribution	73	138	207	295	483	180	190	1,567
(15) Total	1,646	2,047	3,108	3,347	6,314	2,432	5,106	23,998
(16) Without social insurance contribution	1,573	1,909	2,901	3,052	5,831	2,252	4,916	22,431
(17) Total, all levels	3,953	5,568	9,168	10,203	21,659	9,140	27,096	86,788
(18) Without social insurance contribution	3,350	4,620	7,556	8,457	18,935	8,283	26,192	77,390

[1] Nontaxes included.
[2] Excludes refunds.
[3] Excludes tax payments by self-employed.

Source: Survey of Current Business, July 1955, table 8.

Line (1): The basic data used in the allocation of personal income tax are the SRC distribution of personal income-tax liability for 1954 (Federal Reserve Bulletin, June 1955, p. 617). The estimated SRC distribution does not include taxes on capital gains or fiduciary income. Starting from the total yield of $28.153 billion (table A3), we deduct an estimated $1.250 billion tax on capital gains and an estimated $280 million of tax on fiduciary income. The remainder of $26.623 billion is allocated by income brackets according to a distribution estimated from the published SRC distribution by quintiles of spending units. In this way estimates for income-tax liabilities in the brackets under $5,000 could be obtained. For the $5,000 to $7,500 and $7,500 to $10,000 brackets, the personal income-tax liability was calculated and numbers of spending units in that bracket.

The additional amounts of tax on capital gains was distributed according to line (8), table A1, and the amount of tax on fiduciary income was distributed according to line (12), table A1.

Line (2): Estate and gift taxes are assigned to incomes above $10,000.

Line (3): It is assumed that two-thirds of the corporate profits tax is not shifted, but falls upon shareholders. Therefore, $10.907 billion of the total of $16.360 billion Federal corporation profits taxes are allocated according to the pattern of dividend payments, line (7), table A1. The remaining one third of corporate-profits taxes are assumed to be shifted forward to the consumer and are allocated according to the pattern of consumer expenditures, line (5), table A1.

Line (4): It is assumed that excise taxes are shifted forward, falling on the ultimate consumer. The total Federal excises are allocated according to the pattern of consumer expenditures, line (5), table A1. As shown in the initial study (National Tax Journal, March 1951, p. 43), the overall result of this crude approach does not differ significantly from that obtained by allocation according to a more detailed pattern.

Line (5): Customs levies are treated as excises and are allocated according to line (5), table A1.

Line (6): Social insurance contributions to the Federal Government totaled $7,831 million and included the following items (Survey of Current Business, op. cit., p. 20, table 35):

[In millions of dollars]

	Employer	Paid by employees	Total
OASI	2,432	2,432	4,864
Unemployment insurance	1,475	13	1,488
Government life insurance		450	450
Other	309	720	1,029
Total	4,216	3,615	7,831

Two-thirds of the employer contribution to the OASI is assumed to be passed onto the consumer and is allocated according to line (5), table A1. The remainder of the OASI contribution is allocated according to covered wages, line (10), table A1. Similarly, two-thirds of unemployment insurance payments are allocated according to line (5) and one-third according to line (10), table A1. Life-insurance payments and other contributions are assumed to fall wholly on the employee and are allocated according to wage income, line (9), table A1.

Line (9): The distribution of the State income tax is computed by calculating the tax liability on the mean bracket income under the Wisconsin tax which is taken as representative of the 35-State income-tax schedules. Estimating from 1952 data (Preliminary Statement, Statistics of Income, 1952), 2 exemptions on incomes below $4,000 and 3.3 exemptions on incomes above $4,000 are used. Liabilities are multiplied by numbers in brackets and the total of State income taxes, $1.098 billion is distributed in accordance with the resulting distribution of bracket totals.

Line (10): Inheritance and gift taxes are assigned to incomes above $10,000.

Line (11): State corporate profits taxes are treated in the same manner as Federal corporate profits taxes, line (3) this table.

Line (12): State excise and sales taxes are assumed shifted forward to consumers and are allocated on the basis of line (5), table A1.

Line (13): In order to estimate the distribution of property tax payments by income brackets, we must first estimate the distribution of assessments by type of property. The result is shown in table A5.

TABLE A5.—*Property tax allocations*

	Millions
REAL ESTATE	
(1) Farm, land	$637
(2) Farm, improvements	840
(3) Business, land	473
(4) Business, improvements	946
(5) Rental, land	607
(6) Rental, improvements	1,210
(7) Owner occupied residential, land	1,300
(8) Owner occupied residential, improvements	2,600
(9) Total real estate	8,110
PERSONAL PROPERTY	
(10) Business, tangible	450
(11) Business, intangible	450
(12) Farm, tangible	100
(13) Farm, intangible	100
(14) Nonfarm, tangible	450
(15) Nonfarm, intangible	450
(16) Total personal property	2,000
Total real and personal property	10,110

Total taxes on owner-occupied residences are estimated by the Department of Commerce at $3.9 billion (Survey of Current Business, p. 21, table 39), and it appears on the basis of past data that taxes on farm property have ranged at somewhat above 10 percent of total property taxes (Economic Almanac, 1953-54, p. 26). These relationships are made use of and the remaining breakdown is similar to that used in the 1948 Study (op. cit., p. 22). Even though the breakdown shown in the above table involves a good deal of guessing, an explicit statement of assumptions is needed to evaluate the estimated incidence of the property tax.

The amounts shown in lines (2), (4), and (10) to (14) are allocated by line (5), table A1. Lines (1) and (5) are allocated by line (11), table A1. Line (3) is allocated by line (7), table A1; lines (6) to (8) are allocated by line (6), table A1, and line (15) is allocated by line (12), table A1. The reasons which underlie this allocation are developed in the 1948 Study (op. cit., pp. 21-23) and need not be repeated here.

Line 14: State social-insurance contributions are treated in the same manner as Federal contributions. It is assumed that the burden of these contributions falls entirely upon wage income; therefore, allocation of the total is made according to line (9) of table A1.

FEDERAL INCOME TAXES, CONSUMER SPENDING, AND THE DISTRIBUTION OF INCOME

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PART I. FEDERAL INCOME TAXES AND CONSUMER SPENDING

The Subcommittee on Tax Policy of the Joint Committee on the Economic Report has urged that "constant efforts be made to improve the tax system in the interest of assuring for the long run the most rapid rate of economic growth consistent with short-run stability." The first part of this paper will discuss the increased volatility of consumer spending and how tax policy may serve as a stabilizing influence. The second part of the report will cover the effect of income taxes on the distribution of income.

Increased importance of the consumer in our economic structure

One of the principles of economics that has been widely taught is that consumer spending depends primarily on trends in private investment. Fluctuations in private investment cause corresponding shifts in consumer income. Changes in the latter govern shifts in family expenditures. This theory was probably quite correct when our standards of living were much lower, fewer individuals owned liquid assets, and when few families made use of installment and mortgage credit. Today, however, consumers receive some $70 billion of income each year that is over and above their minimum cost of living. This discretionary income is more than double what it was in 1941 (in 1954 dollars) and is rising at the rate of about $5 billion a year. Much of this income can be withheld from spending if consumers believe there will be hard times ahead. Therefore, it is extremely important that those conditions which produce strong consumer pessimism are not allowed to develop.

Another factor in the volatility of consumer spending is the some $200 billion of liquid assets (cash, bank deposits, and United States bonds). If consumers, for some reason or another, should expect shortages or sharp rises in the general level of prices, they could draw upon their liquid assets to try to beat the shortages or price inflation. and this of course could add very heavily to the inflationary pressures. Consumer-owned liquid assets are not only double (in 1954 dollars) the prewar level, but, in addition, they are fairly widely held. About 70 percent of families own some liquid assets, and about 17 million families own over $1,000.

A large percentage of families today are willing and able to make use of the Nation's installment credit and mortgage credit facilities. Today, almost half of the families have some installment debt, and about 14 million families have some mortgage debt. The latter is about triple the prewar number. If strong expectations of inflation were to develop, excessive resort to this type of credit could push the price structure up rapidly. Also, if families became pessimistic about their future financial position, they would very probably concentrate on liquidating these debts, and this in turn would cause unemployment to rise greatly.

Properly administered tax policy can help prevent excessive instability of consumer spending

From the standpoint of tax policy, it is important to understand this great growth since the 1930's in the volatility of consumer spending. Through tax policy, some control over consumption expenditures can be achieved. Precipitous declines can be avoided and inflationary bursts can be curbed. This, of course, does not mean that tax policy should ignore private investment and the question of equitable distribution of the tax burden, but I would emphasize that consumer spending is a much greater element of instability today than in previous decades, and it will be even a greater element of instability in the future. For example, consumers became quite pessimistic in early 1951, and they cut their spending by $6 billion between the first and second quarters. On the other hand, their optimism rose from early 1954 to mid-1955, and spending rose by $23 billion in 18 months.

Granted that consumer spending has and will continue to become more volatile, how can tax policy help produce stable growth of family expenditures? During periods of worsening business conditions, income-tax reduction exerts both a direct and indirect expansionary influence on consumer spending. When individuals receive tax cuts, they have more for spending and will probably purchase more. This condition will be recognized by business firms who then will be more likely to invest in inventories and fixed assets than if there were no tax reduction. The tax cut, therefore, can stimulate both consumer and business spending which in turn would add to employment and improve consumer sentiment. A rise in the latter may do more to increase consumption expenditures than the direct effect of the tax cut. For example, the 1954 tax cut of $3 billion lead to a $3 billion rise in consumer spending. However, the general improvement in consumer optimism, beginning in June 1954, led to a $17 billion rise in consumer spending between the third quarter of 1954 and the same quarter of 1955. Tax increases achieves the same effect in an opposite direction. Thus, tax changes, through their power to change consumer and business sentiment, are a most important weapon in achieving economic stability.

If tax policy, with its objective of economic stability, is to take into account trends in consumer sentiment, consideration has to be given to how consumer expectations are measured. The survey research center of the University of Michigan is one of the groups that is doing an outstanding job of analyzing short-term shifts in family attitudes. Their surveys have correctly anticipated consumer behavior since World War II and were unusually accurate in 1954 in foreseeing the reversal of the 1953–54 business recession. In June 1954, their survey correctly foresaw the upturn in the car market, while the October 1954 study showed a very large car market to be developing. In January 1955, the study showed consumer optimism to be broadly based and subsequent developments proved that this survey provided a basis for accurately predicting trends in general business conditions.

Conclusion

This part of the report has attempted to point out the growing volatility of consumer spending. In order that sharp shifts in consumer expenditures do not alternately produce inflation and depres-

sion, some flattening of these outlays can be achieved through tax policy. Lower taxes have a directly favorable effect on consumer spending, and, in an indirect manner, exert even more influence. This is because lower taxes tend to raise consumer and business optimism, and sentiment is a very important element in business conditions. Sentiment is now measurable to a reasonably accurate degree, and thus the tools do exist to make effective use of tax policy to promote sound economic growth and achieve short-run stability.

Part II. Federal Income Taxes and the Distribution of Income

The following tables show how the progressive income-tax structure of the United States actually affects American families. Those with annual incomes under $5,000 pay an average tax equal to 5.3 percent of their incomes, while for families making $5,000 and over, an average tax of 12.9 percent is paid. Since the number of families in the higher brackets will be rising in the years ahead, while the number in the lower brackets will be lessening, tax rates can be lowered without reducing the revenue of the United States Treasury. Since 1946, the number of spending units making $5,000 or more annually has risen from 5 million to 19 million today. In the same period, the number with annual incomes of less than $5,000 has decreased from 41 million to 36 million.

The effect of the income-tax reduction in 1954 is shown in table I. Before the cut, about 19.5 million spending units were paying $500 or more annually in taxes. After the cut only 17.3 million paid this amount or more. The number paying no tax rose from 14.0 million in 1953 to 14.8 million in 1954.

Table I.—*Size of Federal income tax by income groups, 1954*

	Tax as percent of all spending units	Tax as percent of income	Amount of tax	1954 tax reduction as percent of income
Under $1,000	10	0.4	$20	(1)
$1,000 to $1,999	13	3.3	49	(1)
$2,000 to $2,999	14	5.5	138	(1)
$3,000 to $3,999	17	6.9	240	0.5
$4,000 to $4,999	14	8.5	378	1.3
$5,000 to $7,499	21	10.7	635	1.5
$7,500 to $9,999	6	13.6	1,151	1.5
$10,000 and over	5	21.3	3,598	10.0
All spending units	....	11.4	505	3.2

[1] Due to the small number of low-income families which pay taxes, the survey sample contains too few observations to permit accurate conclusions about the shifting tax burden of these groups from 1953 to 1954

Source: Based on data compiled by the survey research center.

TABLE II.—*Size of Federal income tax by income fifths, 1954*

	Average income	Average tax	Federal income tax as percent of income
Highest fifth	$9,740	$1,602	16.4
Second	5,315	475	8.9
Third	3,759	278	7.4
Fourth	2,435	125	5.1
Lowest fifth	889	25	2.8

Source: Based on data compiled by the Survey Research Center.

TABLE III.—*Frequency distribution of size of tax payments*

Size of tax	Number of spending units (millions)	As percent of all spending units	*Size of tax*	Number of spending units (millions)	As percent of all spending units
No tax	14.8	27.4	$500 to $999	11.3	21.0
Under $100	3.9	7.3	$1,000 to $1,999	4.3	7.9
$100 to $199	4.3	7.9	$2,000 to $4,999	1.3	2.4
$200 to $499	13.7	25.4	$5,000 and over	.4	.7

Source: Survey Research Center.

TABLE IV.—*Effect of taxes on size of income brackets*

[Number of spending units (millions)]

Annual income	Before taxes	After taxes
$5,000 and over	17.3	11.6
$10,000 and over	2.7	1.1

Source: Based on data compiled by the Survey Research Center.

Conclusion

The foregoing tables show the considerable control that the Federal Government now exercises over the spendable income of United States families. In 1920, only $1.3 billion of income taxes were paid; therefore, the Government could not have stimulated business activity through tax reduction very much even if it had tried. Today, however, over 40 million spending units are paying about $30 billion in Federal personal taxes and related payments. Since taxes can be cut quickly, the Federal Government can provide the Nation's economy with a very quick and powerful stimulus, should the necessity arise. Similarly, premature tax reduction could provide quite an inflationary push. Thus, the Federal Government, having acquired considerable control over the shifting levels of consumer spending, has acquired an equivalent responsibility to exercise those controls in the interests of "economic growth and short-run stability."

III. IMPACT OF FEDERAL TAXATION ON THE AMOUNT AND CHARACTER OF PRIVATE INVESTMENT

FEDERAL TAXES AND BUSINESS INVESTMENT POLICIES

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Individuals, businesses, and governmental bodies invest funds in capital improvements such as homes, plant and equipment, highways, and schools, respectively. This paper is limited to a consideration of private business investment, including both fixed and working capital. The former is primarily plant and equipment, the latter covers inventories, accounts receivable, and liquid assets.

Business investment policy is concerned with the sources and uses of capital, which together with land, labor, and management constitute the four factors of production. All are essential to business enterprise in greater or lesser degree in producing the goods and services necessary to maintain or improve our standard of living.

Other papers to be included in this compendium will consider investment and consumption from the viewpoint of the advantages to be gained by offering greater stimulus to one than to the other. However, it is generally agreed that a certain minimum amount of investment is both necessary and desirable. Attention will be devoted then to determining the general magnitude of business investment required for proper functioning of our economy, the possible sources of capital funds for investment, the effects of taxation on the supply and use of such money and possible remedies for any unhealthy situations that are disclosed. Because of the customary risk attending investment of funds in new business enterprise or in a new product, process, or service, money used for such purposes is generally referred to as venture capital. Inasmuch as our industrial progress is dependent upon an adequate supply of venture capital, our attention will be focused on this aspect of the problem.

CAPITAL REQUIREMENTS

Growth of economy

According to studies of the long-term growth of our economy by the National Bureau of Economic Research, the average per capita volume of goods consumed or acquired over the last eight decades has been multiplied over fourfold.[1] This represents an average annual rate of growth of close to 2 percent. While this rate of improvement in our standard of living may seem somewhat moderate at first glance it becomes more striking if one realizes that if this rate of progress

[1] Solomon Fabricant, National Bureau of Economic Research, Inc., Economic Progress and Economic Change, 34th Annual Report, p. 4.

is continued over the next 80 years, at the end of that period family incomes, which averaged $5,000 in 1953, will average about $25,000 in dollars of 1953 purchasing power. This is a level now attained by only 1 percent of all families in the country. Never in history has any country been able to show such improvement in material well-being of its people as has been witnessed in the United States over the last few generations.

To insure continuation of such betterment in living conditions it behooves us to learn the reason for the remarkable progress that has already taken place. Basically it has come about as a result of additions to the supply of capital available, and by reason of increases in the efficiency of its use, beyond that required just to care for the growing population. As a matter of fact, only by such means can "real" income be increased.

According to the latest available evidence, there has been little or no net increase in the per capita amount of labor employed in the production of goods and services over the last four decades. (A decline in the number of working hours per worker has offset a growth in the proportion of all persons in the labor force.) On the other hand, the available quantity of tangible capital resources per person has grown to a volume four times its size in 1870,[2] a rate of increase approximating 2 percent per annum. Thus, the growth in income (output) per capita was paralleled by a similar rise in the amount of employed capital per person. Furthermore, while the people of this country were gaining more and better things over this period, they were able to secure more leisure time in which to enjoy both their material rewards and their spiritual blessings.

Recent investment experience

It may be asked how there could possibly have existed any shortage of venture capital in recent years in view of the tremendous expansion in factory capacity and output which has taken place in response to the addition of military and defense needs to civilian demand. One is only further misled if he examines officially reported statistics on business investment, for without proper adjustment the data indicate a generally rising trend over the last decade in the aggregate of business investment in plant and equipment, inventories, receivables, and liquid assets. However, for proper evaluation of the development, it is essential to make a number of adjustments in the raw figures as reported.

With respect to plant and equipment outlays, dollar totals in recent years have been inflated by the higher price level, thus physical expansion of capacity has not been as striking as expenditures. More important is the fact that fixed assets are constantly wearing out and have to be replaced. Thus, a large part of current expenditure on plant and equipment represents replacement of assets rather than net additions to the resources available. For example, it has been estimated that only one-fifth of total business outlays for plant and equipment over the period 1946–51 represented net increase in business investment, while four-fifths of such gross expenditures were for replacement of fixed assets that had outlived their usefulness.[3]

[2] Op. cit., p. 6.
[3] National Association of Manufacturers, Major Tendencies in Business Finance, Economic Policy Division Series No. 57, January 1953, p. 8.

Similarly, in the case of inventories, the increase in book value during recent years of rising prices was considerably greater than the net physical expansion in stocks of goods held. In fact, it has been estimated that over the 6 years 1946–51 the percentage increase in physical volume of business inventories was little more than half as great as the percentage rise in book value.[4]

When the adjustments described above have been made in reported figures for business investment in plant and equipment and in inventories, some of the cause for complacency in the recent level of gross capital expenditures is removed.

Future capital requirements

Although studies indicate that owing to increasing efficiency in the use of capital the amount of capital required per unit of output has been declining since the 1900–10 decade,[5] ever-increasing amounts of capital will be required to provide the facilities for production of the goods necessary to satisfy the needs and wants of a growing population, and to provide jobs for millions of new workers. Estimates vary as to the amount of capital investment that will be required in the future, but all of them are substantial. Past investment can only be a partial guide to determining future sums needed.

It has been shown that a large part of the recent expansion in output was the result of increased productivity of capital, or efficiency in its use. Nevertheless, the amount of capital employed in manufacturing has been rising nearly as fast as the number of persons employed and will have to continue to do so in the future.

The average capital investment required for each production worker employed in manufacturing industry in 1949 ranged from about $3,000 in the apparel field to over $83,000 in the petroleum and coal products industry.[6] Another source has estimated 1955 average investment per worker in plant and equipment for all private business including agriculture at roughly $9,800 before depreciation and $4,800 after it.[7]

In addition to plant and equipment, which constitute the workers' tools, so to speak, a going concern requires working capital, including inventories, receivables, and a certain amount of liquid assets. If the funds allocated to these uses are included in the total as well as the investment in fixed assets, the capital per worker employed in all nonfinancial business in 1955 is computed at $12,500, of which nonagricultural activities account for $11,400.[8] Using these results the same source conservatively estimated that "if business as a whole is to absorb the annual growth in the private labor force, offset the current consumption of its fixed assets ($25 billion a year), and provide for a normal growth in investment per worker, it must find each year $35–$40 billion (at 1955 prices) in long-term capital."[9] By 1965, the requirements were estimated at $40–$48 billion (at 1953 prices).[10] Another source has projected business expenditures on plant and equipment in

[4] Op. Cit., p. 18.
[5] Daniel Creamer, Capital and Output Trends in Manufacturing Industries, 1880–1948, Occasional Paper 41, National Bureau of Economic Research, 1954, p. 70.
[6] National Industrial Conference Board, Economic Almanac, 1953–54, p. 316.
[7] Machinery and Allied Products Institute, Capital Goods Review, No. 28, August 1955, p. 1.
[8] Op. cit., p. 3.
[9] Op. cit., p. 4.
[10] Machinery and Allied Products Institute, Capital Goods Review, No. 22, May 1955, p. 15.

1965 at $60 billion compared to $38 billion in 1953. This would include $25 billion to replace fixed assets actually retired each year.[11]

There are two major forms of business capital: Borrowed and equity, a proper balance of which is essential to the health of any given firm and to the welfare of the economy. Equity capital is the form of financing that needs the greatest encouragement, yet under existing tax law the choice of this means is penalized. By its legal terms equity capital is suited to venturesome undertakings. It is evidence of ownership rather than of creditor status; it need not be repaid; it occupies a junior position in liquidation; it may earn no return at all, or a very excellent return depending upon success of the venture. Because of these characteristics it is more sound to employ equity capital than borrowed capital for projects attended by some risk, such as new businesses, new products or processes, of the type that mark our industrial progress. In addition, an unimpaired flow of equity capital is required to finance the growth of established companies and products and to protect the financial stability of the economy against the dangers of heavy debt burdens.

Sources of Equity Capital

Internal sources

Undistributed net profit, together with depreciation and depletion reserves, constitutes the internal source of capital funds for a business firm. However, only a small part of total undistributed net profit as reported (1946–51 annual average $10.5 billion, 1952–54 annual average $8.3 billion) was actually available for expansion after making allowance for current consumption of capital values at replacement cost and for the additional investment in inventories required because of rising prices. For the period 1946–51 it has been estimated that only one-third of reported total net undistributed profit was available for actual expansion of assets.[12] This amount was just one-tenth of total profit before income taxes over this period, while taxes accounted for over four-tenths, and dividends for less than one-fourth. Thus, a 25-percent reduction in corporation taxes would have doubled the amount available fof financing expansion of business. It is not believed that the shortage of capital funds can be attributed to an overliberal dividend policy, for the record shows that the percentage of gross business proceeds distributed as dividends declined from 6 percent in 1929 and 4.7 percent in 1939 to an average of 3.1 percent for the period 1946–51 and to 2.8 percent in 1953 and recovered only to 3 percent in 1954.

When a business firm designates a portion of its gross receipts as compensation for consumption of capital assets (a cost of doing business) such funds are available for general financial purposes. Thus, depreciation reserves are ordinarily listed as a source of capital funds. Although substantial in amount, they are inadequate, as has been noted, to compensate for capital consumption on a current replacement cost basis. Therefore, no part of depreciation reserves can be considered as available for financing net additions to capital assets.

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[11] Joint Committee on the Economic Report, Potential Economic Growth of the United States During the Next Decade, materials prepared by the committee staff, Washington, 1954, p. 11.

[12] National Association of Manufacturers, Major Tendencies in Business Finance, Economic Policy Division Series No. 57, January 1953, p. 24.

External sources

External sources of funds comprise borrowing of one sort or another (including bank loans, mortgage loans, bond issues, trade payables, and accruals of income taxes) and new issues of corporation stock. Such sources supplied nearly two-fifths of the total capital funds of nonfinancial corporations over the period 1946–51 but only one-third in 1953 and less than 10 percent in 1954 (when the decline in requirements owing to the recession was reflected entirely in a drop in money supplied externally).

A substantial part of the expansion of business capital assets during and since World War II was financed by borrowing, with the result that net corporate debt expanded from $74 billion at the end of 1939 to $177 billion at the end of 1954, an increase of over $100 billion.[13] This compares with a total of only $18 billion of new money raised by issuance of corporation preferred and common stock, representing equity capital, during this same period.[14]

The excessive reliance on borrowing as a substitute for equity capital has placed many business enterprises in a precarious position to weather economic storms.

EFFECT OF FEDERAL TAXES

Corporation tax

Federal taxes appear to have been an important factor in causing the trend away from equity financing. In the first place taxes impose a penalty on stock financing, for the full income tax must be paid on income used to pay dividends while money used to pay interest on debt goes free of tax. Thus, the cost of stock financing is increased by the income tax while the cost of debt financing is untouched.[15] Furthermore the high rates of personal taxes have encouraged corporations to retain earnings rather than to pay greater dividends and seek additional equity capital from stockholders. But to the extent the corporation tax is not shifted, earnings available for retention have been reduced, forcing businesses to borrow to secure capital. The corporate tax requires the management to sacrifice either on dividends or on funds to be used for expansion.

Individual income tax

Tax provisions have affected both the ability and the willingness of individuals to invest in equities. The increased severity of the income tax in recent years may be indicated by the fact that in 1952 a married couple with no dependents would have required a total income before taxes of $76,700 to yield the same real income (adjusted for rise in cost of living) after tax as total money income of $25,000 gave them in 1929. For a single person with no dependents the 1952 equivalent of $25,000 in 1929 was $163,000, or more than 6 times the earlier figure. For either status, to yield the after-tax real income

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[13] U. S. Department of Commerce, Survey of Current Business, September 1953 and May 1955.

[14] Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, June 1955.

[15] See Dan Throop Smith, Effects of Taxation, Corporate Financial Policy, Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1952, pp. 25, 103.

equivalent of $100,000 before taxes in 1920 the total money income before tax required in 1952 was close to $1,100,000 or 11 times as much.[16]

The willingness of individuals to invest in common and preferred stocks has also been impaired by the steeply progressive tax rates. Instead, there has been a pronounced trend toward investment in tax-exempt securities.

The impact of the discriminatory rates of personal income tax on choice of investment media is seen in the high before-tax yield required on taxable securities to leave an individual an after-tax return equivalent to that on low-yield tax-exempt securities. If, for example, tax-exempt bonds are assumed to yield about 2¼ percent, an individual with an income of $100,000 in 1952 who filed a separate tax return would need approximately a 19-percent before-tax return on a taxable investment to match the return on a tax-exempt security. Under similar circumstances a person with an income of $75,000 would need a 13-percent return on a taxable investment to net 2¼ percent after taxes, and an individual with a $40,000 income would require an 8-percent before-tax return to match 2¼ percent on a tax-exempt bond.[17]

In June 1953 about $12 billion, or 44 percent of the privately held total of wholly tax-exempt securities, was in the hands of individuals. (The major part, about 40 percent of the privately owned total, was held by commercial banks, also at least in part because of the tax-free incentive.) The effect of tax rate changes over the years on distribution of such securities by type of holder has been pronounced.[18]

Institutionalization of savings

The gravitation of personal savings toward financial institutions has become progressively more rapid in the postwar period. For example, it has been estimated that in 1951 only about 8 percent of total liquid savings accumulations of individuals went into equity securities.[19] The bulk of the $19.4 billion personal savings accumulated in that year went to institutional investors, including insurance companies, banks, and mutual funds, which in turn, owing to legal restrictions and natural conservatism, invested relatively little in new stock issues. In view of their trustee status and consequent need to confine investments primarily to assets of relatively stable value, the outlook is not promising for financial institutions ever to become major suppliers of venture funds.

Shortage of venture capital

It is impossible precisely to measure the extent and potential impact of the equity-capital problem; nevertheless, its seriousness is apparent. Some of its effects will not be felt until later. For one thing, inflation has materially lightened all debt burdens (at the expense, it is to be noted, of all creditors). When corporate profits cease to rise and fall instead, as indeed they must sometime in the future, the heavy burden of debt will tend to aggravate and prolong any business recession.

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[16] See J. K. Butters, L. E. Thompson, L. L. Bollinger, Effects of Taxation: Investments by Individuals, Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1953, p. 91.

[17] See J. K. Butters, L. E. Thompson, L. L. Bollinger, op. cit., pp. 184–185.

[18] See George E. Lent, the Ownership of Tax-Exempt Securities, 1913–53, National Bureau of Economic Research, Occasional Paper 47, 1955.

[19] New York Stock Exchange, Taxes—Equity Capital—and Our Economic Challenges, March 1953, p. 30.

There is need ahead for business expansion, not under conditions of inflation such as have existed during the past two decades, but in a stable, competitive economy. Under these circumstances it is unthinkable to continue a system of discriminatory tax rates that penalize and discourage business investment.

Remedies

There is space here only to list some of the steps that should be taken to remove the obstacles to business investment interposed by our present system of Federal taxes.

First and foremost in need of correction are the high income-tax rates and steep progression in the individual income-tax rate schedule, the deterrents to investment toward which the discussion in this paper has been mainly directed. Middle and upper bracket rates should be substantially reduced, and can be without great loss of revenue to the Treasury. In this connection a proposal advanced recently by the National Association of Manufacturers seems worthy of serious study. It has been suggested by this group that as Federal revenues rise in response to an expanding economy advantage be taken of the opportunity to reduce rates correspondingly. Many of the present problems of definitions, exemptions, deductions, and so forth, which often affect only a limited number of taxpayers would disappear under lower rates. After rates have been reduced, other action should be taken at an early date along the following lines:

Corporation income tax

Eliminate tax on intercorporate dividends.
Repeal 2-percent penalty tax on consolidated returns.
Restudy provisions for prepayment of corporate tax.

Individual income tax

Further relieve the double taxation of corporate earnings paid as dividends.

Estate and gift taxes

Remove from Federal jurisdiction.

Reforms affecting all taxpayers

Depreciation.—Allow taxpayer more discretion in choosing rate.

Capital gains and losses.—Reduce rate of tax; shorten holding period; allow deduction of excess of capital losses over capital gains with limitation on tax benefit; permit reinvestment of capital gains without tax.

Tax discrimination.—Taxation of all competitive enterprise should be fair and equal, regardless of legal form of business.

Income from foreign sources.—Business income earned abroad should receive favorable tax treatment, regardless of geographical area involved or form of organization.

EFFECTS OF TAXATION ON THE INVESTMENT CAPACITIES AND POLICIES OF INDIVIDUALS

J. KEITH BUTTERS, Harvard University

This paper discusses the effects of taxation on the investment capacities and policies of individuals.[1] This topic is important because of its relation to the formation and growth of business enterprises.

To put the problem into perspective, it should be noted that taxes may affect the formation and growth of business enterprises in two ways: First, they may dull the incentives needed to induce promoters and entrepreneurs to undertake new developments and the owners and managements of existing enterprises to adopt a vigorous policy of expansion; second, they may curtail the supply of capital required to finance the formation of new enterprises or the growth of existing enterprises.

This paper is concerned with one phase of the second of these areas of tax effects, namely, outside equity capital supplied to business by private investors. The reason for this emphasis is that individual investors supply a major part of the ownership funds available from sources other than retained earnings to new and growing enterprises, particularly those of small to moderate size.

The effects of taxation on the investment capacity and policies of individuals can best be analyzed by breaking the subject into three main questions:

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

WHOSE INVESTMENT DECISIONS ARE IMPORTANT?

The first task is to ascertain which classes of the population are important, insofar as the effects of taxation on the flow of equity capital from private individuals to business are concerned. In particular, are most of such funds supplied by the large mass of the population with small- to medium-size incomes, or by the small proportion of individuals in the society who receive sizable incomes? When the sharply differing impact of the tax structure on people in different income classes is considered, it quickly becomes apparent that this is a key question for any inquiry into the effects of taxes on individual investors.

Broadly speaking, the evidence leads to an unambiguous answer to this question. *From the standpoint of the flow of equity capital from private investors to business, the investment decisions of individuals*

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[1] This paper is based largely on the findings reported in J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation on Investments by Individuals (Boston, Harvard Business School, 1953) and summarized in Lawrence E. Thompson and J. Keith Butters, Effects of Taxation on the Investment Policies and Capacities of Individuals, Journal of Finance, May 1953, pp. 137–151. The research underlying these publications was part of a series of studies of the effects of taxation on business decisions, conducted through the Harvard Graduate School of Business Administration and financed by a grant from the Merrill Foundation for Advancement of Financial Knowledge.

The views expressed in this paper are purely personal and do not necessarily reflect the views of my associates. Most of this paper, however, is paraphrased or quoted from the above publications. Since the background study is available in published form, no effort is made in this summary statement to discuss methodological problems.

in the upper income and wealth classes are of overwhelming importance. This conclusion is based on an analysis of (1) the groups in the population which have the capacity to invest in business equities in large amounts, and (2) the groups which are disposed to do so. It is supported by a study of the accumulations of new investable funds by different income groups, of the attitudes toward business equities by different income groups, and of the distribution of the ownership of common stock among different income and wealth groups. Because of space limitations, I shall cite in detail only our findings on the last of these points.

Our estimates on the concentration of stock holdings were originally made primarily on data for the year 1949, supplemented to some extent by data for other years. As of 1949 we estimate that approximately 65 to 70 percent of all the marketable stock held by private individuals was owned by family spending units with a net worth in excess of a quarter of a million dollars. In view of the rise in stock prices and other asset values which has occurred between 1949 and 1955, it seems highly probable that an analysis of current data would show an increase, rather than a decline, in this percentage. Precise data on the fraction of family spending units with this amount of wealth are not available, but it is clear that only a relatively small fraction of 1 percent of all spending units have a net worth as large as $250,000.

Classified by income groups our best estimate is:

1. About 35 percent of all the marketable stock held by private individuals is owned by approximately the top one-tenth of 1 percent of family spending units. As of 1949, this fraction represented family spending units with incomes of $50,000 and over.
2. About one-half of all such marketable stock is owned by the top one-half of 1 percent of all family spending units. As of 1949, this fraction represented family spending units with incomes of $25,000 and over.
3. About 75 percent of all marketable stock owned by private investors is held by approximately the top 1 percent of the population. As of 1949, this fraction represented family spending units with incomes of $15,000 and over.

In percentage terms there seems little reason to believe that estimates based on current data would show any striking shift in the above figures; such limited current data as are available do not appear to indicate that any such shift has occurred. The absolute income levels representing the cutoff points for any specified fraction of the population have, of course, risen between 1949 and 1955 because of the general rise in income levels which has occurred during these years.

As already indicated, the above data constitute only one of several sources of evidence which point to the conclusion that business must look mainly to a very small percentage of the population for the outside equity capital which it hopes to obtain from private individuals. It would take a marked shift in investor habits to invalidate this conclusion.

Effect of Taxes on Investment Capacity of Upper-Income Individuals

The charge is frequently made that the severe rates of the personal income tax have, for all practical purposes, wiped out the capacity of individuals with large incomes to save. The reason for this widespread conviction is not hard to understand. The increases in personal income tax rates since the 1920's have been so great that on superficial examination they appear to establish a prima facie demonstration of this thesis. Moreover, it can be shown beyond any reasonable doubt that the tax increases of recent years have cut severely into the incomes of upper-bracket individuals and undoubtedly also into their capacity to accumulate new investable funds, provided that the incomes of these individuals bear the full brunt of the individual income tax.

This demonstration, however, falls far short of showing that taxes have wiped out, or anywhere nearly wiped out, the capacity of upper-bracket individuals to accumulate new investable funds. On the contrary, the evidence indicates that as a group individuals in the upper income percentiles are still accumulating large amounts of new investable funds despite existing tax rates.

Two reasons appear to explain the continued large accumulations of funds by individuals in the upper-income groups.

First, the habit of saving appears to be deeply ingrained in most individuals with moderate to large incomes. All the evidence indicates that the overwhelming majority of the individuals in the top 1 percent of the population—ranked by size of income—are still accumulating positive savings, and that the savings of at least half of these individuals amount to a fairly sizable fraction of their incomes before taxes, say, to a fifth or more.

Within the group of persons receiving very large incomes, it is quite possible that those whose living standards were geared to high levels before the period of very high income taxes, and whose disposable incomes have been sharply reduced by the imposition of such taxes, may have ceased to save significantly or may even be living off their capital in many instances. This group, however, appears to be more than offset by individuals whose incomes (both before and after taxes) have risen along with or after the imposition of very high tax rates. The evidence appears to indicate that, as the income of such persons (say, young executive or professional persons) rises, the advance in their living standards is keyed to their disposable income rather than to their income before taxes, and that (by and large) they continue to save despite the high income taxes which they must pay.[3]

A second major explanation of the continued capacity of upper-bracket individuals to accumulate substantial amounts of investable funds is that there are numerous ways in which many groups of upper-bracket individuals can accumulate investable funds without having them subjected to the full impact of the individual income tax. While the data for appraising the extent to which advantage is taken of the opportunities of avoiding the full impact of the individual income tax are not very satisfactory, it can safely be concluded that the use made of them contributes substantially to the surprisingly large accumulations of savings still being made by individuals with large incomes.

[3] For quantitative estimates see Butters, Thompson & Bollinger, op. cit.

In general, then, our conclusion is that the changes in the tax structure over the past 15 to 20 years have substantially reduced the capacity of upper-bracket individuals to accumulate new investable funds as compared with what they would have been able to accumulate under a less progressive tax structure, but that, for the reasons indicated, their remaining capacity is still very large—much larger than is popularly supposed.

Effect of taxes on investment policies of upper income individuals

Besides curtailing the investment capacity of individuals, taxes could restrict the supply of funds which individual investors are able and willing to invest in business equities by reducing the incentive for individuals to risk their funds in such investments. The fact that individuals with large incomes are still able to accumulate large amounts of investable funds under existing tax rates makes it all the more important to determine the effect of taxes on the investment policies of these individuals. If there is real substance to the allegation that taxes have dried up or seriously impeded the flow of equity capital to business, they must have greatly reduced the willingness of individuals to put their funds to venturesome uses; the restrictive effects of taxes on the investment capacity of individuals, though real, have not been sufficiently powerful by themselves to substantiate this allegation.

The first point to be made in discussing the effects of taxes on the investment policies of individuals is that patterns of investor thinking and reactions are extremely complicated and diverse. For this reason any summary statement on this point must necessarily be oversimplified. I shall deal only with the effects of taxes on the willingness of investors to incur differing degrees of investment risks, that is, to follow venturesome or conservative investment policies; other types of tax effects, such as those on the timing of investment transactions or on the use of such means as gifts and trusts to reduce income and death tax liabilities, will not be considered.

At a general level, one fact stands out very clearly. The ways in which taxes affect the investment policies of individuals can be meaningfully discussed only in the light of the investment objectives of groups of investors. Two individuals, similarly situated as to age, family responsibilities, and income and wealth status, may react to the tax structure in very different ways if they have different investment objectives. Before reporting our conclusions on tax effects, therefore, it will be helpful to describe the range of investment objectives which characterize individual investors. Broadly speaking, these investors can be classified into the following categories:

1. Investors who take the extreme position of conservatism and who strive simply (or mainly) to preserve their capital. Most individuals with capital preservation as their main investment objective seem to have in mind the dollar value of their wealth rather than its real value in terms of purchasing power.

2. Investors who have both capital preservation (or security) and a moderate income yield as investment objectives, but who are very reluctant to make investments which involve an appreciable degree of risk of capital loss.

3. Investors who place a major emphasis on an "adequate income yield" or a "good return" from their investments and who

are willing to assume somewhat greater risks of capital loss provided that the prospective income yield is great enough to warrant the assumption of these risks.

4. Investors who stress both an adequate income yield and an opportunity for capital appreciation as investment objectives and who are willing to assume still greater risks of capital loss provided that the prospects for capital appreciation are good.

5. Investors who are interested almost exclusively in capital appreciation and who have relatively little interest in income yield. This type of investor typically expects to assume high risks of capital loss provided that the compensating opportunities for large capital gains are sufficiently attractive.

From the standpoint of tax effects, the most significant breakdown of investors by categories of investment objectives is between those investors who have capital appreciation as a main or important investment objective and those who do not. Individuals with capital appreciation as a major investment objective typically react very differently to the tax structure than do those whose major emphasis is on income yield or on security. To the extent that taxes influence investment decisions at all, they drive the great majority of investors with the latter objectives into more conservative investments, whereas they typically induce investors interested mainly in capital appreciation to make even more venturesome investments than they otherwise would.

A much larger proportion of investors in the upper income groups than in the lower income groups has capital appreciation as a main or important investment objective. For example, only about one-fourth of the individuals whom we interviewed with incomes of less than $7,500 expressed a strong interest in capital appreciation as an investment objective as compared with well over half those with incomes of $25,000 and over.[3]

Because of the sharp differences in the reaction to the tax structure of income-minded and security-minded investors, as compared with appreciation-minded investors, the general nature of the tax effects on individuals can best be described by discussing these two groups separately.

Income-minded and security-minded investors

Income-minded and security-minded investors, in making investment decisions, tend to balance the current income yield of their investments against the risk of capital loss, and to give very little weight in their investment decisions to the possibility of capital gains usually present in investments which also present high risks of capital loss. The high rates of the individual income tax exert by far the most important tax influence on the investment decisions of these groups of individuals, and their predominant effect is to drive these individuals into lower yield, less risky investments than they would otherwise make. The intensity of this tax effect is, of course, closely related to the tax brackets of the investors concerned.

For these groups of investors, the high income-tax rates on upper bracket individuals exert their main effects by greatly reducing both

[3] It is interesting to note that a recent study published by the New York Stock Exchange entitled "The Public Speaks to the Exchange Community" shows sample results from a survey undertaken in August and September 1954 which are very similar to ours for individuals with incomes of $7,500 and over.

the absolute yield and the relative yield on investments with a high yield (such as common stock) as compared with low-yield investments (such as Government bonds). For individuals in very high-tax brackets, the after-tax yields on such investments as common stocks may even be reduced below those available from some types of low-risk investments such as tax-exempt securities and certain life-insurance policies. This reduction (or even reversal) in after-tax yield differentials causes many investors with income or capital preservation as an investment objective to shift part of their funds out of, say, common stocks and into lower yield investments because they do not regard the income yield remaining after taxes from high yield securities as adequate compensation for the risks of capital loss inherent in their ownership.

Theoretically, the fact that in computing taxable income capital losses may be deducted, at least in part, constitutes a partial offset to the foregoing repressive effects. To the extent that capital losses can be offset against otherwise taxable income or capital gains, the net amount at risk by the taxpayer is less than the total amount involved. In other words, the maximum net loss which can be suffered by the taxpayer is the total amount of his investment less any compensating tax savings in the event that the investment turns out to be a total loss.[4] Much has been made of this point in theoretical analyses of tax effects.

Practically speaking, however, these offsetting considerations to the repressive effects of high income-tax rates are of very limited importance for the categories of investors now being discussed. For one reason, the severe restrictions placed on the deductibility of capital losses by the tax law greatly reduce the potency of loss deductions as a factor influencing the investment decisions of individuals. Subject to minor qualifications, the maximum tax benefit which can be derived from the deductibility of capital losses on assets held for more than 6 months is 25 cents for each dollar of realized loss, and even this tax benefit is dependent on the availability of capital gains against which the loss can be offset.

A second reason of major importance in reducing the practical importance of loss offsets for these groups of investors is that these offsets are not usually in the forefront of investor consciousness. As a general statement, investments are made because the investor expects them to be successful, not because he anticipates that they will be a failure. Given this expectation, it is only natural that greater attention is given by investors to the impact of taxes in reducing the return available in the event of success than to the cushioning effect of loss offsets in the event of failure. Consequently, for investors who are motivated by the prospective income yield of their investments rather than by a desire for capital gains, the existence of high surtax rates typically constitutes an investment deterrent and would, we believe, continue to do so even if substantially more generous loss offsets were permitted than are now allowed.

As already noted, the income-tax effects just described account for the large majority of tax-motivated shifts in a conservative direction by the groups of investors under discussion. The only other tax ef-

[4] This statement ignores certain refinements such as discounts which should be applied to the tax savings resulting from loss offsets because they will be obtained at a later date and because their receipt is subject to some uncertainty.

fect causing any considerable number of security-minded and income-minded individuals to shift to more conservative investment positions is the desire for liquidity stimulated by the estate tax. The estate-tax structure creates a definite incentive for many individuals, especially those in the top wealth classes, to increase their holdings of liquid assets and of life insurance in order to provide a ready means of payment of their estate taxes on their death. Generally speaking, however, shifts in this direction appear to be moderate in degree. Only a minority, even of the wealthiest individuals, appear to increase their holdings of these assets substantially for estate-tax reasons.

In contrast, only rarely are income-minded and security-minded investors stimulated by tax considerations to take greater rather than smaller investment risks. Individuals who do react in this way generally are persons under such pressure to maintain a given level of income that they are prompted to shift to more venturesome forms of investment as high taxes (and other factors such as increases in the general cost of living, the loss of earned income on retirement, and declining interest rates) place increasing pressure on their standard of living. Such individuals usually do not have large incomes.

Tax effects on appreciation-minded investors

The tax effects on investors interested mainly in capital appreciation are quite different from those just summarized for the income-minded and security-minded investors. Our evidence points overwhelmingly to the conclusion that, for appreciation-minded investors, *the single most important feature of the tax structure is the differentially low rate at which long-term capital gains are taxed in comparison with the much higher rates on ordinary income, especially for individuals in the upper income-tax brackets.* This differential has stimulated inherently venturesome individuals to seek out investments which offered prospects of capital gains rather than the receipt of ordinary income. As a consequence, it has caused this group of investors to shift funds out of relatively conservative investments, offering little or no opportunity for capital appreciation and into more venturesome types of investments such as relatively speculative marketable common stocks, closely held companies, new ventures, real estate, and oil properties. The incentive to invest in real estate and oil properties, it should be noted, is further stimulated by the opportunity of obtaining what many investors regarded as important tax advantages in the form of percentage depletion and current deductibility of intangible drilling costs on oil properties and depreciation deductions on real estate.

The power of these inducements is reflected in the fact that, of the appreciation-minded individuals who respond at all to tax effects, the overwhelming majority move into more venturesome investment positions because of taxes.

Our evidence indicates that many more investors are attracted by the favorable rate differential accorded capital gains than are repelled by the existing restrictions on the deductibility of capital losses. The differential between the tax rates on capital gains and on ordinary income was mentioned very frequently, especially by investors with large incomes, as a motivating factor in investment decisions. In contrast, only a handful of instances were encountered in which the existing limitations on the deductibility of capital losses were cited

as deterrents to venturesome investments. Similarly, the absolute level of the capital gains rate and the length of the 6-month holding period were cited as investment deterrents only in a very small number of instances.

No single motivation was responsible for the limited number of instances in which appreciation-minded individuals were driven by the tax structure into less venturesome investment positions. The desire for liquidity to meet eventual estate-tax liabilities was occasionally mentioned as a reason for increased holdings of liquid assets and insurance. Other investors indicated that they were reluctant to invest in new ventures or closely held companies because the high rates of the corporation income tax limited the potential growth of these companies. Finally, in a very few cases, the level of the capital gains tax was cited by appreciation-minded investors as an explanation of a decreased willingness to make venturesome investments. But, as we have already indicated, for appreciation-minded investors as a group all these factors combined were far outweighed by the positive inducement to venturesome investments offered by the differentially low rate at which long-term capital gains are taxed in comparison with ordinary income.

Overall appraisal

With all the foregoing factors taken into account, the following is the best one-paragraph summary of our findings which I can give: The tax structure in recent years has cut substantially into the investment capacity of the upper income and wealth classes—the strategic source of venture capital for investment in business—and, on balance, it also decreased the willingness of these investors in the aggregate to make equity-type investments. In other words, for equity-type investments considered as a whole the investors who were induced by taxes to shift to less risky investment positions appear to have overbalanced the opposite reaction of appreciation-minded investors. The latter group, however, may have been so stimulated by the tax structure to seek out investments offering unusually large capital-gains potentialities as actually to increase the flow of capital to such situations. However this may be, it is clear that the combined impact of these effects fell far short of drying up the supply of equity capital which private investors were willing and able to make available to business. The evidence indicates that the accumulation of investable funds by the upper-income classes has been consistently large during postwar years, despite the existing tax structure, and that individuals with large incomes and substantial wealth continue as a group to hold and invest a large proportion of their funds in equity-type investments.

Policy implications

Space does not permit a careful discussion of the policy implications of our findings, but there are 1 or 2 main points which we should like to make very briefly. If our analysis is sound, the tax structure in the postwar years has been much less repressive on the capacity and willingness of upper-bracket individuals to make equity-type investments than is popularly believed. A superficially plausible case could even be made that there is no occasion for great concern over the effect of the existing tax structure in this regard—and, in some

phases of the business cycle, this conclusion may be essentially sound. As a generalized statement, however, it is far too simple.

This conclusion ignores the fact that the postwar period has been one of high business activity, stable to rising price levels, and reasonably optimistic investor expectations. The repressive aspects of the tax structure undoubtedly are much less potent under these conditions than they would be in, say, a time of business depression; similarly, the stimulating aspects of the tax structure have been relatively much more powerful during the past decade than they would be under less favorable business conditions. In a time of depression and investor pessimism, the risk of capital loss would weigh more heavily in the minds of investors than in recent years and the prospects of capital gains or of a high income yield would appear much less enticing. Thus, conclusions as to the extent to which the tax structure stifles the flow of risk capital during a period of high business activity cannot be applied without modification to a time of declining business activity and investor pessimism. The logic of our analysis indicates that the tax structure would be far more repressive in its economic effects in a declining period than it has been during the past decade of generally buoyant economic conditions.

The second major point which I would like to make has more bearing on the problems presented by various proposals for revisions in the tax structure than on the effects of the existing tax structure in different phases of the business cycle. The essential problem can be stated as follows: The existing tax structure has been only mildly repressive in recent years in its aggregate effects on the decisions of private investors largely because it consists of a balance between repressive and stimulating elements; during the postwar years the stimulating incentives have, to a considerable degree, neutralized the repressive effects. These stimulating incentives arise from opportunities provided by the tax law of obtaining income—or at any rate of accumulating investable funds—in ways that are not subject to the full rates of the individual income tax. To many individuals these opportunities of avoiding the full impact of the individual income tax constitute undesirable elements of discrimination in the tax structure which should if possible be eliminated. Thus, the dilemma is posed that the features of the tax law which provide from many standpoints highly desirable economic incentives are, at least in the eyes of many persons, the source of serious inequities.

In effect, the low capital gains rate (as well as the favorable tax treatment accorded certain industries) has made it possible to tax ordinary sources of income at exceedingly high rates without destroying the flow of equity capital from upper bracket individuals to business—at least in periods such as the recent past. I believe it also follows, however, that—so long as the tax rates on ordinary income are continued at current levels and relatively riskless means of obtaining tax-exempt income remain readily available—any substantial tightening up of the capital gains tax would go a long way toward curtailing the willingness of upper bracket individuals to make venturesome investments. In other words, if the existing balance in investment incentives is to be maintained, any increases in capital gains taxation would need to be offset by compensating reductions in the rates at which ordinary income is taxed and preferably also by a

reduction or elimination of the existing opportunities for obtaining tax-exempt income from relatively riskless investments.

The purpose of these brief comments is not to recommend any specific tax policy toward capital gains but rather to comment in general terms on the relationship of the existing tax treatment of capital gains to my general conclusion that the overall repressive effects of the existing tax structure on the capacity and willingness of upper bracket individuals to make venturesome investments appear to have been limited in scope in postwar years. Unless the delicate interplay of investor motivations and specific tax provisions which have produced this effect are understood, the precarious balance now existing could easily be unintentionally upset by revisions in specific portions of the tax structure made without full recognition of their overall effects.

FEDERAL TAXES AND INVESTMENT OPPORTUNITIES

ARTHUR A. ELDER, American Federation of Labor

The criticism most frequently aimed at existing or proposed Federal tax programs by spokesmen for business and investment interests is that they restrict or may adversely affect investment opportunities.

This reproach usually fails to recognize that the encouragement or discouragement of investment opportunities cannot be considered the sole touchstone in judging the social value of any tax program. Indeed, there is room for belief that certain economic patterns might well call for use of the tax machinery as an instrument to put brakes upon investment opportunities in the hope of aiding the general welfare.

The present administration supports the view that high surtaxes curtail the capacity and incentive to invest. In his budget message in January 1954, President Eisenhower made the following recommendations for Federal tax revisions:

> Revision of the tax system is needed to make tax burdens fairer for millions of individual taxpayers. It is needed to restore normal incentives for sustained production and economic growth. The country's economy has continued to grow during recent years with artificial support from recurring inflation. This is not a solid foundation for prosperity.
>
> We must restore conditions which will permit traditional American initiative and production genius to push on to ever higher standards of living and employment. Among these conditions, a fair tax system with minimum restraints on small and growing businesses is especially important.

President Eisenhower and other administration spokesmen imply that Federal tax policy in the past had not been conducive to the development of incentives and the encouragement of investment.

It might be useful to examine the investment scene during the past 20 years in relation to overall tax developments and to try to determine how these developments may have affected investment.

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The following table shows the average gross private domestic investment for 1929 and for 5 periods from 1930 through 1954 in terms of 1947 dollars:[1]

TABLE 1.—*Average yearly investment*

[Billions of dollars]

Year:	
1929	$26.8
1930–34 (inclusive)	7.9
1935–39 (inclusive)	16.0
1940–44 (inclusive)	16.5
1945–49 (inclusive	28.5
1950–54 (inclusive)	41.0

In trying to trace a relationship between tax policy and investment opportunity, it seems pertinent to determine to what degree fluctuations in investment were the result of Federal tax policy at any particular time.

Treasury Secretary Mellon in the Harding, Coolidge, and Hoover administrations during the twenties placed major emphasis on reduction of tax rates on personal and corporate income. The 1921 act reduced surtax rates from 1 percent on net income above $5,000 to 1 percent on net income above $6,000, and at the same time reduced the top surtax rate from 65 to 50 percent. The act also eliminated the excess-profits tax and limited the rate on capital gains to a maximum of 12.5 percent. In 1924 the top surtax rate was cut to 40 percent. The 1926 act cut the top surtax rate to 20 percent. Corporation tax rates were again reduced in 1928. These reductions, as approved by Congress, were actually below Secretary Mellon's recommendations. In his zeal to "stimulate investment and initiative," Mr. Mellon had urged further reductions in top surtax rates and recommended complete elimination of the estate tax.

These successive tax reductions adopted during the twenties had by 1929 brought personal and corporate tax rates to their lowest point since World War I. However, in spite of reductions in rates, Federal revenue averaging in excess of $4 billion yearly, stood at $4.1 billion in 1929 and exceeded expenditures for every fiscal year from 1920 through 1930. The net Federal debt which was $23.7 billion in 1920 declined to $16.5 billion by 1930.[2] Private investments had increased steadily, reaching a high point of $26.8 billion in 1929.

On the basis of the facts cited above, one might have agreed early in 1929 with those editorial writers, Government officials, and economists who supported the thesis that adherence to a tax policy that placed primary emphasis on encouraging investment, coupled with keeping Government expenditures below receipts to permit debt reduction, had achieved its objective.

But in December 1929, Mr. Mellon recommended, and Congress later approved, additional reductions in corporate and normal rates applicable to 1930 income as a means of counteracting the depression. In the face of the tremendous deflationary pressures building up in 1929 and at a time when business and taxpayer confidence was badly shaken, the 1930 tax-reduction bill probably was appropriate.

[1] Economic Report of the President, January 1955, p. 140.
[2] U. S. Treasury data.

Subsequent events, however, seemed to show that the administration had no more real appreciation of the need for relating tax policy to the overall economic requirements in late 1929 than it had had during the earlier twenties. From 1920 to 1929 emphasis had been placed on investment profits and production, to the neglect of adequate consideration of other factors such as levels of employment, wages, and consumption. While some significant wage increases accrued to certain income groups during the twenties, the increased number of workers and the rise in total payrolls in manufacturing and nonmanufacturing industries lagged far behind the 25 percent increase in production that took place between 1923 and 1929.

Economists generally agree that the long-term interests of investors were adversely affected by the tax policy followed during these years. The policy encouraged the building up of excess plant capacity without being coupled with necessary tax and fiscal measures that might have resulted in adequate use of that capacity.

Gross private domestic investment declined from $26.8 billion in 1929 to $17.9 billion in 1930, then fell to $12 billion in 1931 and dropped to an average of $3.2 billion for the years 1932 to 1934, inclusive. (See table 1.) This precipitous decline in investment would seem to indicate that there had been an excess of plant capacity built up and/or that other factors necessary to assure full use of that productive capacity were lacking.

Tax policy, then, which clearly called for higher rather than lower taxes on personal business and investment income during the twenties encouraged initiative and investment but contributed with other factors to building up inflationary forces at the very time higher taxes were needed to check those forces.

The tax reductions approved by Congress in 1930 were more appropriate as measures designed to restore confidence and encourage enterprise at a time when nationwide decline in security values, increased unemployment, price declines, and monetary surpluses were in prospect. Unfortunately, in 1930 neither public spending policies, private spending, nor governmental agencies existed that could reinforce any of the positive effects that might have resulted from the 1930 reductions.

It soon developed that even though there was ample evidence that the stock market crash of 1929 was merely a prelude to a general worsening of the economic situation, Secretary Mellon felt the maintenance of a balanced budget was indispensable. To this end he recomended increases in tax rates. The 1932 act which was passed after Mr. Mills had succeeded Mr. Mellon as Secretary of the Treasury increased personal and corporate income tax rates substantially, increased estate tax rates, and included a gift tax.

These efforts to balance the budget in a depression period through higher taxes not only failed to achieve their purpose, but undoubtedly contributed to strengthening the deflationary depression forces. Unfortunately, the Democrats in office also increased taxes throughout the thirties. More fortunately, however, President Roosevelt recognized that decisive steps were necessary to check the depression and restore the economy, even though such steps substituted deficits for budget balancing.

Undoubtedly the tax policy followed in the thirties had a braking effect on the various programs that were enacted to restore the Nation

to economic health. However, the measure of the administration's recognition of its responsibility for restoring the Nation to economic health is evident in the fact that the net Federal debt increased by $20 billion from $24.3 billion in 1933 to $44.8 billion in 1940. These billions were used largely to finance emergency relief measures and what may be termed long-range economic stabilizers. The Emergency Banking Act, the Unemployment Relief Act, the Federal Housing Administration, the Agricultural Adjustment Act, the Tennessee Valley Authority Act, the Wagner Act, the creation of the Securities and Exchange Commission, the Social Security Act, and other measures had all combined with the creation of the Reconstruction Finance Corporation at President Hoover's recommendation in 1932 to establish a gradual restoration of confidence and stability from 1933 onward.

Many economists contend that the increased tax rates adopted by Congress during the Roosevelt administration had virtually no braking effect on investment. They point out that the higher rates on personal and corporate income were levied on the basis of ability to pay. They argue further that direct economic measures taken to provide jobs, eliminate food surpluses, and stimulate spending by both producers and consumers required a simultaneous development of tax policy that would give assurance that Government credit would be maintained through gradually increasing tax revenue. They believe that this increased revenue should properly be paid by taxpayers in proportion to the economic benefits they derived from the federally financed program of reconstruction and stabilization.

To a large degree Federal measures provided built-in stabilizers that gave assurance to farmers, workers, small-business men, corporations, and professional people that the Federal Government was assuming responsibility for insuring the overall health of the economy, minimizing risks, and providing a measure of security for all. This was done by recognizing the bargaining rights of workers, supporting welfare programs, establishing old-age insurance and assistance, providing grants of public-health services, establishing school-lunch programs, enacting unemployment insurance, aiding widows and dependent children, and enacting minimum wage-and-hour legislation. All these measures operated to provide additional opportunities and incentives to investors. More direct and immediate aid was provided by the Federal Government through agencies created to insure bank deposits, to establish price floors for agricultural products, to aid homeowners and builders, to underwrite publicly owned cooperatives, small businesses, and privately owned corporations, to create regional power and development projects, and to make grants to needy communities for specific purposes.

These measures did not restore our economy overnight. Some, such as the Social Security Act, probably resulted in some hardship and exercised a deflationary effect because they were financed in part by a tax on workers and in part by the general public through the tax paid by the employers. Yet all workers and their families, as well as the whole economy, will benefit through the operation of OASI. Moreover, the steady year-by-year increase in per capita disposable income of from $389 in 1932 to $576 in 1940 (in 1954 dollars) was accompanied by an increase in private investment of from $3.3 billion in 1932 to $22.8 billion in 1940.

The yearly average of investment during the 1950–54 period stood at approximately 2½ times the average investment during the 1940–44 period when wartime needs limited plant expansion. It is possible that investment will not be maintained at the high levels prevailing since 1945, since wartime depletion of plant, equipment, housing, and consumer durable and nondurable goods developed inflationary pressures which began to diminish before 1950 but were given added impetus because of tremendously increased spending by the Federal Government to finance the defense program following the invasion of Korea.

However, investment in equipment and plant expansion since 1951 has been materially stimulated by Federal Government orders and a 5-year tax-amortization allowance on projects involving approximately $32 billion of investment. Some economists have expressed the opinion that surplus plant capacity has resulted from the capital investment that has taken place during the last 10 years. Whether or not there is surplus productive capacity, it would seem that those who favor modifying tax policy to stimulate investment must assume the burden of proof for establishing that present tax policy has impeded investment, and for advancing practical proposals to remove such impediments.

Investment opportunities are not limited to the purchase of equities or the expansion of industrial plant and equipment. No doubt deductions on mortgage interest and tax deductibility for homeowners stimulate the building of homes, though to what extent it is not easy to ascertain. Compared to the influence of the technical revolution, the development of automobiles and highways, etc., the tax-saving factor is probably not important, certainly not to low-income homeowners whose deductions for all purposes do not exceed the standard deduction.

The Federal Government since 1935 has provided direct and positive stimulus to private non-farm-housing construction by underwriting more than 5 million housing units under the FHA and VA guaranteed-loan programs.

Federal Government expenditures for goods and services which averaged $100 billion yearly in terms of 1947 dollars during fiscal years 1943, 1944, and 1945 continue at high levels, having averaged $37 billion for fiscal years 1950 through 1954.

Federal spendings in combination with continually mounting State and local spendings will continue to provide substantial investment opportunities. During the past 15 years new communities have arisen in the United States, Alaska, Hawaii, as well as abroad, centering around naval power developments, Army, Air Force, or AEC installations with substantial fabricating, distributing, and consumption industries which have been largely financed by Federal spendings. On the other hand, the year-by-year increase in personal expenditures nationally of from $115.6 billion in 1935 to $234 billion in 1954 resulted in large measure from various Federal stabilization, fiscal, and spending programs. It would seem that a continued increase in personal expenditures would provide the best assurance of necessary expansion of investment.

All of the developments referred to above during the past 25 years argue very strongly that the Federal Government, by minimizing risks of business, even as it builds up economic security and purchas-

ing power for farmers, professionals, and workers, is providing valuable incentives for investors. Moreover, the record of this period shows that to the degree a climate favorable to the economic well-being of all groups has been established it should be unnecessary to argue for special tax treatment for any particular group.

Corporate return on investment has been at consistently high levels since 1941. For the 3 years 1947–50, inclusive, the ratio of profits after Federal taxes averaged 14.8 percent of stockholders' equity for all corporations with assets ranging from less than $250,000 to those with assets of $100 million or more. Average return on stockholders' equity ranged from 9.8 percent after taxes for smaller corporations to 15.3 percent of stockholders' equity in the largest corporations. The average return for all corporations after taxes in 1953 fell to 10.4 percent of stockholders' equity.[3] This ratio will undoubtedly be higher for 1955 because of the elimination of the excess-profits tax last year and various tax savings accruing to corporations under the 1954 Revenue Act.

Actually, all available evidence now appears to show that present tax laws discriminate against low-income-tax payers' earned income and in favor of investment income and earned income in the middle and higher income categories.

During the past 15 years ever-widening areas of tax escape to "remove inequities" or "stimulate investment" have opened up. The husband-wife income splitting in the 1948 Revenue Act reduces the tax bills of married couples in middle- and upper-income groups by an estimated $2.5 to $3 billion yearly under the current rate schedule. Additional opportunities to make tax savings were provided under the 1951 law to split larger incomes under family partnership rules. Congress in 1954 approved substantial tax savings on dividend income. No adequate allowance is made for expenses in connection with taxes on earned income which are collected at the source. Yet it is estimated that close to $300 million yearly in revenue is lost through failure of the Federal Government to withhold taxes on dividends and investment income.

It is also generally accepted that hundreds of additional millions in taxes on income not subject to withholding at the source is not collected. Tax-exempt securities issued by States and local governments constitute another area of tax avoidance of particular value to upper income group taxpayers who through these various provisions are enabled to lower the effective rate on their income.

Low capital-gains rates do encourage investment but have been extended to types of income which should be taxed at regular surtax rates. The capital-gains provision was originally justified as encouraging long-term investors, not short-term speculators. This purpose was better achieved under the law prior to 1942 under which the tax varied inversely with the length of the holding period. There also appears to be little reason for not applying the capital-gains rate to the transfer of capital assets following decease of the holder. Failure to do so is another instance of unnecessary consideration for investors which has little relation to stimulating investment.

It has been frequently charged, perhaps correctly, that high surtaxes make it difficult for small businesses to compete with big busi-

[3] Economic Report of the President, 1955, p. 192.

ness, and that this has tended to hasten the trend toward large-scale production, to the disintegration and death of small enterprises so necessary to a competitive society.

Yet in some areas the provisions in the tax law which serve to limit the impact of these high rates have also stimulated mergers for the purpose of tax avoidance. In the textile industry, for example, huge mergers have taken place to exploit the tax advantages made possible under the capital-gains provision, the carry-forward provision of the corporation law, and by the tax-free position of pension funds and foundations.

Through long-term purchase programs which require little funds on the part of the buying organization and permit the old management to retain control of the concern and share in the profits, some large companies have been able to escape the heavy taxation which otherwise would have befallen them. The acquired properties have not been expanded or modernized; in some cases they have been abandoned and further centralization and control of the industry achieved.

The carry-forward and carry-back provisions of the Federal corporation income tax, justifiable as they may be, have also stimulated mergers and consolidations. In connection with the merger of the American Woolen Co., Robbins Mills, and Testron, Inc., into Textron American, Inc., the following statement was made in connection with the special meeting of stockholders called January 6, 1955, to approve the merger:

> As at the end of October 1954, the portions of the consolidated net operating losses attributable to each constituent corporation which may be succeeded to and taken into account by the merged corporation are estimated at approximately $18,750,000 for American Woolen, $10 million for Robbins, and $1,300,000 for Textron, or an aggregate of approximately $30,050,000. Such amounts will, subject to the applicable provisions of the Internal Revenue Code, be available as loss carryovers and to the extent not utilized, will expire at the end of 1956 to the extent of $200,000, at the end of 1957 to the extent of $14,250,000, and at the end of 1958 to the extent of $15,600,000.

The merger of these corporations into a single unit has resulted in the closing of a whole host of mills; some of these closings were announced during the negotiations leading to the merger and others were effected subsequently.

In 1948 the Senate of the United States investigated the use of charitable trusts "as a means of tax avoidance and unfair competition with orthodox manufacturers." The inquiry, conducted by Senator Tobey, concentrated on the operations and "interrelations between so-called charitable trusts and Textron, Inc." The report concludes that "one of our largest textile manufacturing corporations and its subsidiaries has made wide use of so-called charitable trusts as a means of providing risk capital for itself." (U. S. Senate, 81st Cong., 1st sess., Committee on Interstate and Foreign Commerce, Investigation of Closing of Nashua, N. H., Mills and Operations of Textron, Inc., Rept. No. 101.)

While the worst abuses of charitable funds exemption have been eliminated by tax laws, individuals continue to exercise control over these funds for the promotion of their own purposes and mergers and consolidations are stimulated thereby. What has been said of the charitable trusts is also applicable to pension trusts. These pension funds often provide funds and channels for mergers motivated

by the desire for tax avoidance through the capital-gains provisions of the tax laws.

It is generally agreed that the Federal Government, in raising revenue for its essential functions, must adopt a tax policy that will insure those conditions necessary for a continuing and expanding prosperity. This is not easy. To protect revenue, promote equity, preserve incentives, encourage savings and investment, and safeguard and expand consumer purchasing power demand a delicate equilibrium between competing forces which may never completely be attained but which it is essential to seek. It is, therefore, difficult to consider one aspect of the tax problem, the effect of taxes on investment opportunity, and base changes in the tax structure on the conclusions drawn therefrom, without weighing the effect of these changes on other taxpaying segments of the population. For even if it is proved that high taxes on upper-income groups decrease the supply of venture capital or diminish investment opportunities, it does not automatically follow that the national economy would benefit by transferring the tax burden to other groups.

In arguing for special tax treatment, certain business groups, as is their right in a democracy where all must present their pet axes for grinding, frequently propose tax policies which, in the long run, may be contrary to the general interests of business investors, and the overall economy.

Many businessmen, for example, agree with economists and tax students that depletion allowances for oil, metal, and other extractive industries are frequently excessive and discriminate against other types of industry, as well as taxpayers generally.

Spokesmen for small business may urge tax concessions that would tend to subsidize inefficiency.

Representatives of big industries have often urged the adoption of excise or general sales taxes which food merchants, department stores, and service establishments opose as injurious to their economic welfare.

Special tax-free privileges offered by some States and communities to attract industries are under constant attack by businessmen and governmental units which are opposed to preferential tax treatment.

The economic validity for special tax treatment should, in the opinion of many observers concerned with the overall picture, be weighed in the balance of the effect on the general economic picture. In a scarcity economy or even in an economy of abundance with certain scarcity areas, special tax treatment might well serve the general welfare. In our own country, with its vast natural resources and gigantic industrial plant, our overriding concern in the formulation of tax policy should be the wise encouragement of the ability to use the bounties of nature, manufacturing resources, and service skills in increasing general living standards.

TAXATION AND CAPITAL FORMATION

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On the principle that a division of labor may also improve the productivity of panelists, my assignment is that of exploring the structure of this problem generally, leaving to others the probably

more useful role of commenting on concrete and specific aspects of the question. The committee's decision to conduct a session on this topic reflects two assumptions which few reasonable people would dispute. First, maintaining a high rate of private investment capital expenditures is an important matter. Second, the size and character of the Federal tax system has something to do with whether a desirable rate of private investment can be maintained.

Most of my comments will be concerned with the second question. There are, however, a few useful things to say about the first. They are not particularly new, but it is well for us to remind ourselves about why this subject is closely related to the economic welfare of people generally.

I

A high rate of private investment is important to economic welfare for at least two fairly distinct and separable reasons. One is, of course, the relationship of capital expenditures or investment to the business-cycle problem. It is almost a "natural law" of economics that depression and unemployment are very difficult to avoid unless private capital outlays are reasonably well maintained. A major reason for the mildness of the 1949 and 1954 recessions was precisely that these capital outlays held up surprisingly well. Indeed, from the peak 1953 quarter to the low point of employment in 1954, expenditures for new construction (both residential and other private) actually rose. This contrasted rather sharply with the 84 percent decline in these outlays during the great depression.

In a modern, high-standard-of-living economy there will be a substantial amount of saving, spending short of income. If markets for a full output are to be maintained, private investment must hold high because this is the process by which these saved dollars are borrowed and put back into the spending stream.

Our preoccupation with the strategic role of private investment in the business cycle has tended to make us ignore the second and in some ways more fundamental reason that a high level of private investment is necessary to our economic welfare. A large amount of capital per worker is essential if high productivity and living standards are to be achieved. And private investment is the process by which this capital formation comes about. There is in use now roughly $11,000 of so-called reproducible wealth per person in the work force. This $11,000 per worker in more concrete terms represents the earth mover by which one man can literally move a mountain, or the tractors and combines by which the 10 percent of workers still on farms can produce more than enough food for the whole population.

The economy, therefore, needs net capital formation to the extent of at least $11,000 per new person in the labor force in order to maintain this average. Moreover, though the factual evidence is unclear on this point, it seems probable that this figure has been growing at the rate of almost 2 percent per year during the last half century, excluding the decade of the great depression.

United States gross national product and the stock of productive wealth

[Dollar amounts in billions of 1953 prices]

Year	Gross national product	Wealth	Civilian labor force	Year	Gross national product	Wealth	Civilian labor force
1900	$69.3	$199	27.4	1924	$136.7	$424	43.7
1904	79.3	228	31.6	1928	160.1	500	47.6
1908	88.3	267	35.4	1936	154.0	491	53.4
1912	109.1	304	38.3	1940	187 6	540	55.6
1916	112.2	339	40.5	1948	269 0	635	61.4
1920	119.1	376	42.5	1955 [1]	385.0	720	65.2

[1] Estimated.

Sources: 1. Gross national product data from U. S. Department of Commerce for years 1936 on. 1909-28 from Potential Economic Growth Over the Next Decade, Joint Committee on the Economic Report (83d Cong., 2d sess.), 1954, p. 35. 1900-1908 from Paul W. McCracken, Richard Lindholm, and Lawrence H. Seltzer, Michigan Economy to 1970, Michigan Council of State College Presidents, 1955, p. 20.

2. Wealth: Raymond W. Goldsmith, A Perpetual Inventory of National Wealth, in Studies in Income and Wealth, vol. 14 (New York: National Bureau of Economic Research), pp. 18-19. Data were converted to 1953 prices by the ratio of the 1953 gross national product deflator to 1929. 1955 was estimated by the use of national income data.

3. Civilian labor force: U. S. Department of Commerce. Data for 1900-1928 from Potential Economic Growth During the Next Decade, op. cit., p. 33. Data are in millions.

The subject of this panel's discussion is, therefore, of critical importance whether we are talking about the problem of maintaining full employment or continued growth in our productivity and living standards. Whether enough capital formation will take place to maintain and enlarge this $11,000 of capital per worker for a growing labor force will depend primarily on the vigor of policies to facilitate the process of private investment.

And it seems reasonable to suppose that the nature of our tax structure is quite importantly involved in this process. In 1954 total government receipts (Federal, State, and local) were $90 billion—equal to 30 percent of our $300 billion national income.

National income and government receipts, 1929-54

[Dollar amounts in billions]

Year	National income	Government amount	Receipts as percent of national income
1929	$87.8	$11.3	12.9
1940	81.6	17.7	21.7
1950	240.0	69.4	28.9
1954	299.7	89.8	30.0

Source: U. S. Department of Commerce national income data. Government receipts are for Federal, State, and local units combined.

This contrasts sharply with the 13 percent of national income accounted for by Government receipts in 1929, or even the 22 percent for 1940 (a year of relatively low national income).

The tax system is bound to exert a substantial impact on capital formation simply because of the magnitude of the tax flow relative to the size of the economy. But this also means that specific side effects and inequities which might have inconsequential effects with a low general tax level may now have considerable significance. The major purpose of this paper is to raise some of these issues, particularly as they relate to private investment.

II

Decisions are not made about aggregate capital formation or total private investment. Total capital formation is made up of thousands of specific projects about which individual decisions must be made as to whether a specific plant ought to be built or a specific lot of machinery should be purchased.

If the tax system influences capital formation generally, it does so by impinging on the elements which are the raw material for decisions about a specific capital expenditure project. And there are three basic questions which constitute the ingredients of any decision about whether to go ahead with a specific program of capital expenditures—the purchase of new machinery or the construction of a new plant.

1. *What is the program going to cost?*—Apart from a period such as the puffy postwar cost-plus era, this question can usually be answered within quite narrow tolerances. And in general the lower the cost the more attractive the project will be.

2. *What is the cost of money to finance the project?*—Obviously the contribution of the project to profits must exceed the going interest rate on funds for the project to be worthwhile. If the money is borrowed this is clear cut. But the principle is equally valid even if the project could be financed by funds on hand. There is no point in putting the company's money into a new plant or new machinery expected to yield a 2-percent return, for example, if the funds could be invested in bonds at 3 or 4 percent.

3. *What will this project contribute to the profits of the company during its expected useful life?*—After arriving at a judgment on this matter, and knowing what the project will cost, management can calculate the average rate of return it would expect to make. This is a matter of arithmetic.[1] If the project is a machine, for example, costing $1 million and good for 1 year, the expected rate of return is 6 percent if management expects revenues to be $1,060,000 greater (before deducting any interest cost on borrowed money) by having the machine. If money can be borrowed at 3 percent, the project is theoretically worthwhile. If the cost of money is 6 percent, there would be no net advantage to the project.

Now there is one important difficulty. This third question cannot really be answered. The cost of the project can within narrow limits be a known. But to estimate the probable rate of return which this project will yield, a company must also guess at how much larger profits will be if the capital expenditure is made. And this contribution which the project will make to company profits cannot certainly be known. It can only be guessed at. A great deal depends on such things as the probable volume of production and sales, the firm's or product's competitive position in the market, the general business outlook, the probability that the new equipment might or might not quickly become the victim of even newer technological developments, etc. None of these matters can certainly be known at the time of the decision to spend the money. The whole matter hinges, therefore, on what assumptions about these matters management is

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[1] If by putting $100 into a project (good for 1 year) management expects the year's revenues to be $106 higher, the expected rate of return is 6 percent. If it is a 3-year project and revenues are expected to yield an average of 6 percent, the equation would be:

$$\frac{Z_1}{1.0R} + \frac{Z_2}{(1.0R)^2} + \cdots \frac{Z_n}{(1.0R)^n}$$

This can be generalized, of course, for a project of n years.

willing to make in betting the company's money. Things which make management uncertain about the future can affect the expected rate of return and therefore private investment adversely. The intangible matter of business confidence can be important in maintaining a high rate of capital formation. On that the lessons of history are quite clear.

One of the major postwar developments in business management has been the substantially greater attention given to capital budgeting.[3] As budget departments have been organized, and more attention has been given to the problem, capital expenditure decisions unquestionably have been made on a more orderly, and rational, and scientific basis.

Nevertheless in the real world these calculations about the probable profitability of a capital outlay are often not made with mathematical precision. In some cases it would be impossible, e. g., an ornate office building for prestige reasons. Often rough rules of thumb are used to sort out and array various possible projects—those with a short or rapid payout being considered (often incorrectly) better than those with a longer payout.

But the key to the problem is still management's estimate about the contribution to profits of the new project. And this cannot certainly be known until after the money is spent.

III

Taxes can serve as an incentive or stimulus to private investment. This is possible in many ways.

1. Taxes used to finance developmental public works projects may enlarge the opportunities for profitable private investment. The use of gasoline taxes, for example, to rebuild and enlarge our system of highways undoubtedly enlarges the market for automobiles and, therefore, the capital outlays in the automobile industry. Indeed, it can be demonstrated that the deficiencies of our highway system relative to the number of cars on the road is already limiting the market for automobiles.

While to some extent the expenditures to provide these facilities are separable from the relevant taxes, it is still meaningful to say that such taxes can be part of a fiscal operation which enlarges rather than contracts total private investment.

2. The existence of taxes could theoretically serve as a spur to businesses to step up their capital outlays. It seems reasonable to suppose that most managements do not take on all capital expenditure projects down to the marginal one where the expected rate of return is just equal to the cost of money in the capital market—even though the simple theory of investment suggests that this is what ought to transpire. For a variety of reasons managements will stop short of this theoretical equilibrium point, omitting some projects even though they would probably be profitable.

A business may have some profit target or objective (either in absolute terms or as, for example, a rate of return on stockholder equity).

[3] The literature on capital budgeting and the theory of investment is quite extensive. Three basic contributions representing different facets of the subject are:
1. J. M. Keynes, A General Theory of Employment Interest, and Money (New York: Harcourt, Brace, 1936), Book IV.
2. Joel Dean, Capital Budgeting (New York: Columbia University Press, 1951); and Managerial Economics (New York: Prentice-Hall, 1951), ch. 10.
3. George Terborgh, Dynamic Equipment Policy (New York: McGraw-Hill, 1949).

If so, the imposition of a tax may force management into buying new cost-reducing equipment in order to keep profits up to the target objective. The tax may, therefore, serve as an incentive for managements to go ahead and do what perhaps all along would have been profitable, but would not have been undertaken except in the absence of these taxes. (It seems quite likely that for taxes to have these net affirmative results they should be relatively moderate and not heavily progressive in character. But it would be even more unrealistic to assume that a tax system collecting revenues in excess of zero has a disincentive effect, the effect growing as the size of the tax burden enlarges.)

3. The possibility of imposing on the Treasury a part of any loss can also serve as inducement to private investment. The most clear-cut manifestation of this point is the penchant of some high-income individuals for relatively risky ventures, such as oil-well wildcatting. For corporations this may take the form of expenditures to put new products on the market—the very real chance that the venture may not go being offset by the negligible net loss after taxes in that case. (In cases where the return from the successful venture can take the form of a capital gain the effect is even more clear cut.) In appraising the effect of the Treasury's taking a substantial share of business earnings, the fact that the Treasury participates in losses must not be overlooked.

4. The present tax structure tends to tip the scales in favor of corporations' retaining their earnings. Stockholders can then take these earnings in the form of more lightly taxed capital gains. (If we assume that a given amount of taxes must be raised somehow, the more lightly taxed status of this income might largely be an illusion.) For two reasons, therefore, retaining the earnings increases the flow available for investment. They escape, at least partially, some of the personal income taxes. And it is quite unlikely that if all the earnings had been paid out, the added dividend income (after taxes) would all have been saved and returned through the capital markets to finance capital expenditures. To the extent that the flow of capital expenditures is at least somewhat sensitive to the volume of savings, the existence of taxes on corporate income might exert a bullish effect on private investment.

IV

Our tax system also exerts disincentive effects on private investment. Indeed because this is the more frequently explored aspect of the subject, it seemed useful to point up a few considerations on the other side of the problem first. But the remaining comments here will deal with some of the ways taxation may inhibit capital formation.

1. The point is frequently made that our present tax system tends to penalize the growing firm relative to those who have already "arrived." Retained earnings constitute the single most important source of new funds for added growth and expansion.[3] If half the earnings are diverted to the Treasury at the outset, the supply of funds for further expansion and growth is severely limited. The largest

[3] According to the SEC quarterly reports earned surplus and surplus reserves, at the end of 1954, accounted for $62.5 billion of the $110.8 of the stockholders' equity for all United States manufacturing corporations. For various reasons the actual proportion is probably larger.

single element in the capital structure of most older corporations is the earned surplus reflecting retained earnings. Would a Ford Motor Co., for example, have been possible if a 50 percent corporate income tax had existed since the company began?

This is obviously a question of substantial importance. The vigor and vitality of a free-enterprise system is absolutely dependent on having existing companies subject to constant challenge not only by present competitors but by new firms as well. This is an important part of the process by which the productivity of the American economy has been kept so high. Anyone with a better idea should be free to make an assault on the status quo. In that way we are assured that only those who can most effectively utilize our productive resources will survive.

If our tax system impedes this process, it is a serious matter, with the growth in our standard of living in jeopardy. The factual evidence as to whether it is in jeopardy is unclear. That mergers have been occuring is common knowledge, but it is not clear that business in any meaningful sense is becoming more concentrated. The number of "live" businesses is in line with our national income, and the number of new businesses being formed is not low relative to current levels of business activity.[4]

2. A Federal tax system which absorbs about 20 percent of our national income alters the character as well as the amount of private investment. This problem has many dimensions. Does our tax system, for example, unduly foster residential construction which now accounts for about one-fourth of gross private investment? Clearly it fosters homeownership. A renter can always reduce his taxable income to the extent of the mortgage interest by buying the house. The interest is deductible but the value of the housing service is not included as a part of taxable income.[5]

A clear example is the privileged tax sanctuary enjoyed by State and municipal obligations. The differential in their yield rates, relative to other obligations, is one indication of the extent of this privileged position. Corporate Aaa bonds currently sell to yield roughly one-third more than corresponding high-grade municipal obligations. In July of this year, for example, the yield rates on Aaa corporate bonds were 3.06 percent, compared with 2.23 percent on high-grade municipals or 2.96 percent on long term United States Treasury obligations.

Such a privileged position inevitably gives municipal obligations an inside track in the capital market, and tends abnormally to divert funds in the direction of financing these State and local public works projects. This is not to say that we are having too large an expenditure of funds by State and local governments. Indeed the amount is still too small. The privileged tax status of their obligations is completely neutralized by the fact that the Federal Government has preempted so much of that part of our national income we are willing

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[4] Betty C. Churchill, Recent Business Population Movements, Survey of Current Business, January 1954, pp. 11–16. Cf. also M. A. Adelman, The Measurement of Industrial Concentration, Review of Economics and Statistics, November 1951, pp. 269–296. Mr. Adelman summarizes his comprehensive study in three statements the third of which is: "The extent of concentration shows no tendency to grow, and it may possibly be declining" (p. 295).

[5] It is included in national income.

to spend collectively through Government. In the real world it may be essential to balance off a handicap with an advantage. But so long as this privileged tax position exists we cannot be sure that a distortion in the allocation of our capital resources will not emerge.

Another question is whether the high and highly progressive personal income-tax rates unduly choke off investment in risky ventures. The high-income people, according to this argument, are the only ones who can afford these risks. The heavy tax rates make the possible net gains after taxes moderate and provide incomplete assurance that the Treasury will participate equally fully in the losses. Therefore, assets such as tax-exempt municipals loom relatively more attractive to these investors. And the tax-exempt feature is more attractive to precisely those on whom society ought to rely for its most venturesome capital.[6]

3. Do corporate income taxes correspondingly reduce the amount of retained earnings? It seems clear that the volume of gross retained earnings (before depreciation changes) is a limiting factor on the size of a corporation's total capital expenditures even if theoretically projects whose rate of return substantially exceeds the cost of money must be excluded. This reflects the generally recognized preference for internal financing particularly by manufacturing corporations.

An unresolved question is, of course, the extent to which corporate income taxes result in less corporate income after taxes (dividends plus retained earnings). The answer derived from pure economic theory is clear—corporate profits taxes are not passed on in the form of higher prices or lower wages. Therefore, corporate income taxes correspondingly reduce corporate income after taxes. But there is enough contrary sentiment in the business community to suggest that the answer is less clear cut. Even the statistics are inconclusive. Corporate profits after taxes in 1950 were 9.2 percent of national income, not significantly lower than the 9.5 percent in 1929—this in spite of the fact that corporate profits taxes absorbed 14 percent of before-tax profits in 1929 and 45 percent in 1950. By 1953, however, profits after taxes were down to 5.6 percent of national income. For 1955 the figure will be roughly 7 percent, with taxes taking about half of corporate profits.

These data suggest that the question of whether corporate profits taxes reduce dividends and retained earnings cannot be given a simple "Yes" or "No" answer. The more fruitful approach must be to explore when and under what circumstances retained earnings are lower than they would otherwise be because of profits taxes. It is reasonable to suppose, for example, that the immediate impact of a change in taxes probably is at the expense of dividends and retained earnings, with retained earnings reflecting most of the change. It is probable that the capacity of businesses to adjust to profits taxes weakens as the tax burden becomes relatively heavier. What is true of a tax taking one-fifth or one-quarter of profits may not be true for a tax taking half or more of corporate income—particularly if high marginal rates are involved, as was true with the so-called excess-profits taxes.

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[6] The Treasury does now share more fully in losses. An individual may carry his (unincorporated) business losses back 2 years and forward 5. And for a corporation losses on one operation are, of course, consolidated into the income statement for the company. Losses from a corporation's ownership in another corporation, where the income is not consolidated, can only be offset against capital gains.

One dimension of this problem is the overstatement of profits and therefore profits taxes because of the tax treatment of depreciation charges. The response of businesses to accelerated amortization suggests that capital outlays are influenced by tax policy with respect to depreciation. This problem has been moderated by the change in the Revenue Act of 1954 which does permit some more flexibility in handling depreciation. But it does not take care of the understatement of costs and overstatement of earnings and taxes because of a higher price level. This understatement has been estimated at $5 billion for businesses, and capital consumption allowances on a current cost basis have been estimated as much as 35 percent higher (for 1949) than the figure actually used in the national-income accounts.[7] If capital outlays are sensitive to depreciation policy, it does not make sense to pursue a policy which actually does not account for the full current cost of production.[8]

4. Does our high and highly progressive tax structure reduce the amount of national income being saved? If so, it probably means some less investment since the volume of capital outlays is not completely unrelated to the flow of savings into the capital markets.

The logic of the case suggests that our tax structure ought to work in this direction. Our present tax system is heavier on the high-income groups than on those with lower incomes. We also know that society's savings come importantly from those with higher incomes. Therefore, it seems to follow, our highly progressive tax system ought to work in the direction of reducing total saving.

The empirical evidence as usual is a bit inconclusive on this matter. A shortage of savings should be reflected in relatively high rates of interest. Yet interest rates are lower than the preprogressive income-tax era. (But this is not conclusive because our tax system may have reduced the demand for capital even more than the supply.) Moreover, there is reason to believe that the structure or the progressivity of the tax structure (as distinct from its absolute magnitude) may affect the flow of savings less than had been thought.[9]

For whatever the reason, however, there is evidence that the ratio of total national savings to national income has undergone a modest secular decline. A trend of the ratio of total national saving to national income for the period 1897–1929 would give an average ratio of 13.1 percent for the years 1946–49, compared with the actual figure of 11.2 percent.[10] This conclusion is also suggested by the data on the increase in productive wealth, which show smaller increases relative to the increase in the labor force in recent decades than was true for the early part of the century.

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[7] Realistic Depreciation Policy—A Summary, Machinery and Allied Products Institute, 1953, p. 19; Raymond W. Goldsmith, A Study of Saving in the United States, vol. I (Princeton: University Press, 1955), p. 31.

[8] The fictitious element in profits represented by understating costs of materials charged against sales is allowed for in national-income data by the inventory-valuation adjustment. This logic should be extended to the understatement of profits from present depreciation policy.

[9] Richard A. Musgrave and Mary S. Palmer, The Impact of Alternative Tax Structures on Personal Consumption and Saving, Quarterly Journal of Economics, August 1948, pp. 475–499.

[10] Raymond W. Goldsmith, A Study of Savings in the United States, vol. I, op. cit., p. 82. This is the concept of savings excluding consumer durables. If purchases of consumer durables are included in savings the gap is smaller though still present. The denominator of the ratio is actually net national product rather than national income. Since depreciation charges were too low in 1946–49, net national product is probably overstated and the "true" savings ratio understated, which might account for a substantial part of the gap.

The most reasonable conclusion, therefore, seems to be that the ratio of national savings to national income or product is slightly lower now than in the latter part of the last century or the early part of this one. But the decline has not been severe, and we cannot rule out the possibility either that it is an optical illusion reflecting imperfect data or that it would have occurred in the absence of the changes in our tax structure.

5. The view that heavy taxes impede capital formation has some support from theoretical analysis.[11] The theory of investment implies that a firm will undertake all capital outlay projects from the most profitable down to those whose rate of return is just equal to the cost of money. If the cost of money (e. g., interest on debt) is fully deductible as a cost in computing taxable income, a business income tax should not restrict private investment. The tax affects both the cost of money and the rate of return equally. A project whose rate of return exceeds the cost of money on a before-tax basis will also exceed the cost of money on an after-tax basis. The imposition of the tax narrows the gap but does not eliminate it for any project.

It is pretty clear, however, that the actual decision-making process does not reflect quite this precise a calculus. The actual outcome of any new venture cannot certainly be known at the outset. The penalty on those particular personnel who make or recommend these decisions may be particularly severe if a project proves unwise—considerably more severe than foregoing projects that might have been profitable.

These considerations may help to explain the real-life fact that most capital budgets stop considerably short of all projects whose probable rate of return exceeds the cost of money. This problem may take the form of the requirement that a certain spread between the cost of money and the probable rate of return must exist before the project be undertaken. The imposition of corporate income taxes, even if the cost of money is deductible, will then eliminate certain projects if we visualize this gap to be a certain number of percentage points of return.[12] And capital outlays would thereby be adversely affected.

If the cost of money for financing capital outlays is not fully deductible for tax purposes, the imposition of a business income tax will clearly reduce private investment. The after-tax probable rate of return on projects is lowered by more than the net cost of capital. Thus marginal projects which would just have been undertaken no longer qualify for the capital budget. And there is reason to expect that projects with a longer expected life would be particularly adversely affected.[13]

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[11] The literature on this subject is quite extensive. Cf.: E. Cary Brown, Business-Income Taxation and Investment Incentives in Income, Employment, and Public Policy, Essays in Honor of Alvin H. Hansen (New York: Norton, 1948), pp. 300–310; Evsey D. Domar and Richard A. Musgrave, Proportional Income Taxation and Risk-Taking, Quarterly Journal of Economics, May 1944, pp. 388–422; Richard Goode, Accelerated Depreciation Allowances as a Stimulus to Investment, Quarterly Journal of Economics, May 1955, pp. 191–220. Cf. also the various studies by J. Keith Butters and colleagues on the effects of taxation.

[12] For any firm the supply curve of funds is almost infinitely elastic. And the slope of the schedule of the marginal efficiency of capital is negative. Therefore, the slope of the supply curve on an after-tax basis remains unchanged (but its level is lower) while the level and slope of the schedule of the marginal efficiency of capital are reduced. Therefore, the requirement of some fixed premium for the rate of return beyond the cost of money will, of course, reduce investment.

[13] E. Cary Brown, op cit., p. 301. Accelerated amortization helps to neutralize this adverse effort.

In the real world, of course, the cost of money is only partially deductible. Interest on debt is an expense which can be deducted before arriving at taxable income. But for business generally sound financial management requires that considerably less than all requirements for new money be met by debt financing. For all manufacturing corporations at the end of last year, long-term debt accounted for only $19 billion of the $134 billion of permanent investment. For public utilities the ratio is somewhat higher, but even here it is generally considered to be unwise for debt to account for more than one-third to one-half of total capital. The remainder is equity capital and the "cost of money" for equity capital is not, of course, deductible for tax purposes. If we make the reasonable assumption that as a matter of financial policy businesses will want to retain essentially the present capital structure, debt financing can then be a source of substantially less than half of total new capital requirements. It then follows that for only a minority of new capital requirements is the "cost of money" deductible for tax purposes.

This seems to be the policy businesses have actually pursued. For all corporations permanent investments from 1945 to 1952 increased $138 billions, of which an increase in long-term debt accounted for only $40 billion or 29 percent. This did, however, raise the share of long-term debt in the capital structure from 20 percent in 1945 to 24 percent in 1952.[14]

V

It may be useful to summarize the four basic points covered in these comments.

1. Maintaining a high rate of private investment is important to our economic welfare not only in order to avoid unemployment but also because a rising amount of capital invested per worker is one of the primary sources of our high and rising productivity and standards of living.

2. Taxes can serve as a stimulus to private investment. Tax effects are not all adverse.

3. The weight and progressivity of our tax structure also impede private investment in numerous ways. The availability of funds may be altered. The equilibrium amount of desirable capital outlays may be reduced. The structure of the tax system may considerably alter the pattern of allocation of our capital outlays.

4. The weight of theoretical reasoning and empirical evidence suggests that the rate of private investment has been moderately reduced in recent decades relative to the earlier period when the share of the national income going to the tax collector was lower.

[14] U. S. Treasury Statistics of Income, pt. II, 1945 and 1952. These figures are for corporations filing balance sheets.

IV. IMPACT OF FEDERAL TAXATION ON MANAGEMENT AND ENTREPRENEURIAL EFFORTS AND ON TYPE OF REMUNERATION; EFFECTS ON LABOR SUPPLY AND PROFESSIONAL SKILLS

IMPACT OF THE FEDERAL INCOME TAX ON LABOR FORCE PARTICIPATION

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1. THE PROBLEM

Is the tendency of people to be in the labor force[1] influenced by the size of their own or their families' incomes and by the fact that they must give up an appreciable part of those incomes as a tax?

Economists and others have differed widely in their speculations on this question. There are those who have argued that the lower the income retained (because of a tax or other reasons) the less the incentive to work, especially in the case of a progressive tax which takes larger percentages of a high income than of a low income. There are others who have held that the lower the income retained, the greater the need to work, in order to earn enough after tax to maintain a desired living standard, or to save enough to provide for the future or to retire. There are still others who have pointed to the many noneconomic reasons for working—rank, fame, power, an altruistic mission, companionship, convention, love of work, or habit—and have urged that income and taxes on income would have little or no influence on the decision to enter or leave the labor force.

How are we to proceed on the basis of these speculations? Perhaps the safest course is to begin with the assumption that the answer cannot be discovered from mere analysis of human motivation. Even if people were motivated solely by the incomes they could retain—their decision whether or not to work (as their incomes were reduced by a tax) would depend on how the individuals value income in rela-

[1] In the United States the labor force is currently defined as the sum of all persons who are reported by the Census to be employed or unemployed during a certain specified week. The employed category covers all persons 14 or older who have jobs or businesses for pay or profit. Specifically, it includes wage and salary employees, supervisory employees at all levels, employers, self-employed persons, and it even includes unpaid family workers—such as wives or children who labor in the family store or on the family farm—provided they help produce a salable product or service. It also includes employees of non-profit-making enterprises and Government agencies. The unemployed includes persons 14 and older who have no job or business of the above-mentioned sort and are seeking such employment during the survey week. There are many things that are less than satisfactory about this concept from an economic point of view, and a full discussion of them may be found in a monograph now being prepared for publication. (The Labor Force Under Changing Income and Employment. National Bureau of Economic Research, Inc., 1955 mimeographed, chs. 8 and 4.) It is not believed that these defects are such as to impair the results of the present study.

tion to leisure.[2] With the same income and the same tax, some persons would work more and others less; and the net outcome could be discovered only by observing how changes in income and income taxation affect the amount of labor that people supply in actual practice.

The speculations on this question go back at least several hundred years, but the first systematic study was made about two decades ago by Prof. (now Senator) Paul H. Douglas in his Theory of Wages, one of the great books in economics.[3] The Douglas study found that in a certain year, for example, 1920, the proportion of the working-age population in the labor force tended to be relatively high in United States cities with relatively low average earnings (where labor force participation was adjusted to take account of differences among cities in the age-sex, color-nativity composition of the population, and where average earnings were adjusted for differences among cities in the cost of living and in the age-sex composition of earners, so as to reflect the real purchasing power of an equivalent adult-male worker). Thus, the Douglas studies, though not relating directly to the income-tax problem, would seem to bear out the second group mentioned earlier, in its expectation that reduced incomes would induce more people to work.

However, the Douglas studies—conducted as one aspect of a much larger research in which he was then engaged—referred only to the relationship between labor force and earnings among large cities and at a given moment of time (his first study was for 1920 and his second, in collaboration with a junior author, was for 1930[4]). His studies did not investigate whether similar relationships would appear over long- and short-run periods of time—during peacetime growth, war mobilization or demobilization, or economic depression and recovery. They did not investigate the income-labor force relationship among States, among urban and rural areas of States, and among nations. And, on the basis of the data then available, they could not investigate the relationship between the labor-force participation of wives and the income of husbands—materials that free us from the need to rely exclusively on the crude unit of a large city. Finally, they did not investigate the relationship between labor-force participation and a host of other factors which may influence it either directly or through its relationship to earnings—family size; marriage; child-care responsibilities; use of household appliances, factory-produced food and clothing and commercial laundries, and other services for the home; school attendance; education completed; social security; retirement systems of firms; length of workweek; and many others. These gaps in our knowledge the present writer has attempted to fill in an investigation just recently completed.[5]

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[2] Lionel Robbins, "On the Elasticity of Demand for Income in Terms of Effort," Economica (June 1930), pp. 123–129. There are other theoretical effects depending upon how taxation alters the distribution of income among individuals and families. Earl Rolph maintains that a system of taxes which markedly reduces income inequality may be expected to increase the supply of effective work. The Theory of Fiscal Economics (University of California Press, 1954), p. 255. But even this conclusion will depend upon the assumptions as to human motivation. A perfectly equal distribution of income might conceivably destroy all rivalry among consumers and workers and thus lead to a rather lethargic attitude toward effort and self-improvement. In any case we shall see later that the United States income tax has had very little effect on the size distribution of income for the overwhelming majority of the labor force.

[3] The Macmillan, 1934, ch. XI, pp. 269–294.

[4] Erika H. Schoenberg and Paul H. Douglas, Studies in the Supply Curve of Labor, Journal of Political Economy, February 1937, pp. 45–79.

[5] The Labor Force Under Changing Income and Employment, National Bureau of Economic Research, Inc., 261 Madison Avenue, New York 16, 1955; mimeographed.

That recent study—which itself leaves many gaps to be filled—gives rather remarkable confirmation of the results of Paul Douglas, insofar as his results were meant to go. In answer to the question, "Do changes in income influence the labor force?" the study has concluded: Probably yes, provided other things do not change very much. The higher the income the lower the labor-force participation—with rather great changes in incomes required to bring about moderate changes in the overall labor-force participation rate.

But this conclusion applies to comparatively static conditions. Under dynamic conditions, the study observed that income has seemed to exert little or no influence on the size of the labor force relative to the working-age population.[6] If the labor-force participation has appeared to vary oppositely with income or earnings at a moment of time, but to be unrelated to them over time, what can be said about its response to the Federal income tax?[7]

In an attempt to answer this question, we make three types of study: One analyzing the labor-force participation of different income groups before and after income tax at a moment of time in the United States; the second comparing the bahavior of the labor-force participation of these income groups between two different periods of time—before and after the income tax; and the third examining the behavior over time of the labor-force participation of five countries with their differential changes in the amount of income taxation.[8]

2. Labor Force Participation of Wives by Income Group of Husband

The only information available by income groups at a moment of time is for wives. The Census has released none of these data from the latest (1950) census, but it has presented, on the basis of its sample survey data, the April 1951 labor-force participation of wives 20–44 classified by the 1950 income of husbands, in groups ranging from under $500 to $10,000 and over, and by whether the wife had children under 18 and under 6.

No information is given on the actual income tax paid by the families in these various income groups. The estimates made in this study are based on computations, by the Internal Revenue Service, of the individual income-tax liability of selected income groups of married persons in 1950, depending on whether they had no dependent or two

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[6] Concerning this observation, more will be said in sec. 4.

[7] Strictly speaking, the Federal income tax should be treated in connection with State and local income taxes, but they are very complicated in their application and in any case took less than one-half of 1 percent of total family personal income in 1950. U. S. Department of Commerce, Income Distribution in the United States, 1953, p. 7.

In some ways the workers'—even the employers'—contributions for social security also partake of some of the characteristics of the income tax, but are nevertheless neglected here as not falling under the strict definition of an income tax. They differ, moreover, in that (1) they do not apply on incomes over a certain figure and are therefore regressive rather than progressive, and (2) they may conceivably be regarded by workers as a kind of savings or insurance payment and therefore differing from a pure income tax for which they receive no direct quid pro quo.

Also neglected in this study are any relation between excise taxes and labor force participation. Yet excise taxes can be levied in such a way as to have theoretical effects on labor supply analogous to those of the income tax.

[8] This analysis neglects any impact of the income tax on other dimensions of the labor supply—the hours which the labor force is willing to work, the intensity of the effort it is willing to put into its work, the skill and education it is willing to acquire in order to increase its effectiveness and its income, or the distribution of the labor force by industry and occupation. However, the determination of tax effects on any of these would be a major inquiry in itself, one which, unfortunately, would run up against a lack of the kind of statistical materials that we have been able to draw upon for the study of labor force.

dependents.[9] My own estimates were further based on the assumption that, regardless of income group, the average married couple with children under 18 had 2 dependents for purposes of income-tax computation.[10] They also rest on the assumption that only the husband received income and that income tax was paid only on that income.[11] This assumption does not hold, of course, if the wife or another dependent works. In the absence of completely detailed information on the incomes of different family members, restriction to husband's income is an advantage rather than a disadvantage. For, if the wife's income were included, the income data could no longer be regarded as an independent variable affecting her decision to work, but rather a variable that was partially dependent on her labor-force participation and her earnings; nevertheless, leaving it out limits the amount of information to be derived from this relationship.

In table 1, the variations in labor-force participation of wives, associated with differences in incomes of husbands, are presented for 3 classes of wives: With children under 6; with children between 6 and 17; and with no children under 18. Within each class, the first association presented is that with husband's income before tax. This shows that, regardless of the child status of the wife, the higher the husband's income the lower the wife's labor-force-participation rate. The tendency is greatest for wives with children under 6 to care for—a 1-percent higher income of husband being associated with more than one-third of 1 percent smaller labor-force participation of the wife. It it intermediate for wives with children between 6 and 17—a 1-percent higher income of husband being associated with a one-fourth of 1 percent smaller labor-force participation of wife. And it is smaller for the wives with no children under 18—a 1-percent higher income of husband being associated with a one-fifth of 1 percent smaller labor-force participation. These differences were probably to be expected, on the ground that the greater the child-care responsibility of women, the more quickly they would respond to their husband's prosperity to leave the labor force in order to care for the children.

So much for the average tendency for all income groups. In regard to variations among individual income groups, several features of behavior may be noted. One is that the higher the income level the more sensitive the labor-force participation of the wives to a 1-percent higher income of the husband. The other is that a few of the variations were not inverse but positive. In most cases the positive association was probably owing to randomness from sampling or interview error, for the instances did not usually occur for the same income change among all three classes of wives. In the case, however, of the income variations on the highest level, the change from an average income of $8,500 to one of $15,000[12] was associated with a higher

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[9] Statistical Abstract of the United States, 1954, pp. 374–375.

[10] This assumption seems to be very close to reality. Statistical Abstract of the United States, 1954, p. 55: Current Population Survey, Income of Families and Persons, 1950, P–60, No. 9, p. 26.

[11] The income received by the husband is rather comprehensive. It includes money wages and salaries; net income from operation of a farm, business, or profession; net income from rent or royalties; interest and dividends; pensions; veterans' payments; Armed Forces allotments for dependents; other Government payments or assistance; alimony; insurance benefits. It excludes, however, receipts from sale of property; withdrawal of bank deposits; money borrowed; tax refunds; gifts; lump-sum inheritances or insurance payments. Current Population Reports, Labor Force, Series P–50, No. 39, p. 6.

[12] The average income of those receiving over $10,000 was assumed here to have been $15,000.

labor-force participation of wives—perhaps because these wives tend, like their husbands, to be higher earners who could afford to hire domestic help to facilitate their release from home duties.[13]

So much for the labor force behavior of wives associated with incomes of husbands before income tax. The associations after tax are given for wives in the different child-status classifications on lines 2, 5, and 8. The effects of the tax, computed as the differences, are given on lines 3, 6, and 9. In the case of the overall averages, weighted by the number of wives attached to each income class, these effects turn out to be negligible—except for wives with children between 6 and 17, for whom the effects are small.

In part this was because the lowest income groups pay no taxes; the higher income groups nearly all show some impacts of the tax and these impacts are in the direction of making the labor force seemingly more sensitive to income changes. An alternative method would be to exclude these nontaxpaying groups and compute weighted averages from those higher income groups which paid taxes. If this is done, the tendency becomes one in which wives appear to leave the labor force in even larger percentages at higher incomes of husbands, both before and after tax; but the effect of the tax is still negligible except for wives with children between 6 and 17, for whom it is larger absolutely but not relatively.

Actually, it is an exaggeration to describe these results as measuring the effects of the income tax on labor force participation. They are really an arithmetic consequence of subtracting income tax from income and then recomputing the percentage relationship between the same labor force participation rates and the smaller range of income variation after tax. The only tax effects that such a recomputation reveals stem from the fact that higher incomes are taxed at higher rates than lower incomes, and these so-called tax effects in table 1 are small or negligible because the United States Federal income tax is not very progressive for incomes below $10,000—in other words for the range of income covered by all but about 3 percent of the labor force.[14] If the tax were strictly proportional, the income-labor force association would be the same before and after tax and no such effects would be revealed.

More important, however, is the fact that the computations in table 1 can tell us nothing about how the earnings, and the tax on earnings, of other family members beside the husband would influence the decision of the wife to work. Furthermore, they can tell us nothing about those cases in which the wife—facing the prospect of paying an income tax on her earnings, usually without deductions for many extra household expenses incurred as a result of her working—would decide that it was not profitable to work. There would be no objective measure of such a decision, for in those instances in which the decision was not to work, both the potential earnings and the labor force participation would be unrecorded.

How then can such effects be detected? Only, it would seem, by studying the labor force participation over time—before and after the income tax.

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[13] This is the explanation given in the census report. Current Population Reports Labor Force, Series P-50, No. 39, p. 4.

[14] See the discussion toward the end of this study.

3. The Labor Force of Wives by Income Group of Husband—Comparison of the Before-Tax Situation in 1940 With the Tax Situation in 1951

For such a study we can compare the results for 1951 with statistics on labor force of wife by income of husband from the 1940 census when the income tax was so low that it was not effective for virtually the entire range of income groups covered by the census labor force-income tabulations (table 2). Since the income groupings at the two dates were very different, only the weighted averages are compared. According to these averages, wives manifested less sensitivity to changes in income of their husbands (before or after tax) in 1951 than in 1940, but the difference was scarcely significant in the case of wives with young children and was only moderate in the case of wives without young children.

This lack of manifest difference does not prove that the income tax paid on husbands' incomes has had no effect on the wives' labor force participation. For one thing, the comparisons are not exactly the same. The data on husbands' income in 1939 cover only wage and salary earnings, including tips, commissions, and bonuses; whereas those of 1950 cover husbands' incomes from virtually all sources. The wives in 1940 are those with and without children under 10, whereas the wives in 1951 are those with and without children under 6 years of age. The weighting was less satisfactory in 1951, because less information was then available on number of wives with and without children in each income grouping. The economic situation in April 1940 was still one of severe depression, whereas that of April 1951 was one of Korean war prosperity, so that wives of different income groups in 1951 may have faced very different relative employment opportunities. Finally the labor force participation of wives had increased very greatly over the intervening decade, so that it stood on a much higher level in 1951 than in 1940.

It is therefore possible, though scarcely likely, that these differences produced effects on the labor force participation of wives that almost exactly canceled the opposite effects of the income tax. In any case, the investigation so far refers only to the income of the husband and the labor force participation of the wife in the United States. We turn therefore to our third study.

4. Labor Force Participation of All Groups and Income Tax Changes Over Time—Five Countries

The larger study mentioned earlier has found that the overall labor force participation rate has been extremely stable from one high employment census year to another, and that this stability has held for the United States as a whole since 1890, and partly since 1820; for Great Britain since 1911, and partly since 1841; for Canada during 1911–51; for New Zealand during 1896–1951; and for Germany during 1895–1939.[15] In the United States the labor force participation rate has also been stable over time in rural areas, urban areas, and large cities (taken in the aggregate, but not individually). The labor force

[15] A discussion has been made of the differences in labor force concept and measurement technique in the United States over time, and between the United States and the other countries. The Labor Force Under Changing Income and Employment, op. cit., ch. 4.

participation has remained relatively stable in all the five countries during periods when real annual disposable incomes per adult male equivalent worker, or per capita, were increasing. All the countries except Germany (for which the income changes were uncertain as the result of great military defeats and territorial changes), manifested substantial income increases, for both the overall period and almost every decade.

The overall labor force participation rate has remained thus stable in spite of marked changes in the labor force participation rates of major age and sex groups within the labor force. In all five countries every male age group has manifested some decline in labor force participation—as might be expected on the basis of Douglas' and my studies of the relationship between income and labor force at a moment of time. But most female groups have shown some rise—in defiance of the results among cities and among wives of husbands in different income groups.

The above results were drawn from comparisons of labor force participation with personal incomes after income tax. What would have been the results, if the labor force participation had been compared with changes in the tax itself? The following behavior is based on tables 3 and 4.

United States.—There was no Federal income tax during 1890–1910, and during 1920–40 the tax took only 1 or 2 percent of personal income and bore on only a tiny proportion of the labor force. Between 1940 and 1950, however, the tax had risen to 7.7 percent of personal income and was paid by perhaps two-thirds of the Nation's earners. There does not seem to have been any change in labor force behavior that could be traced to the change in the amount and coverage of the tax—certainly no disincentive effect. The male labor force participation, which had been declining at every decade date since 1890, continued to decline, though slightly; the female labor force participation, which had been rising at every decade date since 1890, rose substantially: the overall labor force participation, which had maintained a high degree of stability from one decade date to another, continued to show only minor changes, i. e., a slight rise.

Great Britain.—There was an income tax at every decade date between 1911 and 1951. The average percentage of personal income paid in tax rose to a level between 1911 and 1921 almost as high as that in the United States three decades later. It was associated with a slight decline in the labor force participation of males, females, and both sexes, but these declines were negligible—much smaller than that which occurred between 1921 and 1931 when the tax scarcely changed at all. There was a sharp rise again between 1939 and 1951, to an average payment of 10.8 percent [16]—about 1.4 times that of the United States at approximately the same time. The British tax has also been more progressive than the United States tax on moderate incomes.[17] During this interval of world war and recovery, the labor force participation of males fell substantially, that of females rose a bit, and

[16] This is the average percent which the amount of income tax was of all personal incomes, including transfer payments, during the 3 years 1949–51. The percentage which it bore to taxable income was somewhat higher.

[17] In 1950–51, persons in the low-income range, £150–250, paid 2 percent of their total income in income tax, whereas those in the moderate income range of £750–1,000 paid 16 percent and those in the still moderate range of £1,500–2,000 paid an average tax of 28 percent. Great Britain, Central Statistical Office, Annual Abstract of Statistics, vol. 90, 1953, p. 244.

that of both sexes combined declined somewhat. However, the overall labor force participation rate, standardized for age and age-sex composition, was almost exactly the same as in 1911 when the effective tax was very low.

Canada.—The percent of personal income paid in tax was very small in 1921 and 1931 and still small, but more substantial, in 1941. Between 1941 and 1951 it became sizable; but even in the latter year it was well below that of the United States and only half that of Britain at approximately the same time. This rise was associated with an increase in female labor force participation about the same as that which had occurred in 1921–31 and 1911–21 when the tax was not rising; and it was also associated with a fairly sharp decline in male participation. The labor force participation of both sexes also declined, but this was largely because 1941 was a war year when the labor force had been inflated; the 1951 labor force participation was still somewhat above that of the decade dates 1911–31.

New Zealand.—The income-tax percentage was very low in 1901, the only year before 1926 for which fairly satisfactory income data are available. It was higher in 1926 and 1936, but still comparatively low. Between 1936 and 1945, however, the average tax increased to 11 percent of personal income. After 1945 there was a decline but the tax was still 9 percent in 1951—not much above the United States average, though it should not be entirely ignored that the social services taxes in New Zealand bring the total of direct taxes in 1951 to 18 percent. The labor force participation of males was sharply down between October 1945 and 1951, compared to 1936, no doubt partly as a reaction from the years of enforced service in the military forces and defense industry, for New Zealand had taken an extremely active part in World War II. That of females was up substantially over 1936, though less so in 1951 than in 1945; that of both sexes combined was down a bit in 1945 and down a bit further in 1951.

Germany.—Some income tax was levied in Germany throughout the period 1895–1950. It was negligible during 1895 and 1907, appreciable in 1925 and 1933, substantial in 1939 and 1950, though below the averages in the United States and New Zealand. The rise was less than that occurring in the United States during the same decade. The labor force participation of females in 1950 was below that in 1939, but about the same as in 1907. That of males was well below 1939, 1925, or 1895. That of both sexes combined was somewhat below most of the previous census years, but it was a bit above 1895.

Concerning all these developments in the five countries over time, several features are noteworthy. First, there was no tendency for the labor force participation to change in any systematic way with the percentage of personal income paid out in tax. In the years when the effective income tax rose the most, the overall labor force participation either failed to change, changed only mildly, or changed in about the same amounts as it had in years when the income tax was a negligible factor or was not changing.

Second, the differences in the labor force participation among the five nations in recent years, when the income tax has been a substantial percentage of personal income in all the countries, has not borne any relation to the size of that percentage. Canada had the lowest labor force percentage and the lowest relative tax, but Germany, with only a slightly higher tax, had the highest labor force participation, and

New Zealand with the next to the highest percentage of income taxation had the median rate of labor force participation among the five nations.

Third, the labor force has rather definitely been a lower proportion of the working age population (standardized for differences in age and sex composition) in those nations with high average real incomes per equivalent adult male employed worker;[18] and this inverse tendency seems to have been stronger with incomes after tax, suggesting that though the income tax has not been a powerful enough factor to determine the size of the labor force by itself, it may have exerted some influence in conjunction with the level of income on which it is based.

5. Conclusion

On the whole, these various studies summarized in this paper give the impression that the income tax has not exerted much influence on the level of the labor force participation either in the United States, or in the four foreign countries whose experiences we have examined.

This does not mean, of course, that the income tax is incapable of exerting manifest influence on the labor force participation. In the foregoing studies of changes in the income-tax burden over time, there was only one instance—a minor one—in which a rise in income tax was responsible for leaving the average labor force member with a smaller real income after tax than he had at a previous decade date with a smaller tax. In all these countries the decades of the greatest increase in percentage of personal income going to tax were also generally the decades of the greatest increase—both absolute and relative—in the real income after tax.

So much for the average tax on average personal income of all workers. Concerning the distribution of the income tax among individuals, it may be said that the income tax has not been a major burden on most of the labor force—even in recent decades when it reached its highest peacetime levels and most progressive peacetime rates, and when it could be said that it was the most productive revenue source in the American tax system.[19] In the United States in 1950, 97 percent of the individual tax returns, including joint returns, reported incomes of under $10,000 and paid an average tax of 10 percent or less of adjusted gross income;[20] and the lack of progressiveness of this tax for most of the labor force is attested by the fact that the distribution of the personal income tax by quintiles differs very little after tax from that before tax. Even the percentage of income going to the top 5 percent of income recipients was not changed much by the income tax.[21] In Great Britain in 1950–51, 93 percent of persons receiving incomes above £135, paid 8.6 percent or less of their total income in income tax.[22] In Canada and Germany the tax has been still less burdensome on most individuals.[23] In New Zealand—not count-

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[18] The Labor Force Under Changing Income and Employment, op. cit., ch. 5.

[19] Lewis H. Kimmel, Taxes and Economic Incentives (Brookings Institution, 1950), p. 67.

[20] The extra income tax paid by the $10,000 to $15,000 group over that paid by the $5,000 to $10,000 group was less than 20 percent of the extra income; the extra income tax paid by the $5,000 to $10,000 group over that paid by the $4,000 to $5,000 group was about 16 percent. Statistical Abstract of the United States, 1954, p. 378.

[21] Income Distribution in the United States, op. cit., pp. 9, 86.

[22] Annual Abstract of Statistics, 1953, p. 244.

[23] The Canada Yearbook, 1952–53, p. 1044; Statistisches Jahrbuch für die Bundes republic, Deutschland, 1954, p. 423.

ing the very heavy social security taxes—three-fourths of the income-tax assessments in 1950–51 were for an average tax of 4.5 percent or less of their returnable income.[24] Thus, the absence of a manifest effect of the income tax on labor force participation may have been because during the history of the tax thus far it has been relatively moderate and unprogressive for most of the labor force; the effect of the tax on that small part of the labor force in the high-income groups upon whom the tax is high and progressive would have to be enormous in order to carry a discernible impact on the labor force as a whole.

[24] New Zealand Official Yearbook, 1954, tables on pp. 847 and 858.

TABLE 1.—*"Effect" of the Federal income tax on variations in the April 1951 labor-force participation of wives 20–44, associated with differences in income of husbands in 1950 (United States)*

[Percent by which rate of labor-force participation of wives 20 to 44 (per 1,000 wives of same age, child status, and income group) was changed for every additional 1 percent of income received by their husbands in the previous year]

	Change in level of income received by husbands before tax													Weighted average [1]	
	$250 to $750	$750 to $1,250	$1,250 to $1,750	$1,750 to $2,250	$2,250 to $2,750	$2,750 to $3,250	$3,250 to $3,750	$3,750 to $4,250	$4,250 to $4,750	$4,750 to $5,500	$5,500 to $6,500	$6,500 to $8,500	$8,500 to $15,000 [2]	All income groups	Income groups paying taxes
Wives with children under 6: [3]															
1. Before tax	−0.21	+0.67	−0.47	−0.35	−0.82	+0.51	−0.25	−2.60	−1.95	−0.09	+1.58	−1.48	+0.08	−0.36	−0.15
2. After tax	−.21	+.67	−.47	−.35	−.82	+.73	−.30	−2.95	−2.16	−.12	+1.76	−1.64	+.09	−.37	−.46
3. "Effect" of tax (line 2 minus 1)	(4)	(4)	(4)	(4)	(4)	+.22	−.05	−.35	−.21	−.03	+.18	−.16	+.01	−.01	−.01
Wives with children between 6 and 17: [3]															
4. Before tax	+.02	+.34	−.81	+.24	+.84	−1.46	+1.36	−2.72	+1.83	−2.56	−.60	−2.38	+1.97	−.26	−.75
5. After tax	+.02	+.34	−.81	+.24	+.84	−2.07	+1.57	−3.09	+2.05	−2.88	−.68	−2.62	+2.41	−.36	−.95
6. "Effect" of tax (line 5 minus 4)	(4)	(4)	(4)	(4)	(4)	−.61	+.21	−.37	+.22	−.32	−.08	−.24	+.44	−.10	−.20
Wives with no children under 18: [5]															
7. Before tax	0	−.06	+.39	+.26	−.63	−.08	−.24	−.36	+1.19	−3.01	+.32	−2.34	+1.87	−.19	−.31
8. After tax	0	−.06	+.39	+.40	−.70	−.09	−.26	−.38	+1.26	−3.27	+.34	−2.51	+2.08	−.19	−.31
9. "Effect" of tax (line 8 minus 7)	(4)	(4)	(4)	+.14	−.07	−.01	−.02	−.02	+.07	−.26	+.02	−.17	+.21	(6)	(6)

[1] Weighted by number of wives belonging to different income levels of their husbands in 1950.

[2] The income groups ranged from under $500 at the bottom to $10,000 and over at the top. The central figure was taken as the mid figure, e. g., $250 was the mid figure for the under $500 group. It was assumed that the average income of those in the group $10,000 and over was $15,000.

[3] Income tax of husband deducted on the basis of married persons with 2 dependents.

[4] No tax paid by this income group.

[5] Income tax of husband deducted on the basis of married persons with no dependents.

[6] Difference insignificant when percentage was rounded to 2 decimal places.

Sources: Bureau of the Census Current Population Reports, Labor Force Series P-50, No. 39, p. 11; Statistical Abstract of the United States, 1954, pp. 374-375; 1950 Census of the United States, vol. II, pt. I, United States Summary, p. 304.

TABLE 2.—*Weighted average*[1] *percent by which the labor-force participation rate of the wives was smaller, for each 1 percent by which husbands' income was larger; comparisons between 1940 when the income tax was not effective for most of the labor force, and 1951 when it was effective on most labor force groups, by child status*[2] *of wife (United States)*

	1940[3] No tax effective	1951[3]	
		Tax not deducted	Tax deducted
Wives with young children	−0.41	−0.36	−0.37
Wives without young children	−.34	−.22	−.25

[1] Weighted according to number of wives attached to the various income groups.
[2] Children under 6 in the case of the 1951 data; children under 10 in the case of the 1940 data.
[3] Labor force for April; income of the previous calendar year, i. e., 1939 and 1950. For explanation of differences in labor force and income classifications, see text.

Sources: 1940: 16th Census of the United States (Population, The Labor Force), Employment and Family Characteristics of Women, table 23, 1951. This study, table 1.

TABLE 3.—*Personal disposable national income*[1] *per adult-male-equivalent employed,*[2] *3-year average,*[3] *before and after income tax,*[4] *1929 United States dollars,*[5] *5 countries*

UNITED STATES

	1890	1900	1910	1920	1930	1940	1950
Income before tax	1,011	1,203	1,418	1,521	2,102	2,328	2,925
Tax	0	0	0	35	23	35	224
Income after tax	1,011	1,203	1,418	1,486	2,079	2,293	2,701

GREAT BRITAIN

	1911	1921	1931	1939	1951
Income before tax	1,216	1,220	1,309	1,428	1,843
Tax	26	85	85	96	199
Income after tax	1,190	1,135	1,224	1,332	1,644

CANADA

	1921	1931	1941	1951
Income before tax	1,352	1,422	1,678	2,339
Tax	12	11	44	136
Income after tax	1,340	1,411	1,634	2,203

NEW ZEALAND

	1901	1926	1936	1945	1951
Income before tax	1,046	1,599	1,251	2,018	2,804
Tax	6	35	45	220	252
Income after tax	1,040	1,564	1,206	1,798	2,552

See footnotes at end of table.

TABLE 3.—*Personal disposable national income*[1] *per adult-male-equivalent employed,*[2] *3-year average,*[3] *before and after income tax,*[4] *1929 United States dollars,*[5] *5 countries*—Continued

GERMANY

	Post-World War I boundaries without Saar					Federal Republic of Germany without Berlin	
	1895	1907	1925	1933	1939	1939	1950
Income before tax	783	784	670	787	925	956	792
Tax	3	5	27	28	59	57	50
Income after tax	780	779	643	759	866	899	742

[1] Includes, where data are available, national income (wages, interest, dividends, rents, and profits) less corporate profits withheld and social-security contributions paid or withheld, but plus Government and business transfers to persons. Where such data are not available an approximation to this concept has been made through modification of national product data. The Labor Force Under Changing Income and Employment, op. cit., appendix F.

[2] The numbers of equivalent adult male employed workers is approximated roughly by weighting the number of women and youths by a crude measure of their average earnings relative to adult males. Op. cit., appendix C. These adjustments have no relevance to the estimate of the income tax paid, but are made so that changes in the age-sex composition of the labor force will not affect the statistics of income per worker.

[3] Except for years when data were not available, the income data refer to the average of the census year and the 2 preceding years. The use of 3-year averages has the advantage of minimizing variations arising out of statistical difficulties in measuring income or of allocating its flow to a particular year. It also recognizes the fact that the worker may not respond in his labor force participation to income changes without some lag or may not respond to income changes which he regards as temporary. However, comparisons have also been made elsewhere with incomes of the census year alone. These comparisons do not yield results essentially different from those achieved through use of the 3-year averages. Op. cit., appendix F.

[4] Actual aggregate income taxes paid by individuals divided by the number of equivalent adult-male employed workers.

[5] See op. cit., appendix F, for explanation of the income data, the methods used in adjusting the incomes for changes in prices, and methods used in converting incomes expressed in foreign currencies to United States dollar equivalents.

TABLE 4.—*The labor force per 1,000 population, 14 and older of the same sex, 5 countries*

UNITED STATES, APRIL 1890–1950 [1] [2]

	1890	1900	1910	1920	1930	1940	1950
Males	890	874	860	859	840	790	783
Females	190	210	228	232	237	254	284
Both sexes	540	542	544	546	538	522	533

GREAT BRITAIN, 1911–51 [1]

	1911 April	1921 June	1931 April	1939 June	1951 April
Males	919	916	904	903	873
Females	345	338	358	385	388
Both sexes	632	627	631	644	631

CANADA, JUNE 1911–51 [1] [2]

	1911	1921	1931	1941	1951
Males	872	863	857	858	823
Females	161	171	184	219	232
Both sexes	516	517	520	538	527

NEW ZEALAND, 1896–1951 [1]

	1896 April	1901 March	1906 April	1911 April	1921 April	1926 April	1936 March	1945 Sept.	1951 April
Males	951	969	948	937	923	898	899	849	848
Females	210	226	230	254	256	237	256	284	276
Both sexes	580	598	589	596	590	568	578	566	562

GERMANY, 1895–1950 [1]

	Post-World War I boundaries without Saar					Federal Republic of Germany without Berlin	
	1895 June	1907 June	1925 June	1933 June	1939 May	1939 May	1950 Sept.
Males	902	893	894	857	872	882	858
Females	345	428	450	452	480	475	428
Both sexes	623	601	672	654	676	678	643

[1] Standardized for age-sex composition on the basis of the composition of the United States population in 1940.

[2] Standardized for rural-urban composition of the population on the basis of the composition of the United States population in 1940. In the case of Canada, rural-urban labor force participation rates were lacking, and it was assumed that the effect of standardization for changes in rural-urban composition was the same as in the United States for comparable years.

Source: The Labor Force Under Changing Income and Employment, op. cit., appendix A.

EFFECTS OF TAXATION ON METHODS OF REMUNERATION FOR PERSONAL SERVICES

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This subject, of necessity, relates to those persons in the higher income brackets. Progressive rates of income tax, and the distinctions accorded by the internal-revenue laws in favor of investment appreciation and other unearned income as against earned income, have generated a series of methods adopted by executives and other high-bracket income earners to try to spread their annual incomes over periods longer than the periods in which their principal efforts are expended, and major services rendered, and to provide funds for what may be expected to be their leaner years.

Certainly the Congress is aware of at least some of the trends presently prevailing in this field. It seems safe to say that sophisticated executives today generally seek to achieve means of receiving their high compensations in a variety of ways designed to mitigate the effect of high tax rates. More and more frequently, they are content to receive currently the rewards of their achievements only to the extent needed to maintain their desired standards of present living.

PRINCIPAL METHODS UTILIZED TO DEFER COMPENSATION OR REALIZE OTHER BENEFITS FROM SERVICES

The methods, both statutory and nonstatutory, utilized today to defer compensation and in some instances to realize capital gain are briefly outlined herein and their tax consequences compared.

EMPLOYEE STOCK OPTIONS

One of the more popular techniques currently in vogue is the granting of stock options to key employees presumably as an incentive device for the corporate employer's benefit, but, equally realistically, to defer and transform what might otherwise be additional compensation to key executives and employees into more net keepable cash. So-called restricted stock options to buy stock of the employer are granted to employees at a price which in an expanding economy is by all odds calculated to favor the recipient employee when he exercises his option at some subsequent date. For a number of years the Treasury had distinquished between "compensatory" and "proprietary" options and determined the taxable or nontaxable status thereof to the employee by reference to the purely fact question of the employer's purpose in offering the option.

The Treasury ceased to make this distinction following the decision of the Supreme Court in *Commissioner* v. *Smith* (324 U. S. 177 (1945); rehearing denied, 324 U. S. 695 (1945)). Although it is perhaps difficult to find, in this decision itself, justification for the Treasury's interpretation, the Treasury nevertheless changed its prior attitude and thereafter took the view, by amendment to its regulations, that if, pursuant to option or otherwise, an employee purchases property from his employer for less than its value at the time of the purchase, the differential must be treated as compensation taxable as ordinary income to the employee, notwithstanding that he would have

to pay such tax out of other funds if he were unable immediately to dispose of such property for cash.

Congress did not wholly approve of this single-minded treatment and in 1950 gave its blessing to restricted stock options as a matter of social policy and sanctioned a means whereby corporations may attract new management, retain the services of executive employees, and stimulate keener interests of the employee in the business and, in addition, the employee may eventually realize capital gain rather than ordinary income. Presumably Congress believed that the contributions of the executive class of employees to the national economy were sufficiently important to justify this type of advantageous tax treatment. Today, when a stock option qualifies as a restricted stock option, no tax is imposed, either at the time the option is granted or at the time it is exercised. The only tax impact, if any. is at the time the stock is sold or otherwise disposed of, and thus, under certain conditions which are usually met with little trouble, any gain then realized is a capital gain. Moreover, if under usual conditions the executive holds his stock until death, even the capital gain tax may be avoided.

Perhaps the use of restricted stock options goes further than the original congressional intent. Many executives today are happy to receive additional recognition of their services by way of stock options instead of increase in salary, and, indeed, it is rumored that some have gracefully submitted to a decrease in salary in order to obtain the difference by way of the stock-option route.

So long as our national economy is expanding, little doubt exists that this means of receiving compensation at capital-gain rates will grow; in the event of a declining economy, however, the lack of anticipated benefit will, because of the likely failure of the stock to increase in value over the option price, go far to halt its progress.

If the congressional intent was to reward the executive class of taxpayers for their contribution to the economy, it is perhaps pertinent to point out that the class so rewarded consists almost entirely of the executives of large publicly held corporations. In a very practical sense, the statutory relief does not lend itself to use by a closely owned corporation because of the unique and specially difficult problem of accurately valuing the stock of such corporations.

The fact is that, whether it intended to do so or not, Congress has favored the key executives of large publicly owned corporations and has afforded no similar degree of benefit to executives of smaller or closely held corporations. And it seems appropriate for the practical and perhaps unintended results of legislation generally to be called to the attention of Congress for proper consideration by that body.

Section 421 of the Internal Revenue Code provides that in order to meet the statutory definition of a restricted stock option, the option price must be at least 85 percent of the fair market value of the stock on the date of granting the option. Most closely owned and many other small corporations and their executives have no desire to take the risk of placing a value on stock where there are no acceptable measures of value such as independent sales or public listings. In far more simple matters involving valuation, taxpayers' valuations are continuously challenged by the Treasury, and, when an entire intended result may fail because of a difference of opinion in regard to value, it is not difficult to understand why section 421 is of little avail to closely owned corporations and their particular key employees.

Under two recent decisions, compensatory stock options which do not qualify under section 421 have been held to generate ordinary income to the employee only to the extent of the spread in value at the time of receipt of the option, rather than the greater spread at the time of its exercise, the option itself being treated as the only intended compensation rather than as a contract right to acquire additional compensation (*Commissioner* v. *Stone's Estate*, 210 F. (2d) 33 (C. A. 3d 1954); *McNamara* v. *Commissioner*, 210 F. (2d) 505 (C. A. 7th 1954)). In view of these decisions it is apparent that in some instances a nonrestricted option may be more beneficial than a restricted one.

LEVERAGE STOCK

Because restricted stock options are for practical reasons not generally available in close corporation situations, many such companies have turned to transactions involving outright sales of stock to executives. Most elementary, of course, is the outright sale of stock to an employee for cash. This is not an appealing alternative, because in normal circumstances the executive does not have sufficient cash to purchase more than a minute participation in the business. The financial hardship thereby generated is sometimes alleviated by long-term payment arrangements under which the executive acquires a block of stock and pays for it over a period of several years, but this, too, has its drawbacks. Unless there is a binding obligation on the executive to keep up the payments and the financing arrangement has all the other elements of a bona fide loan from an institutional lender, the transaction may be deemed the equivalent of an unrestricted compensatory stock option. On the other side, if there is an irrevocable commitment by the executive, he may later find that he is burdened with an obligation which he cannot meet, and this risk is most seriously aggravated if, in a time of declining economy, he must continue to pay for stock which has decreased substantially in value.

Understandably, therefore, numerous corporations have turned to the so-called leverage stock transaction. There are numerous variations of this procedure, but the common goal is to reduce the present value of the stock to be sold to the executive down to a point where a comparatively small outlay of cash will buy a respectable percentage of the common stock equity. If, for example, only one class of common stock is outstanding, new preferred stock may be issued tax free, either by way of stock dividend or pursuant to recapitalization, to the present holders of the common. Since the tax-free issuance of the preferred to the present stockholders will diminish the value of the outstanding common, the executive can then purchase, for a relatively modest amount, a significant common stock equity which, if all goes well, may be worth a substantial sum in the future.

In any of these stock purchase arrangements, the question of fair market value must, of course, be met. However, if there is evidence of good faith and arm's length negotiations or other bona fide efforts to sell the stock at its true value, there is relatively little degree of risk that any element of compensation will be found.

In those leverage situations where preferred stock is utilized, the preferred stock so received by the old stockholders will ordinarily constitute so-called section 306 stock under the Internal Revenue Code

of 1594, subject to the special inhibitions of that section, and the old stockholders may not be enthusiastic about receiving such tainted preferred stock in order to enable one or more executives to acquire common stock at a price within their means to pay. That is to say, although a stockholder is customarily free to sell off a portion of his stock with the profit subject only to capital-gains rates, the sale by him of preferred stock received by way of tax-free stock dividend or recapitalization while he still retains all or most of his underlying common will result, by reason of section 306, in the receipt of ordinary income and not capital gain; whereas the sale by him of some or all of his remaining diluted common will, of course, diminish his participation in the future growth of the enterprise.

One of the most critical problems of small business today is attracting and retaining the services of top-flight personnel. It appears that it is increasingly more difficult for small corporations to cope with the situation. Although unable in most cases to pay as high salaries and bonuses or to grant as substantial benefits by way of pensions as publicly listed corporations, the average smaller company has the one advantage to offer in that, if the necessary arrangement can be worked out, an executive may end up with substantial ownership of the business.

Whether this objective is in some measure indirectly impeded, however, by the restrictions imposed by section 306 as respects preferred stock which may have to be issued tax-free to old stockholders as a preliminary step, is something of an open question, and section 306, which was enacted primarily for the purpose of preventing so-called preferred stock bailouts, may have the collateral effect of further retarding acquisition by key employees of a common stock participation.

PENSION AND PROFIT-SHARING PLANS

Pension and profit-sharing plans have long been recognized as presenting an appropriate method whereby an employer may provide an additional source of remuneration which can be made available to the highly paid executive or employee at a time when his income is likely to be lower and therefore subject to tax at a lower rate.

The Congress has legislated most extensively in this field, primarily in the Revenue Act of 1942, with the intention of fostering the adoption of such plans as a matter of social policy, and it is the clearly established position of the Federal Government that certain tax advantages will be made available to both employers and employees entering upon an approved plan of this type.

In order to secure this preferable tax treatment, however, it is necessary that a separate fund be established as the source of future payments under the plan, and that the particular plan meet the conditions prescribed under sections 401 et seq. of the 1954 code, which are designed to restrict this treatment to those plans which will accomplish the aims intended by the Congress. These conditions, the technical provisions of which are well known, are primarily intended to insure that any such plan shall be used for the exclusive benefit of the employees participating therein, and, most specifically, that the plan shall not be discriminatory in favor of highly paid officers and executives.

If the plan complies with the statutory conditions, the contributions made to it by the employer will be deductible in the year in which they are made, within the limitations set forth under section 404 of the 1954 code. The employee, in his turn, will not be taxed with respect to any such contributions until amounts from the fund are actually paid or distributed to him. Moreover, under the more recent amendments to the code, if the employee or his estate should receive the total distributions payable under the plan in a single taxable year on account of his death or other separation from the service of his employer, the amount so distributed will be eligible for capital gain treatment.

In the case of the highly paid individual, while the benefits of a pension or profit-sharing plan are of undoubted value to him, such plans are of somewhat limited utility as a device whereby he may protect any very considerable portion of the compensation for his services from the effects of a high rate of tax. The statutory requirements which must be met if the plan is to have the status of a qualified plan necessitate the coverage of relatively large classes of employees and, for the most part, effect a practical limitation on the amount of benefits which can be made available to any particular participant. Consequently, the use of these plans is commonly regarded in contemporary thinking on the subject as providing only a partial or interim solution to the key executive's problem.

Nevertheless, the realistic desirability of providing a more effective measure of remuneration to an executive and the necessity of providing additional inducements to him in order to meet the possibility of outside competition for his services, has led many corporations and other employers to adopt such plans.

It would be both interesting and beneficial to determine how many plans presently in effect have been adopted primarily to obtain coverage for certain key executives or employees, without much thought being given to the social policy involved. I know of no available statistics on this point. It is, I think, quite possible that if key personnel could be successfully afforded protection in other ways, the number of plans, adopted by the smaller companies at least, would be somewhat less than at present. Although these plans conform to ideas of sound social policy which have long carried common acceptance, it would seem that this result may frequently be more incidental than intentional, and that many employers are motivated to a considerable extent by the desire to retain key personnel in their employment.

DEFERRED COMPENSATION

In the absence of adequate legislative coverage, certain groups of taxpayers who derive their income primarily from personal services have resorted to what are commonly known as deferred compensation arrangements. Such arrangements are widely used for corporate executives and for the benefit of persons whose chosen careers are normally much shorter in term of years than is that of a corporate executive. For example, in the entertainment industry, and in the field of professional sports, many variations of deferred compensation arrangements have come into play.

It was long ago settled that the purchase by the employer of an annuity for an employee outside of and not as part of a qualified

pension or profit-sharing plan, did not solve the problem. If the employee's rights to the annuity contract are nonforfeitable when the employer purchases the annuity, the employer receives a tax deduction for his payment currently and the employee is currently taxed on the amount of such payment, whether or not he can benefit ultimately therefrom in any way except by living long enough, and notwithstanding that he has to obtain other funds with which to pay an immediate tax thereon. Nonforfeitable annuity contracts do not help the employer substantially in holding the services of the employee and do not help the employee to spread income.

Likewise, if the employee's ultimate rights to the annuity contract are forfeitable, as for instance, if they are dependent upon his remaining in his employment for a specified further period after the employer has paid for the annuity, the employee is not taxable until he actually begins to receive the annuity payments, but the employer at no time gets a tax deduction for payment of the annuity.

Transfers to nonqualified trusts for future payments to employees are more or less similar to annuity arrangements and are unsatisfactory to the employer and to the employee for the same reasons as are annuity contracts. The income tax statutes subject such nonqualified employee trusts and annuities to similar rules.

The inadequacy of such arrangements in practical operation has led to the use of deferred compensation contracts, unsecured and uncollateralized by annuity or trust or other setting aside of funds by the employer for such purpose.

Under one of the more typical forms of deferred-compensation contracts currently popular, the employer agrees that if the employee remains in the service of the employer until normal retirement age, the employer will pay him a designated amount thereafter for a specified number of years or for life. In some such contracts provision is made for certain payments to the employee's widow or other designated beneficiaries after his death. Even though employers undertake pension or profit-sharing plans which qualify under the Internal Revenue Code, they frequently make use of individual deferred-compensation contracts also.

Two theories for taxing the employee prior to his actual receipt of such compensation have been advanced by the Treasury. One is the theory of constructive receipt, and the other is the economic benefit theory. The Treasury has had little success in promoting either theory, and, in fact, has thus far been defeated in the courts in all cases involving the economic benefit theory. See, for example, *Commissioner* v. *Oates* (207 F. (2d) 711 (C. A. 7th, 1953)). *Veit* v. *Commissioner* (8 T. C. 809 (1947); *Veit* v. *Commissioner* (8 T. C. M. 919 (1949)).

Some strange and curious concepts have evolved from the somewhat sparse litigation in this field. For instance, the Tax Court has distinguished ordinary commercial annuity contracts from unsecured deferred compensation contracts by saying that the former represented the absolute right to receive annuities with no conditions whatsoever, whereas the latter amounted to a mere promise to pay compensation in the future. And it is frankly difficult for many tax experts to see any sound or logical justification for differentiating the economic benefit attributable to the receipt of an insurance company annuity contract which has no realizable cash surrender value and cannot be

assigned or otherwise anticipated from the economic benefit inherent in the acquisition of an unconditional right to enforce a similar promise directly from a corporate employer such as, say, the United States Steel Corp.

It was generally understood, as far back as 1947, that the Internal Revenue Service was actively working on and proposed to publish an overall basic policy ruling on deferred-compensation arrangements. So far no such ruling has been issued, and taxpayers are still subject to the risk of courting disapproval by the Service of their arrangements. It is common knowledge that numerous arrangements along these lines exist throughout the country, and revenue agents are undoubtedly aware of them, but apparently pass most of them on audit.

As the matter stands today, a deferred-compensation contract which contains valid conditions attaching to future payments to the employee appears to involve relatively little tax risk to the employee. Some tax experts even take the position that such conditions are unnecessary.

Those advisers who insist upon attaching valid conditions to contracts of their employee clients have witnessed some astonishing negotiations. It is certainly an intriguing experience to listen to corporate officials make an offer to pay an employee over 10 years for 5 years of active services with no other strings attached and to hear the prospective employee insist that the proposed contract must impose valid conditions upon him with respect to the payments in the latter 5-year period.

So far as the corporation is concerned, it is ready and willing to accept the postponement of tax deductions until payments are made in future years in spite of the fact that deductions might be more valuable to it if taken at the present time. In the fields of entertainment and sports the primary concern of the employer is to secure the employee's talent while it is salable to a fickle public.

It is interesting to note also, in passing, that Congress has granted to professional inventors the privilege of receiving capital gains treatment on the sale of the products of their efforts, under section 1235 of the 1954 code, although the distinction thus made as between inventors, on the one hand, and authors or other persons engaged in creative activities, on the other, has been the subject of considerable comment and criticism.

In 1954 an attempt was made to settle the controversial subject of deferred compensation contracts by legislative action. H. R. 8300, as passed by the House, contained a provision which would have taxed deferred payments of compensation to the employee or executive in the year in which he received them under an arrangement with his employer, even though his rights to the payments vested in a prior year. Under this bill the employer would have been allowed a deduction for the year in which payment was made to the executive or employee. As you know, this particular provision of the bill failed to pass the Senate, perhaps because it was included in an extensive new approach relating primarily to pension, profit-sharing and stock-bonus plans, which approach was at least temporarily discarded.

The whole question of the method of taxing deferred compensation seems to me to be one of policy. Congress has sanctioned stock options for executives and employees most of whom are in higher tax brackets. It is difficult to justify denial of legislative relief of a comparable

sort to persons in the entertainment and sports professions, when as a matter of fact they are notoriously prone to dissipate or lose their high earnings almost currently, and it is no secret that the collection of income tax deficiencies from some of them has proved impossible. There are many who sympathize with the tax plight of such persons. Much of their spending is unallowable as expense deductions although it is admittedly customary in their professions.

Deferred compensation contracts are becoming more and more prevalent and it appears to me that it would be a wise course for Congress to give most careful consideration to the matter presently for the sake of both taxpayers and a sound administration of the revenue. Such special arrangements are no less subject to legislative action than many other matters which have already been codified.

Comments in Conclusion

The doctrine that individuals who earn larger amounts of income should bear a greater share of the general tax burden, in proportion to their greater ability to pay, is, of course, one of the fundamental premises of our national tax structure. The question of the extent to which such taxpayers should be favored or penalized in their efforts, undertaken within the context of this existing tax structure, to retain for themselves more of the fruits of their own labors is, therefore, one which involves tax policy considerations of the most basic sort. Whether the contributions which these individuals make to the national welfare is to be considered as of such value that they should be afforded further incentives to increase the productiveness of their activities is a matter which Congress alone can decide.

Most of the methods available today to permit the effective enjoyment, by persons in high income tax brackets, of a greater percentage of the remuneration for their services and thus to enable them to provide for their security in their retirement years, such as stock options, leverage stock and pension and profit-sharing plans, are available only to corporate executives and personnel. Even to the corporate employee, they may be of only limited utility, and they have the additional disadvantage that they may be cumbersome or impractical to establish or maintain for business reasons. However, even these methods are not available to any real degree to self-employed or to itinerantly employed individuals, including such persons as entertainers, professional athletes, and others whose period of high earning is frequently of limited duration, and who, therefore, have no other recourse than that of using the deferred compensation contract.

The spread-back benefits provided under section 1301 et seq. of the 1954 code with respect to income attributable to several taxable years are available only in a limited area and in infrequent circumstances.

The self-employed or itinerantly employed individual's problem has naturally received a very considerable amount of attention in professional and technical journals in recent years, and numerous solutions have been proposed. Congress has given consideration in the past to proposals to equalize the effect of the tax burden over an extended span of years through the use of various methods commonly known as averaging. There is also increasing support being given today to proposals that Congress sanction the establishment of

private, tax-qualified retirement funds for self-employed individuals, including professional men, deposits from the individual earner to which would be currently deductible from gross income. Congress has as yet taken no action on proposals of this nature, and the Treasury has generally opposed them. It may be significant, however, that the Honorable George M. Humphrey, Secretary of the Treasury, admitted at hearings before the Ways and Means Committee on H. R. 10, 84th Congress, 1st session, that the Treasury would be sympathetic to a limited form of special allowances to self-employed individuals and employees whenever general tax relief becomes possible.

In the absence of any other generally satisfactory method, the practice of using deferred compensation contracts is steadily increasing and becoming more widespread with the passage of time. If legislative action with respect to this practice is postponed until some future date, we will undoubtedly find an increasing number of taxpayers already committed to contracts of this sort, thus raising a problem as to the retroactive effect to be accorded to whatever statutory provision may ultimately be enacted. The interests of both the Treasury and the taxpayer would be better served, in my opinion, by a direct and considered legislative approach to the matter at this time, rather than by allowing the tax treatment of such arrangements to evolve by happenstance. Administrative and legislative silence, though itself a sort of action, is not the most realistic solution to the problems in this area.

INCOME AVERAGING FOR INDIVIDUAL INCOME-TAX PURPOSES

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The subject of income averaging involves the interaction of two of the basic principles of our present income-tax system: The progressive tax structure and the annual accounting system. The progressive tax rates, which now range from 20 percent to 91, are based on the premise that the tax burden is to be distributed in accordance with the principle of ability to pay. As income increases, the rate of tax levied on the marginal dollar of income also increases, until the maximum rate is attained. The sharply progressive rates which have been in effect, with relatively minor modifications, since the commencement of World War II have been the subject of some criticism and attempts at legislative change, but have generally been accepted as necessary in a period of high governmental expenditures.

However, when these rate are applied on a strict year-by-year basis without any consideration of the income status of prior or subsequent years, a serious inequity may result. The annual accounting period is, of course, basic to the administration of the tax system and the Government's need for revenues at fixed and definite times. Nevertheless, the use of a yearly accounting period should not prevent consideration of items of income or loss in other taxable years for the purpose of properly determining the amount of taxable income, the character of income items, or the applicable rates in the current year. The Internal Revenue Code, prior to its revision in 1954, contained numerous provisions such as the net operating loss deduction,

designed to relieve the rigidity of the annual accounting concept. Several other provisions to this effect were added in the 1954 code.

Despite the provisions of existing law which permit some amelioration of the fixed accounting periods, there is a serious and continuing problem in the manner in which the annual accounting system affects individuals with periodic or irrigular income. If the income of an individual fluctuates materially from year to year or if he receives the principal part of his income from personal or business activity in a single year or a few years, he may be required to pay substantially greater taxes than an individual who receives the same total amount of income in more nearly equal amounts. The difference in taxes between two such individuals is illustrated in table 1.

TABLE 1

Year	Taxpayer A, stable income		Taxpayer B, fluctuating income	
	Taxable income [1]	Tax liability	Taxable income [1]	Tax liability
1955	$10,000	$1,960	$2,000	$400
1956	10,000	1,960	1,000	200
1957	10,000	1,960	2,000	400
1958	10,000	1,960	2,000	400
1959	10,000	1,960	5,000	1,100
1960	10,000	1,960	10,000	1,960
1961	10,000	1,960	15,000	4,730
1962	10,000	1,960	20,000	7,260
1963	10,000	1,960	30,000	13,220
1964	10,000	1,960	13,000	3,830
Total	100,000	19,600	100,000	33,500

[1] Tax liability is computed on basis of rates applicable in 1955. It is assumed that the taxpayer is unmarried and not the head of a household.

NOTE.—Difference in tax burden between A and B, $13,900.

This table shows 2 single individuals each receiving total taxable income of $100,000 over a 10-year period. Taxpayer A has a taxable income of $10,000 annually and pays a total tax of $19,600. Taxpayer B receives the same total taxable income in annual amounts ranging from $1,000 to $30,000 and pays a tax of $33,500, or $13,900 more than the individual with stable income. Taxpayer B with irregular income pays a tax which is 71 percent greater than that paid by taxpayer A.

The foregoing example is by no means extreme. It is typical of the tax penalty borne by individuals in many sectors of the economy. The person undertaking an investment in a small business may have many lean years before prospering. Even after the business has been established, vagaries of technological change and competition may cause the income to fluctuate substantially. The farmer typically has good years and bad years. The fisherman may have a big season and then a poor one. Artists, entertainers, and athletes have wide variations between earnings in successive years. The professional man, lawyer, doctor, or architect, usually works for some time to build a clientele before he begins to realize his potential.

The effect of the present tax system on individuals with fluctuating incomes in different income brackets is shown in table 2.

TABLE 2

Taxable income	Aggregate tax on col. 1 income received in 3 successive years[1]	Tax on 3 times col. 1 income received in 1 year[1]	Percentage of disparity (col. 3 over col. 2)
(1)	(2)	(3)	(4)
$5,000	$3,300	$4,730	43
$10,000	7,920	13,220	67
$15,000	14,190	23,220	63
$20,000	21,780	34,320	58
$25,000	30,000	46,170	52
$50,000	80,460	111,820	39
$100,000	201,960	247,820	23
$200,000	470,460	520,820	17

[1] Tax liability is computed on basis of rates applicable in 1955. It is assumed that the taxpayer is unmarried and not the head of a household.

This table shows in column 2 the total tax that would be paid (assuming 1955 rates) if the amount shown in column 1 were received in each of 3 successive taxable years. Column 3 shows the tax payable if the same aggregate amount had been received in 1 year. Column 4 shows, in percentage form, the excess of the tax paid where the income is received in a single year as contrasted with the tax on the same income over a 3-year period.

It will be seen from table 2 that the inequity has varying application in the different income brackets. The greatest relative significance is in the lower or medium income brackets. At the level where $10,000 of income is received in 1 year instead of being spread over 3 years, the tax penalty is 67 percent as contrasted with a tax penalty of 17 percent where the principal sum involved is $200,000.

There are, primarily, two adverse consequences of the present treatment which merit consideration in an evaluation of the income-tax system. First, the present system results in a serious inequity as between different individuals and groups in our economy. Secondly, the present system discourages activity or investment in occupations characterized by irregular income and hinders the growth and development of our economic system.

The equity problem presented is fundamental to our whole taxing system. The progressive rates rest upon the principal of ability to pay; yet persons with irregular incomes may be required to pay a substantially greater tax than those with steady incomes. This difference can hardly be rationalized on the basis that their income was received in lumps. In fact, the very irregularity and unpredictability of income indicates that they may have less ability to pay than those with relatively secure incomes. It is sometimes said that the irregular income may be in the nature of a windfall but this also may be true of the more stable income. Actually, irregular income is more often the result of intense personal effort. Any distinction based on whether the income is more or less than the individual merits is not a sound basis for a difference in rates. It may be fairly said that there is no substantial argument against achieving greater equality in tax payments as between the two groups. In recognition of this, Treasury spokesmen and tax scholars have conceded the equity of the case, although reservations have been expressed on other grounds.

It should be emphasized that the equity considerations, although intangible, are of fundamental importance to the continuing effectiveness and integrity of the tax system. Because of the hardships imposed on persons with irregular incomes, a number of specialized provisions have been added to the law. Taxpayers who have been unable to obtain legislative relief have often entered into questionable long-term or deferred compensation contracts. A sensible measure of relief within the tax structure would make unnecessary many devices and arrangements of doubtful status and would develop greater respect for the tax system as a whole.

The second undesirable aspect of the present treatment is the effect upon individual incentive and investment in activities which characteristically produce irregular income. The influence of the tax statutes on personal efforts is extremely difficult to calculate. Decisions as to vocation are ordinarily based on factors other than taxation. Nevertheless, it would appear that, particularly for those in the affected areas, the experience of bunched income and the incidence of the progressive rate structure probably result in a slackening of activity, an unwillingness to make the additional exertions necessary to produce more income, and in the end frequently a shift to other modes of activity which do not suffer the same tax penalty. For the investor, tax considerations are even more important and commonly a deciding factor in choosing between different lines of activity. Under the present system, the tax pressures are strongly in favor of investing in stable types of business and against investing in businesses which have a fluctuating income. As a consequence, misapplication of economic resources occurs between these types of business.

Moreover, the businesses which are hardest hit by this factor are those lines which are highly dynamic and which stimulate growth of the economy. For example, the introduction of new products often show substantial irregularity of income. Again, many of those affected are small-business men, entrepeneurs, or professional people seeking to gain a foothold in business or professional life. The tax penalty on irregular incomes results in a greater tax burden for the dynamic element of the economy than for those who are well established or have a diversified line of activities.

Another aspect of the fluctuating income problem is that persons in the low-income brackets who receive fluctuating income may be deprived of the benefit of their exemptions in years in which their income is less than the total amount of exemptions. Thus, a married man with three children would be entitled to total exemptions of $3,000 ($600 per capita). If he is unemployed for a part of the year, his income may fall below the $3,000 level, yet he will be unable to apply the unused portion of the exemption against the income of other years. This is part of the fluctuating income problem, although since only the first bracket rate is ordinarily involved, the magnitude and severity of the tax penalty is not as pronounced as where the bunching of income results in application of the higher rates.

Proposals Relative to Fluctuating Income

Proposals with respect to fluctuating income have generally been directed to one or more of the following objectives: (1) Allow a more effective carryback and carryover of losses; (2) permit a carryback

or carryover of unused exemptions; and (3) provide a system of averaging for irregular incomes.

The loss-carryover problem has been resolved in substance by recent legislation permitting a 2-year carryback and 5-year carryforward of operating business losses. Improved definitions of the business loss concept in the 1954 code have eliminated many of the prior limitations on use of the carryover. Further proposals will undoubtedly be made for lengthening the carryback and carryforward period. Experience will indicate whether the present periods are adequate.

A continuing problem for individuals, however, is the fact that the carryback or carryforward of a loss requires that the loss reduce the entire income of one year before it can be applied to another year. Greater equity would be achieved for individuals if, through some averaging device, the loss were applied on a pro rata basis in the carryover period.[1] This problem is not generally as acute for corporations because of the flat corporate rates of 30 and 52 percent.

The proposal to permit carryovers of unused exemptions is simple mechanically, but raises a number of administrative problems. The carryover of exemptions could be accomplished by allowing the deduction for exemptions to enter the net operating loss. The unused exemptions would then be applied to the income of prior or subsequent years as part of the net operating loss deduction. The difficulty, however, is that the suggestion would necessitate the keeping of records or filing of returns by millions of taxpayers whose income is below the reporting requirement. The tax benefit to some might be more than outweighed by the burden imposed on the Government in keeping track of these returns and the inconvenience to numerous individuals who would not benefit from the carryover of exemptions. It also appears that the lack of a carryover of exemptions does not have any substantial effect on economic incentive.

The third type of proposal relates to general forms of averaging designed to relieve the inequity of the graduated rates as applied to irregular or bunched income. This may be accomplished by various methods of averaging income over a number of consecutive years and paying a tax as if an equal amount had been earned in each of the years so averged.

AVERAGING TECHNIQUES

Most of the general averaging proposals which have been developed have been variants of 1 of the 3 following methods of averaging:

(1) *Simple averaging.*—This method would allow the taxpayer at the close of a given number of years, such as 5 years, to elect to recompute his tax for the period as if the income had been earned ratably over the period. For example, if he earned $5,000 a year in each of 4 years, and earned $30,000 in the fifth year, he would average the income and pay a tax based on the average yearly income of $10,000. At the expiration of another 5-year period, he would again be permitted to average the income of such period. Variants of this system would allow the individual to obtain a refund only if the tax as paid was 5 or 10 percent greater than the tax as recomputed. The use of a percentage limitation would eliminate the effect of very small changes in income from year to year.

[1] See Pechman, A Practical Averaging Proposal, 7 Nat. Tax, p. 261 (1954).

The principal weakness of the simple averaging plan is that any particular year can be included in only one averaging period for any one individual. The taxpayer is thus forced at his peril to select the group of years to be averaged. If he guesses incorrectly as to future income, he may find that he has chosen the wrong group of years.

Although one of the incidental advantages of averaging is that it minimizes the shifting of income and deductions so as to equalize incomes, the shifting problem would continue as between one averaging period and another.

The simple averaging system is the one presently in effect in Canada for farmers and fishermen.[2]

(2) *Moving average.*—Under this system, an individual's tax for a given taxable year is computed by reference to the average income over a certain number of preceding years and the taxable year. Thus, if a 3-year moving average were employed, the taxpayer would average the income of the 2 preceding years and the taxable year. If his income was $4,000, and $6,000, respectively, in such prior years and $11,000 in the taxable year, his average taxable income would be $7,000 (total of $21,000 divided by 3).

This system may work well in a period of rising incomes, since it serves to postpone tax liability until a stable income level has been attained. However, when income declines, the results are disastrous. For example, if the income was $4,000 and $6,000 in the first 2 years, and $2,000 in the third year, the taxable base for the third year would be $4,000, or $2,000 more than the actual income. In a year of declining income, the taxpayer may be without funds to pay the tax. While an adjustment will ultimately occur as succeeding taxable years are brought into the picture, the depressing effects of the system have already been experienced.

A further practical disadvantage of the plan is that, where applied on a mandatory basis, it is impossible for taxpayers to compute their tax for the current year without income tax data of prior years. As applied to a mass income tax, the system is obviously impractical.

A moving averaging plan minimizes problems in the shifting of income and deductions, but involves substantial complications for those entering or leaving the tax system. Great Britain, Australia, and Wisconsin experimented with a moving averaging system but were compelled to abandon it.

(3) *Progressive average.*—This method, as does the moving average method, provides for a tax based upon the average of the income for the taxable year and certain preceding years. An additional complication is the introduction of a concept to reflect the discounted value of tax payments.[3]

The plan involves such complications that it can hardly be considered a realistic approach to the problem.

There are, of course, other averaging proposals which do not fit within any of the patterns described above. One of the most interesting made in this connection is a suggestion to expand existing code provisions relating to "back pay" and services rendered over a period of 36 months or more to include numerous specific items, such as

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[2] For an excellent discussion of the simplified averaging plan, see Groves, Postwar Taxation and Economic Progress (1946), pp. 223–236.
[3] See Vickrey, Agenda for Progressive Taxation (1947), pp. 164–195.

accumulated dividends on preferred stock, which are likely to be lumpy in character.[4]

EXPERIENCES IN OTHER JURISDICTIONS

The pressures in favor of income averaging have resulted in adoption of an averaging plan in several foreign jurisdictions and in the State of Wisconsin. Although most of these plans have been abandoned for one reason or another, experience under the plans indicate some of the limitations, and, at the same time, the possibilities of income averaging.

The earliest averaging plan was that enacted in Great Britain in 1799 with the advent of the British income tax. The plan provided that the income tax should be based on a 3-year moving average. The tax base for a given year was the average income received during that year and the 2 preceding years.

The British system compensated to a great extent for fluctuating incomes but the system had defects which soon became apparent. The moving average system, as indicated above, results in a postponement of tax. As a consequence when an individual had two relatively good years followed by a poor year, the tax might be proportionately greater in the low income year. A further defect of the British system was that it was mandatory and required all taxpayers to make the computations which were of substantial benefit only to those with substantial fluctuations in income. The British averaging plan was repealed in 1926 and was substituted with a 5-year carryforward of net operating loss.

Australia established an income averaging system roughly patterned after the British plan. The Australian plan provided for a 5-year averaging period rather than the 3-year period used in England. In order to meet the problem faced in England of a high tax in a low income year, the Australian system provided that only the rate of tax would be determined by the 5-year average, and the rate so determined would be applied to the actual income of the current year.

The Australian plan fostered mixed feelings. Most primary producers, i. e. farmers, were strongly in favor of its continuation. Others voiced objections that the program was too complicated for the benefits it furnished, since the procedure was obligatory for all taxpayers. In 1938 the averaging provisions were limited to primary producers.

A moving average plan based upon a 3-year period was adopted in the State of Wisconsin in 1927. This plan had all the defects of the British program and none of the mollifying provisions added by Australia. Although it was considered very satisfactory during the prosperous years of its inception, the depression years which followed illustrated again the hardships likely to accompany such a mandatory averaging program. As a result, the legislature in 1931 enacted legislation for the gradual transition away from averaging. This transition was completed in 1934.

In 1949 the Canadian Government adopted an averaging plan which is currently in effect and appears to have been relatively successful. Individual income averaging has been limited in Canada to those persons whose principal income is derived from farming or fishing.

[4] See footnote 1 above.

Even for these individuals the program is completely optional and in order to enjoy any benefits thereunder, a special election to average must be filed in conjunction with the regular tax return. At the end of any 5-year period an eligible person may elect to average his income over that period and his tax for the fifth or final year may be reduced by any net overpayment over the preceding 4 years. In the event the reduction exceeds the current year's tax liabilities, a refund may be obtained. A particular taxable year may not be included in more than one 5-year averaging period, however, for any one individual.

The program seems to have been widely accepted in Canada and the only defect which has become evident is the limitation therein against the inclusion of a single year in more than one averaging period. In the event that a farmer has had 4 mediocre years followed by a good crop, if he then averages his 5-year income he is compelled to pay a full tax on a successive good crop even though it may be his last for several more years. This problem could easily be alleviated by replacing this block system with a substitute which would allow an averaging period to end with each consecutive year provided the prior includible years were treated as already having the average income which was assigned to them in the prior averaging.

In addition these seems to be no logical basis for the decision to allow this averaging privilege to one certain segment of the economy while denying its benefits to other vocations.

EVALUATION OF AVERAGING PROPOSALS

It is generally recognized that, on grounds of equity and economic incentive, there is a definite need for some form of averaging in an income-tax system with progressive rates. The numerous provisions which have been added to the income-tax law to permit averaging for one limited group or another attest the validity of the principle. Income averaging has been incorporated in our tax system where income received in 1 year is attributable to services rendered in prior years. Thus, under section 1301 if an individual works on a project for 36 months or more and receives 80 percent of the compensation in 1 year, he may spread the income back over the entire period during which services were rendered. Under this provision, income may be averaged over a period of 5, 10, or more years. Related provisions permit authors, composers, and others to spread back the income from artistic compositions, but only if the bulk of the receipts are concentrated in a single year. An individual receiving accumulated back pay may under restricted conditions compute the tax as if the income were received in prior years. These provisions are desirable and essential, but they are inadequate. Not only are they hedged with extreme limitations, but they are confined to cases in which the income is itself "attributable" to services in a prior period. Frequently, irregular or fluctuating incomes are not attributable to specific prior services, although a long period of education or development may have been a necessary precedent to the income receipts.

The 1954 code recently added several provisions which provide for averaging of income not attributable to services in prior years. For example, an individual who receives the proceeds of an endowment policy or face amount certificate is allowed under section 72 (e) (3)

to pay a tax computed as if the income had been received over a 3-year period. This provision represents a pure form of averaging. However, it is limited to insurance policies and face amount certificates and does not apply, for example, to the millions of holders of United States savings bonds who may receive an accumulation of 10 or 20 years' interest income when the bond is cashed. Many of the existing provisions of limited scope point the way to averaging but they create substantial inequities between persons similarly situated.

While there appears to be an irresistible trend in the development of a mature income tax structure toward income averaging, the general averaging provisions thus far suggested or adopted have for the most part proved unsatisfactory. This has been due to a failure to recognize fiscal and administrative requirements of an income-tax system. Any averaging system, such as the British or Wisconsin plans, which postpones the payment of tax, inevitably creates an impossible burden in years when income declines. The widespread use of withholding and estimated tax payments indicate that the tax must be paid in the year when the income is received. This is important both from the point of view of the taxpayer who must meet the obligation and the Government which needs current revenues. The solution to this problem lies, of course, in confining averaging to an adjustment of applicable tax rates. This is the method employed in Canada and in the several averaging provisions in the present code. The tax is computed on the income in the current year on the basis of the tax that would have been payable had the income been received ratably over the averaging period.

Another fiscal consideration is the extent to which averaging would affect monetary weapons used to combat inflation or deflation. For example, in a period of rising price levels and increasing incomes a general averaging provision might blunt the edge of a tax increase designed to reduce inflationary pressures. These results would be significant, however, only if averaging is applied to millions of taxpayers experiencing small income changes. If averaging is limited, as any practical system must be, to those cases in which there is a very substantial change in income, the countercyclical aspects no longer represent a deterrent to averaging.

Some of the averaging proposals are designed not only to permit averaging on a rising income but also on a declining income. The arguments are that such averaging produces greater equity and may exert a countercyclical force by permitting the taxpayer whose income has been reduced to obtain a refund on the basis of his average income for the averaging period. While the advantages of averaging on the downgrade are substantial, it is not yet apparent whether such a system is administratively feasible. The countercyclical arguments, while a factor, would hardly justify the introduction of a burdensome system.

Another fiscal aspect of averaging is, of course, the extent of the revenue loss involved. Since averaging will permit individuals with irregular incomes to pay a tax based on their average income level, it will of necessity result in a reduction of tax payments. The amount of the revenue loss, however, depends principally on the limitations imposed on the averaging system. If averaging is limited to cases of

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very substantial income fluctuations, the revenue loss would not appear to be substantial and would be justified in view of the greater equity achieved as between taxpayers. An averaging system, it should be noted, merely permits individuals with varying incomes to pay the same tax as those with more stable income.

The administrative aspects of averaging have generally been the major hurdle to the adoption of such a system in our Federal tax structure. There are two major facets of the problem: (1) the complexity of many of the averaging plans, and (2) the burdens imposed on millions of taxpayers if the averaging plan is made applicable to minor or normal changes in income.

It would seem to be basic to the adoption of an averaging system that it be simple and relatively easy to apply. The "simple averaging" plan used successfully in Canada meets this requirement. Another type of averaging which would be feasible for adoption and which underlies the present code provisions relating to averaging would be to permit a spread back to prior years of lumpy or irregular income received in 1 year.[5]

However, even if a plan is fairly simple, its application indiscriminately to taxpayers with minor changes in income poses a problem for taxpayers generally and for the Government in its administration of the revenue laws. The income of almost every individual is to some extent irregular. While these minor fluctuations may to some slight extent affect the relative tax burden, it would impose a greater burden on taxpayers, in terms of tax computations, the hiring of tax specialists, etc., to seek to adjust these tax payments in every case. There must be a balancing of the various factors, the inequitable taxpayments on the one hand, and the mass of paperwork on the other. If the matter is viewed realistically, it would appear that averaging of income is warranted only when there is a serious inequality in taxpayments such as to reflect upon the integrity of the tax system and such that such inequality may limit economic incentive. There is no need to provide averaging for the mass of routine changes in income. At some point, however, the inequity is severe and an adjustment is appropriate. The dividing line is one for the Congress to establish after consideration of all the factors. Such a line might be established by requiring a percentage change or a change of a specific dollar amount in income or in tax liability.[6]

Another type of limitation would be to confine averaging to certain types of income such as income from farming, accumulated dividends on preferred stock, etc. Such limitations based on the kind of income, however, may prejudice persons receiving income from other sources which is subject to extreme fluctuation.

Evaluation of averaging in the light of past experience and the practical alternatives which are available indicates that this is an area which should be given greater study by Government officials and the legislators. Limited averaging and relief provisions are constantly being added to the tax structure which would in many cases be unnecessary if a general averaging provision were available. While it is impossible to repeal many of the provisions which have been adopted

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[5] See Pechman, footnote 1 above; also H. R. 7837, 84th Cong., 1st sess.

[6] Note the 5- to 10-percent limitation on change of tax liability proposed by Thomas N. Tarlean before House Ways and Means Committee, Revenue Revisions, 1947–48, pt. 3, 80th Cong., 1st sess.

in the past because of the absence of an averaging provision, this trend could at least be held in check for the future. Perhaps, however, the greatest single reason for the adoption of a workable averaging plan would be the impetus provided toward additional production, the creation of new products, and artistic works, all of which would be stimulated by a tax system which applied more equitably to fluctuating incomes.

THE EFFECT OF HIGH TAX RATES ON EXECUTIVE INCENTIVE

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I was glad to accept the invitation of your committee to present my views as to the probable impact of high personal taxation on the future of business enterprise. It is encouraging to me to see a committee of the Congress inquiring into this subject, for I am convinced that it is an area of extraordinary importance to national growth and prosperity.

Inasmuch as my views are not wholly based on demonstrable evidence, and must rest to some extent on opinion, I should first define the bounds of my competence. I am not an authority on taxation, and I have no technical qualifications either for defending or for deprecating any particular method of tax assessment.

Neither am I an expert on budgetary matters, and so I cannot suggest how much it is wise, or desirable, or necessary, for our Government to spend. The views I shall express are those of an executive who must face the very practical problems involved in the operation of a large corporation. These, of course, embrace the present, and the usual problems of customer, employee, and stockholder relations. In a much more important sense, however, they are problems of the future and comprise, insofar as possible, the development of policies and practices which will insure continuing effective performance well beyond present horizons.

One of our difficulties arises out of the realization that governmental expenditures will remain very high for a considerable period, even with maximum emphasis on economy, and that the tax burden on our people will be correspondingly large by previous standards. If this were not the case, the question of executive incentives would hardly be an issue of importance.

As our country has developed and matured, we have become increasingly dependent on an active and dynamic industry for our economic growth and prosperity. Without minimizing in the slightest the important contributions to our national economy made by the farmers, the professions, the service trades, the fact is that our standard of living is firmly anchored to our industrial development.

Since this is so, it follows that how business and industry fare must be a matter of great importance to all Americans. Their standard of living, their future well-being, are vitally dependent upon an American industry that continues to be dynamic, resourceful, and progressive. This desirable state of affairs can continue only so long as industry can compete successfully for the limited supply of talented people. For an industrial corporation is not a machine that can be

run by automation. It is a team of human beings that must have first-class direction by intelligent and able management. And if we have learned one fundamental truth in industry, it is that first-class performance can never come from second-class performers.

It is not an exaggeration to say that the success of any business enterprise will depend very substantially upon the caliber and character of its management group. I have thought a good bit about the personal characteristics that lead to managerial competence, for selection of outstanding people is my most important single responsibility. The best I can do is to define an executive as one with the ability to blend men with a great variety of essential technical talents into a harmonious and well-knit ensemble. The analogy with the conductor of a great orchestra might be used, but the executive has a tougher job, since we have no Beethovens or Mozarts in the business world to provide us with a score that we can follow.

But whatever definition or analogy one wishes to use, I am quite sure that the competent executive is a rare bird—and is found only by combing through large numbers of eager candidates.

His job also becomes more and more difficult as time passes and our industrial technology becomes still more complex. The executive of the next generation must inevitably be a better man than his predecessor, just as managerial competence has grown from its position a generation ago.

The point I make is that industry, if it is to keep abreast of its responsibilities to the Nation, must have a great number of first-class minds at its disposal. It must compete for them with all other phases of our society, for there are never enough to go around. The fields of government, education, the military, the arts, the professions, all are seeking to persuade able young men to cast their lot with them. Each has its own type of incentive to offer, and the demand for talent always exceeds the supply.

The Essential Question of Incentive

The question of incentive is essential, whether we are speaking of business getting its share of the talent crop or of encouraging the exercise of that talent once it is enlisted. It is perhaps unfortunate that human beings should require lures of any kind as the price of initiative, but I am afraid we have not yet reached that state of grace in which people will surely do their best without external motivation. People being people, they will for the most part respond with their highest abilities only when there is some stimulus or some satisfaction associated with success.

Adequate incentives, of course, differ with different people. Some are attracted most strongly by the promise of prestige. Some are more interested in leisure time, to follow scholarly pursuits or perhaps simply to meditate upon the ills of the world. To some people, public notice or outward signs of rank and importance are alluring goals. Some seek power. For most, however, the strongest and probably the most desirable incentive is financial reward. Furthermore, financial reward is not only an incentive in itself; it is the only fluid medium that can be used to balance the attractions of the more intangible compensations, such as prestige, power, or public notice.

There is another aspect of the monetary incentive that seems to me worthy of comment. It is the only reward that can be cut down on a basis of fixed percentages. We do not, for example, withhold 91 percent of an Oscar going to the best moving-picture actress of the year. The winner of a Nobel prize does not have to give the Government a certain percentage of the prestige accruing to him. A brilliant violinist does not have to share his applause with the collector of internal revenue. These illustrations may seem facetious, yet they are based on a serious foundation, for we do in fact make the recipient of monetary rewards, and him alone, give up significant percentages in taxes. We are, that is, penalizing only one manifestation of success, and this seems to me, frankly, not only unfair but, for the future, a dangerous practice.

I do not propose to debate the relative nobility of these various carrots that are held out before us human donkeys for that seems to me to make little difference so long as there is one toward which we will stretch. I see no reason, however, to believe that financial gain is any less worthy than prestige or recognition, and it is certainly less stultifying than the lust for power or mere social preening. It is, also, the incentive that American industry has historically used.

This is largely because it is the type of inducement most consistent with the business environment. In other fields, tangible and intangible incentives have been developed over the years, each more or less characteristic of its own activity. In the academic world, for example, professional prestige and personal recognition have a certain magnetism that attract gifted minds even though the financial remuneration is unjustifiably low.

The world of politics affords an opportunity for public service and public attention which, to some people, is highly attractive. In the arts and the theater, one has the goal of fame and the limelight. In pure science there is the distinction that goes with the highest awards such as the Nobel prize. In the Army, Navy, and Air Force, incentive to move up through the various echelons of command is based on rank and perquisites; even the church has its hierarchies and various symbolic tokens of achievement.

Business, for the most part, is in a poor position to compete in these intangible areas. With few exceptions executives of great ability remain relatively unknown. A player of even minor roles in the films, a leader of a jazz orchestra, or a writer of only average accomplishment may be far better known than many leaders of industry. For businessmen there are few medals, prizes, degrees, uniforms, patriotic citations, or grandiose honorifics. There are few featured players on the industrial stage.

There is, of course, the satisfaction that comes from work well done. But this is peculiar to no special section of our society; it is common to all. For the purposes of this discussion, it simply cancels out.

And so industry must rely most importantly on financial compensation. As it becomes increasingly less able to do so, it will lose its capacity to induce qualified people to make their careers in industry, or to seek to advance to their maximum capacity.

THE EROSION OF THE MONEY INCENTIVE

It is here, as I see it, that our danger lies. I am certain that the effectiveness of the money incentive is being eroded by the tax rates that prevail in the upper brackets today. While many companies are experimenting with nonmonetary incentives, basically industry must rely upon the coin of compensation must suitable to its character. I am afraid the raw truth is that, in the long run, we shall begin to lose out and our proportion of the available candidates will fall unless some relief can be obtained.

I am necessarily talking in the future tense, because it is quite clear that the point of concern is not the executive of today, or even of the immediate future. I think, if we are to focus the picture, we must rule out consideration of the present management group. I doubt that high personal taxation has had substantial effect upon the performance of present-day management people, even though they may not be happy over the realization that at top levels each additional dollar of gross income nets its earner about 9 cents. I confess to some pain in this respect myself, but I cannot say that I am inclined as a result to work less diligently or to take my responsibilities less seriously.

Today's executives are, I think, reasonably immune. By the time a man has reached a position of eminence within his organization, he is influenced importantly by his sense of loyalty, his sense of obligation, a preoccupying interest in the work, or, as has been unkindly suggested, by conditioned reflex.

The same applies, I would guess, to those who may be regarded as the immediate successors, for they too have reached a point where the challenge and associations of the work present an incentive that will probably override reduced financial motivations. At this point one might ask: If we are not talking about present management, who is it that concerns us?

There are two major areas of concern. There is, first, the effect of high income-tax rates on long-range monetary incentives, which promises to make it more difficult than heretofore to persuade young men with real ability to enter the rank of business. Let me make it clear that I am not asking for an improvement in industry's competitive position opposite the other fields of endeavor. I merely want to maintain it.

There is, second, increased difficulty, also tracing to high tax rates, in persuading men of ability who have risen to the point where they are in sight of reaching their top capacity to keep on going rather than to rest on their oars.

I want to comment on each of these, for they are the heart of industry's problem.

It has been noted by many sociologists that for young men of ability the lure of security at a modest level has gained greatly in recent years as against the desire to venture and work to reach the top. I suspect that one of the basic reasons for this is that the financial rewards offered today just don't seem worth the struggle. Why, a young man could well be thinking, should he enter the industrial arena when he knows that the higher he gets on the ladder, the more of his time will be spent working for the Government and the less working for himself? And this is a critical question for in most cases the choice of a career made by a man when he leaves college governs his activities for

the rest of his working life. If he enters law, medicine, the church, politics, the armed services, Government, the arts, teaching, research, business, the chances are strong that he will not leave that field, but will perhaps through inertia make it his career.

Beyond this, I am sure that with few exceptions, the young man with the ability to do well in one of these fields could do well in many of them. There is, save in cases of unusual physical coordination such as marks an Artur Rubinstein, or a Caruso, or even a Babe Ruth, no particular identifiable set of abilities impelling one to choose any of these fields. Enrico Fermi, for example, was an outstanding scientist. From my knowledge of him, I feel sure he would, had he so elected on leaving college, have made an outstanding business executive, a splendid lawyer, or doctor, or writer, or what you will.

What I am saying is that each of these fields must appeal to the same group of talented young men, and trust that the incentives it has to offer will attract sufficient numbers of them to carry on its work. And since the chief incentive industry has to offer is financial, it follows that any erosion of that incentive makes it more difficult for industry to get its share of the supply, with inevitable serious consequences for the future.

Of those who enter the business field, a certain number will be equipped potentially to handle the executive functions at various levels. It is to the advantage of the individual company, and ultimately to the advancement of the American economy, that those advancing into the upper levels of management be selected from as large and as eager a group as possible.

I think it is plain that the selection of 1 man from a list of 50 promising candidates offers more qualitywise than the selection of 1 man from a field of 20, or 15, or 5. The principle is the same in business as it is in the military, say, or in Government. As citizens, we are uneasy when we note a reluctance on the part of individuals to seek public office. As a business executive, I feel uneasy if there are not more than a few talented candidates for advancement. And this leads me to the second major area of difficulty.

Is Promotion Less Attractive?

In business, as elsewhere, it is important for us to induce as many of our younger men as possible to set their sights on the job ahead and to broaden their shoulders for responsibilities to come. If we are to do so, the game must be worth the candle. And some of my associates have already noted that there are signs among the younger men that promotion is a little less attractive than it used to be. How this trend may be expected to show up, in specific terms, is hard to say; my own guess is that it will take the form of slow attrition, beginning with borderline cases. Where we now have 10 who want to try for the jobs of major importance, we may have 9 tomorrow—1 candidate deciding that since it is worth considerably less after taxes, it isn't worth the extra effort. So we have 9, and the next year we may have 8, and management will be the poorer for the loss. For it is that extra effort that wins, that has made American industry what it is today. The progress we have made has not been achieved by perfunctory or routine performance; it has come about because people have been inspired or induced to give everything they had to the task at

hand, and not to take it easy. The industrial miracle of America has come because our people have shown a capacity for accomplishment well beyond their rated potential. It must follow that anything that weakens that capacity will weaken our industrial potential, and with it, the Nation.

In the Du Pont Co. we recognize 16 levels of employment, each successive one embracing more authority and more responsibility than the one below. In order to make it attractive for a man at one level to strive to advance to the next, there must be sufficient incentive to make the increased effort seem worth while. And this increase must be net, after taxes, for actual spendable money is what counts. The large gross figure, impressive though it may appear, gives one no advantage opposite the landlord or the butcher, or the increased financial demands that go with increased responsibility and higher standing in the community.

However, in order to provide significant net increases for the levels down the line, the gross salaries in the top levels must be very high indeed. Suppose we assume that the net increase between levels which will provide incentive to advance is about 25 percent, and then work out the progression for 16 levels. One arrives at figures at the top which are in the realm of pure fantasy which perhaps explains why my predecessor 30 years ago received a compensation after taxes twice as great as mine today with no adjustment for the purchasing power of the dollar. Being an honest man I think I should say that when I pointed the discrepancy out to him he replied merely that he was easily twice as good as I and hence deserved it.

Fortunately for this phase of my argument, the television program, The $64,000 Question, has provided quantitative evidence quite outside the realm of speculation. I am told that only one contestant has actually tried for the big payoff, and he, a Marine captain, was motivated by pride in his organization, not by after-tax benefits. For all others the risk involved to win a few thousand dollars after taxes just didn't seem worth while. Conversely, from the viewpoint of the sponsor of the program, to give a prize of $450,000 so that the winner could have his $64,000 net of taxes seemed understandably imprudent. It might have been interesting for your deliberations to have the viewpoints of the unwilling contestants on the question of the tax collector versus individual incentive.

When the contestants fail to do their best on The $64,000 Question, no one is the loser but the individual concerned—assuming he could have answered the question correctly. But when a promising young business executive decides that he won't try for the $64,000 question, when he decides that the job of, say, plant manager is sufficiently rewarding, and that he isn't interested in becoming production manager because the increased net just isn't worth the extra effort and strain, then everyone is the loser.

Who Will Be the Loser?

This brings us up against the hard fact that if, through declining incentives, business cannot attract the great numbers of capable management personnel it must have to move ahead, the chief losers are not the individuals concerned. If the caliber of management available to American business declines, the results will be reflected

inevitably upon everyone, in business or not. The economy we have created in this country is closely intertwined; the effect of one activity upon another is intimate and continuous.

Management ineptitude would assess its penalties in terms of higher costs, diminished opportunity, and a slowing down of the kind of bold venture that is necessary to growth. It would be demonstrated, I think, in declining stability, for often the failure of one firm engulfs others. In so highly integrated an economy as ours, shock waves are transmitted with great speed and ruinous force. We cannot sustain many such shocks without impairing our strength and security as a nation.

And so every citizen has a stake. He wants lower prices, expanded employment, a degree of job security, good prospects for advancement. He wants better schools, better medical facilities, better care for the aged, more cultural facilities. He can have them in an era of rapidly expanding population only if industry grows more dynamic rather than less, better managed rather than worse.

This is why all of us must take with great seriousness any threat to the future successful operation of industry, for it is clear that industry is the keystone of our economic arch. The real wealth it produces makes possible progress in all our other fields of endeavor, educational, cultural, charitable, governmental, and so forth. Conversely, any act that cripples our industry, cripples the Nation and the free world along with it. In proof one need only look at Communist efforts to foment discord in American industry.

It is essential that our friends as well as our enemies realize the disastrous consequences of any such development, for economic laws take no account of motives. Violate them and the penalty is assessed even though the violation might have been committed for the most worthy and helpful motives.

I see in the present high tax levels such a threat to American industry. Let me emphasize again that my concern is not with the present crop of executives nor with their immediate successors. It is with the future. It is somewhat nebulous and hard to grasp because it is not an immediate and finite problem. But its importance is no less great because of that, and statesmanship implies concern for what lies ahead as well as for what presently confronts us.

How the problem is to be met is a question to which I do not have the answer. I am hopeful that the deliberations of your committee may produce helpful data and valuable conclusions. But of this I am sure: the dollars involved in the high-tax brackets constitute but a very small percentage of the return to the Government from personal-income taxes. I am not necessarily arguing for a limitation, but for the sake of illustration it can be pointed out that personal-income taxes in excess of 50 percent paid in the calendar year 1954 amounted to $1,075,000,000. This is 3.8 percent of total personal-income-tax collections for that year. It is, incidentally, 1⅔ percent of Federal expenditures for 1954, and would have run the Government for 6 days.

The exactness of these figures is not important, however. What is important is that it would be a tragic thing, indeed, if, for such a relatively small amount, we should jeopardize the future successful operation of our industry. If it should not hold its own in the years to come—indeed, if it should not do much better than hold its own—all of us will face a bleak and static future.

THE EFFECTS OF TAXATION ON WORK INCENTIVES

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The point of view that high income-tax rates such as have prevailed in this country since World War II seriously sap the work incentives of the American people and thereby deter economic growth has been presented with great vigor and persistence. Typically the conclusion is treated as self evident or as so reasonable, given a little thought, as to eliminate the need for direct empirical evidence. One may admire the strategy of this line of attack, but further investigation shows the forces involved in it to be largely illusory.

The first three sections of this paper are concerned with the economic factors which determine the influence on work incentives of the taxation of earned income. It will be seen that there are at least as good reasons for believing that such taxation will have a net incentive effect as there are for believing it will have a disincentive effect. In the next two sections a similar analysis is applied to income taxes on property incomes and to excise and sales taxes. Finally, the findings of a number of recent empirical studies of worker behavior are examined briefly. The results are likely to surprise those who have accepted the disincentive argument as conclusive. High income taxes, it would appear, have as yet not had any serious disincentive effects. It is true that some workers have been led to contract their efforts, but at the same time others have been induced to work both harder and longer. Whatever the merits of fiscal policies aimed at lowering income-tax rates may be, the encouragement of greater productive activity on the part of workers does not appear to be one of them.

Incentive and Disincentive Effects of Income Taxation

To many taxpayers the disincentive proposition given at the beginning of this paper probably appears realistic enough. They may reason that "with tax rates as high as they are now it is not worth my while to do any extra work because the income from it after taxes is inadequate." The implication, of course, is that at lower tax rates the additional work would be undertaken. In reaching this conclusion, however, the taxpayer is likely to be thinking in terms of a given base income to which a larger reward from a given amount of extra work is added when tax rates are lowered. This argument overlooks an important fact—that lower tax rates would increase the taxpayer's base income—and at higher income levels, as empirical studies have shown, people typically want to take more leisure time rather than less. A lowering of income-tax rates, in short, exerts two opposing influences on work incentives: a stimulating one because after-tax rates of pay are higher, and a discouraging one because for a given amount of work taxpayers have more money. Conversely, an increase in tax rates, by lowering wage rates, tends on the one hand to induce greater effort because taxpayers find themselves with less money to spend, but, on the other, makes added effort less attractive by reducing the reward.

Some workers may react to higher taxes by simply tightening their belts, preferring to economize on consumer goods and services and on saving rather than on leisure time. Others may work more, thereby

economizing on leisure as well as on other things. Still others may work less, illustrating the disincentive effects of tax increases. These people, it may be noted, show a marked lack of attachment to the rewards from productive activity, since they are led by a fall in earned income as a result of taxation to cut their incomes still further by reducing their efforts. Such a reaction is, of course, possible. To elevate possibilities of this sort to the rank of inevitabilities, as some of the more ardent critics of income taxation are prone to do, seems, however, more than a little extreme.

Another way of describing the effects of income taxes on work incentives is in terms of the value to the worker of the disposable income obtainable from the last unit of work he does. "Value" in this case does not refer simply to the number of dollars earned but more fundamentally to the usefulness of those dollars to the worker and his family. When tax rates rise the value received from a unit of effort is reduced since fewer dollars are brought home to the family coffers, but the usefulness of each dollar is increased since the family has fewer total dollars to spend. If, on balance, the value of the income earned by the last unit of effort decreases, the worker will tend to work less as a result of the increased tax rates; if, on the other hand, the value increases he will continue to work as much as before and may well wish to expand his supply of labor. Opposite results occur when tax rates are lowered. Again we note the existence of opposing lines of influence and the indeterminacy of the final outcome at this level of analysis.

High income taxes, then, do not necessarily have important disincentive effects. Some workers, it is true, may work less hard because of the influence of high tax rates. Others, however, may be led to increase their efforts, and a good many people may be virtually unaffected. Additional evidence is needed before any useful conclusions can be drawn. Fortunately, both theory and observation can help provide that evidence.

The Effects of Inflexible Monetary Commitments

Most of us have more than a nodding acquaintance with relatively fixed monetary commitments of one kind or another. Monthly payments on a home mortgage or rental to a landlord, life-insurance premiums, contributions to pension and annuity funds or to prepaid medical plans, union or professional dues, and other fixed costs of earning income, periodic payments incurred when consumer durables are bought on time, the obligation to support and educate children or to care for elderly relatives—all fall in this category. Possession of such commitments tends to make the taxpayer react to an increase in income taxes by increasing his efforts to earn income. The disincentive effect of lower take-home rates of pay is more than offset by the incentive push of a lower level of income when living expenses are not easily contracted.

High income taxes, therefore, are likely to have incentive effects on workers with large families, on young people who are setting up homes and acquiring their stock of consumer durables, and upon all who, for whatever reason, have become heavily indebted to others. A period following a rapid rise in consumer and mortgage debt, when higher taxes may well be called for because of strengthening in-

flationary pressures, is relatively favorable to the imposition of higher income taxes since their incentive effects will be intensified and their disincentive effects lessened by the previous growth in fixed-debt obligations. For similar reasons, a high and rising birthrate is favorable to high income taxes. On the other hand, Government policies which reduce the pressure of fixed monetary commitments on the worker, such as baby bonuses, provision for old age and retirement, for temporary periods of unemployment, or for sickness and injury tend, by themselves, to strengthen the disincentive effects of income taxation. These adverse tendencies, however, will be offset to the extent that Government benefits of this sort are closely matched by contributions on the part of the beneficiary.

A worker is also effectively committed to the maintenance of a given level of living in the face of an increase in income taxes if that level of living represents the minimum necessary for continued physical existence in his society. On the lowest income groups, therefore, income taxes may be expected to have incentive effects. At higher income levels the purely physical pressure of minimum subsistence is absent, but it may be replaced by equally effective social pressures well-defined modes and standards of living which the workers feel they must maintain.

Fixed monetary commitments of various kinds, therefore, exist at all income levels. Together they provide an important set of factors which strengthen the incentive effects of high income taxes at the expense of the disincentive effects.

The Effects of Changes in Personal Exemption Allowances

A raising or lowering of personal exemption allowances has a powerful effect upon income-tax revenues because of the large proportion of income taxed at the lowest bracket rates. Such changes are also likely to affect work incentives. Unfortunately we can specify the result definitely only for those who remain in the same tax bracket both before and after personal exemptions are altered. For them the marginal rate of tax, and hence take-home rates of pay on the last units of work done as well as on any additional units that might be done, remains constant, while disposal incomes rise or fall as exemption allowances rise or fall. The sole effect on incentives, therefore, comes from the changes in disposable income, larger exemptions tending to reduce effort and smaller exemptions to increase it.

A large number of taxpayers, however, will be shifted into a different tax bracket when personal exemptions are changed. For them both marginal and average tax rates—i. e., take-home rates of pay and disposable incomes—change, and opposing influences on work incentives are again set in motion. Increased exemptions, for example, stimulate desires for more leisure time as a result of increased disposable incomes, but increased rates of pay at the margin make work more attractive. The strength of the latter effect will differ at different points on the income scale since rate changes from one tax bracket to the next are not uniform. By far the largest change, of course, occurs at the bottom of the tax scale where the rate plummets from 20 percent to zero for the income receiver who moves down out of the first bracket.

The net incentive or disincentive effect of a given change in personal exemptions, therefore, will depend upon the extent to which taxpayers are concentrated at the boundaries of the various tax brackets rather than at the centers. For those at the boundaries the effect may go either way, but those at the centers will be induced to work harder by reduced exemption allowances and to work less by greater exemptions. A relatively even distribution of taxpayers over the various tax brackets, therefore, would create the presumption that lower exemptions are favorable to work incentives and higher exemptions unfavorable. On the other hand, a significant concentration at the bracket boundaries, especially at the bottom of the lowest bracket, could easily produce exactly the opposite result.

THE TAX TREATMENT OF PROPERTY INCOMES

Another relevant issue to be taken into consideration in studying the incentive effects of any income tax is the treatment of incomes which are more or less independent of any labor services rendered by the income receiver. At given levels of yield—and this is the only important comparison to make—a general income tax which treats all types of income equally will be more favorable to work incentives than one which exempts some property incomes entirely and taxes others only partially.

As compared to the selective tax, the general one taxes certain kinds of property income more heavily but all other types of income less heavily. Since the two taxes are equally productive, taxpayers as a group have the same total disposable income in each case, but under the general tax they realize higher rates of take-home pay from the rendering of labor services. This acts as an incentive to still greater effort. The fact that this kind of tax treats some kinds of property income more severely has little or no effect on work incentives since little or no labor is involved in the creation of these incomes. On the average, therefore, the general tax is more favorable to productive activity. It has the further virtue, of course, of being more equitable since it treats all types of income the same way.

For these reasons policymakers should scrutinize closely proposals which would have the effect of narrowing the base of the individual income tax. If the incomes involved are largely of the property type, the influence of the income tax at given yields is shifted in the disincentive direction. Present provisions concerning capital gains and losses, tax-exempt bond interest, percentage depletion, certain allowable deductions (such as those for meals and the like, which to a large extent are personal consumption on the part of the taxpayer rather than costs of earning income) all tend to make the individual income tax less favorable to work incentives than it would otherwise be.

THE INCENTIVE ASPECTS OF EXCISE AND SALES TAXES

One of the traditional tenets with reference to the relative merits of different kinds of taxes is that excise and sales taxes are more favorable to work incentives than are income taxes. Let us examine this assumption for a moment.

Consider first the probable effects on work incentives of the price changes induced by sales and excise taxes. A general increase in

consumer good prices, for example, makes consumers with relatively fixed money incomes worse off and thereby tends to induce more effort. The rewards from that effort, however, have undergone a reduction in their buying power and so the effort itself is less attractive than it once was. When considering the extra work the worker finds himself both pushed toward it (by his lower real income) and repelled (by the lower real rates of pay) at the same time, and he may in the final analysis expand his labor supply, contract it, or leave it unchanged.

It is true that many consumers may fail to perceive the price changes induced by changes in excise taxes,[1] but they are likely to be much more aware of what it costs them to maintain their accustomed standard of living and what happens to the level of their cash balances in the process. Some evidence of the effects of high prices on worker behavior is provided by a recent British investigation which found that approximately 40 percent of the workers interviewed regarded high prices as a factor which deterred their productive efforts and some 70 percent thought they were also a factor making for greater incentive.[2]

Taxpayers may, of course, do more work not in order to buy additional things but primarily to raise their level of saving. Even in this case, however, the tax-induced price increases are by no means irrelevant. The saving may be specifically earmarked for a future purchase of a taxed good or service. Unless the tax is believed to be temporary, the incentive effect is likely to be the same here as in the case of a person who works in order to consume. Even the person who saves in order to accumulate a certain amount of capital may adjust his goals upward when prices rise.

Finally, excise and sales taxation will affect work incentives in still another way. Such taxes reduce the money incomes of certain income receivers below the levels which would otherwise prevail. An excise tax on watches and clocks, for example, will lower the earning power of workers who are highly skilled in watchmaking, and these effects are likely to spread to all who do the same type of high-precision, fine-scale work. As we have already seen the incentive effects on these people may go either way. Lower income levels induce more effort, but reduced rates of pay have the reverse effect. Until we know more about the types of workers whose incomes are reduced by different kinds of sales and excise taxes and the extent to which these reductions take place—and this whole area of analysis is currently undergoing extensive reexamination[3] we cannot formulate a complete picture of the incentive-disincentive effects of sales and excise taxation.

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[1] Cf. Robert Ferber's conclusion that "* * * awareness of reductions in Federal excise taxes or in selling prices on particular items 6 to 8 weeks after the fact was quite limited. Judging by the general tenor of the replies, most people were aware that some changes in excise taxes had been made, but few were able to identify specific changes." (How Aware Are Consumers of Excise Tax Changes? National Tax Journal, VII (December 1954), p. 358).

[2] Royal Commission on the Taxation of Profits and Income, Second Report, CMD 9105 (London, 1954), sec. 87.

[3] See in this regard: Earl R. Rolph, A Proposed Revision of Excise-Tax Theory, Journal of Political Economy, LX (April 1952), 102–17; R. A. Musgrave, General Equilibrium Aspects of Incidence Theory, American Economic Review, Proceedings, XLIII (May 1953), 504–17, and On Incidence, Journal of Political Economy, LXI (August 1953), 306–23; J. F. Due, Toward a General Theory of Sales Tax Incidence, Quarterly Journal of Economics, LXVII (May 1953), 253–66; J. A. Stockfisch, Excise Taxes: Capitalization-Investment Aspects, American Economic Review, XLIV (June 1954), 287–300; H. P. B Jenkins, Excise-Tax Shifting and Incidence; A Money-Flows Approach, Journal of Political Economy, LXIII (April 1955), 125–49; and Paul Wells, A General Equilibrium Analysis of Excise Taxes, American Economic Review, XLV (June 1955), 345–59.

The Effects of Labor Market Rigidities

So far we have not concerned ourselves with the extent to which the worker if free to satisfy his own preferences with regard to the amount of labor services he supplies to the market. The great majority of workers, of course, must either have a full-time job or none at all. We cannot, however, count on this fact to neutralize, for such workers, the potential incentive or disincentive effects of income taxation. For one thing, their preferences may be only temporarily frustrated. Future bargaining with employers may restore the balance. In addition, workers typically have ways of changing their labor supply other than by altering the number of hours worked a week or the number of weeks worked a year. Overtime opportunities may be available and be refused or exploited more fully, other members of the family may enter or leave the labor force, proposed ages of retirement may be altered, or absenteeism on a day-to-day basis may change. These possibilities must be kept in mind in evaluating the results of empirical studies. In flexible behavior in one area or disincentive effects in another do not necessarily imply either insensitivity or reduced incentives as far as the labor supply as a whole is concerned.

Empirical Studies of Work Incentives

Since the pioneering work of Senator Paul H. Douglas[4] in this area, a number of empirical studies of the reactions of workers to changes in their rates of pay have been made. The results, to be sure, are incomplete. We still lack detailed information about the behavior of a number of important worker groups, especially independently employed professional and business people at the middle- to high-income levels, who are both strongly affected by income taxes and able to vary their labor supply more freely than wage earners or salaried personnel. Wage and salary workers, as noted in the preceding section, may vary their supply of labor in a number of different ways, and full information on these various possibilities is not always available even for groups that have been studied rather extensively. In addition, it has frequently been difficult to be certain that the behavior actually observed was due to changing pay rates rather than to other factors which also exert an influence on work incentives. Nevertheless, the evidence so far compiled warrants careful consideration because it is both extensive and consistent as to the direction in which it points.[5] For the most part it appears that income taxes exert relatively little influence on work incentives, and that when they do they induce greater effort as frequently as they deter it.

Thomas H. Sanders, for example, concluded, on the basis of an extensive postwar study of executive behavior, that—

> the cases in which the evidence showed executives to be working harder were at least equal in number to those indicating less effort, and the former were more definitely recognizable as a tax influence.[6]

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[4] Paul H. Douglas, The Theory of Wages (New York, 1934).

[5] A more detailed summary of the results of studies of the United States labor market up to 1953 is included in the author's Income Taxes, Wage Rates, and the Incentive To Supply Labor Services, National Tax Journal, VI (December 1953), 350–1. More recent investigations are noted in the text below.

[6] Thomas H. Sanders, Effects of Taxation on Executives (Boston, 1951), p. 20.

In addition, there was evidence that high taxes induced more wives of business executives to enter the labor force and, in general, led the executives themselves to postpone their dates of retirement from active participation in the business. Offsetting these tax incentives, however, was a tendency for some to refuse promotions and advantageous offers from other companies when the change meant greatly increased burdens and relatively little increase in net compensation. Finally, it was noted that a good deal of executive effort was being diverted into a study of tax laws and of ways of reducing tax burdens.

Another study of a small sample of 7 surgeons with incomes between $36,000 and $115,000 led the author to conclude "* * * we would judge that increased taxes have not reduced the surgeons' incentive."[7] He also noted that 1 of the 7 doctors planned, at the time of interview, to retire later than they had previously planned (before World War II) because they had been unable to accumulate sufficient capital. These reactions might be attributed to the influence of higher taxes or higher prices, or both.

It is interesting to note that in a recent British study, although over two-thirds of the male workers interviewed believed that as a general matter income taxes discouraged productive effort, less than one third of them felt that taxes had affected their own personal effort adversely, and almost as many thought the effect was to induce them to work harder.[8] When workers who had turned down an opportunity to work overtime were asked why they had done so, only 5 percent or less of them cited high taxes in reply.[9] The National Coal Board, as a result of a number of studies of absenteeism in the British coal mines, concluded that "Tax considerations were * * * responsible for only one-third of 1 percent of the shifts lost.[10] The Royal Commission itself reached the general conclusion that "the levels of taxation within present limits do not inhibit or induce any significant proportion of the working population to modify their attitudes to their working behavior.[11]

These findings are the more significant since the pressure of taxation is in general greater in Britain than in the United States, the income tax starts at lower levels of income and its rate structure rises more steeply, and British workers are provided with comprehensive low-cost medical and dental services which, alone, might be expected to push the influence of income taxes in the disincentive direction. In addition, a recent study shows that central government tax and expenditure programs have carried the redistribution of income further in Britain than in the United States.[12]

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[7] Robert Davidson, Income Taxes and Incentive: The Doctor's Viewpoint, National Tax Journal, VI (September 1953), p. 297.

[8] Royal Commission on the Taxation of Profits and Income, op. cit., secs. 74 and 81.

A similar result for the United States appears when we contrast Kimmel's 95 percent affirmative response to the question: "Do you believe that the higher the tax rate the less the incentive to work and save?" with the results of Sanders' study of executive behavior. Cf. Lewis H. Kimmel, Taxes and Economic Incentives (Washington, 1950), pp. 101–102.

[9] Royal Commission on the Taxation of Profits and Income, op. cit., secs. 74 and 81.

[10] Ibid, sec. 39.

[11] Ibid, p. 115.

[12] Allan M. Cartter, the Redistribution of Income in Postwar Britain—A Study of the Effects of the Central Government Fiscal Program in 1948–49 (New Haven, 1955), especially pp. 91–92.

CONCLUSIONS

Human motivation is a complex phenomenon no matter what the area of study. People who are keenly interested in their jobs are not likely to be much deterred by even significant changes in taxes. Strong personal ambitions may also push even very high income taxes into the background. Workers in a society that is alert and active and progressing rapidly may not be deterred in their efforts by taxation, whereas workers in a stagnant and disillusioned society might well be. Strong public support for what the Government is doing and a widespread belief that it is accomplishing its objectives in an efficient and honest manner may tend to impart favorable incentive aspects to taxation. Cultural and religious patterns, by imposing on the individual certain habits of thought and action, may govern his reactions to taxation of various kinds, and so on.

In spite of the complexities, we are by no means completely at sea. Careful empirical studies have been made and, incomplete as the results still are, it is encouraging to note that neither in Great Britain nor in the United States is there any convincing evidence that current high levels of taxation are seriously interfering with work incentives. There are, in fact, as indicated above, a number of good reasons for believing that considerably higher taxes could be sustained without injury to worker motivation should the need arise. Conversely, the social and economic need for strong work incentives does not, at the moment, make imperative a reduction in Government expenditures or an expansion in the role of excise and sales taxation in order to bring about a reduction in income taxes.

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V. RELATIVE EMPHASIS IN TAX POLICY ON ENCOURAGEMENT OF CONSUMPTION OR INVESTMENT

STIMULATION OF CONSUMPTION OR INVESTMENT THROUGH TAX POLICY

JOHN C. DAVIDSON, National Association of Manufacturers

INTRODUCTION

The question suggests use of tax policy as a means for manipulating the economy. This approach is contrary to the policies of the National Association of Manufacturers, which follow the philosophy reflected in the statement of Secretary of the Treasury George M. Humphrey before a congressional committee on July 18, 1955:

> The power to tax is the power to destroy and revenue laws should be used only to equitably raise revenue, not for other indirect purposes.

It is assumed that the frame of reference for discussion here is tax reduction within the general limits of a balanced budget. Nevertheless, it is interesting to note that current support of tax reduction to stimulate consumption—despite near-capacity operation of the Nation's economy—stems from earlier emphasis on tax reduction to increase purchasing power. For example, Prof. Colin Clark in the early months of 1954 stated that Federal taxes should be reduced by $20 billion in order to create deficit money and thus stave off serious recession. More recently, in February 1955, an organization called the Conference on Economic Progress also advocated drastic tax reduction for the purpose of creating deficits and increasing purchasing power. We can imagine the inflation which would have already resulted if the recommendations of these purchasing-power advocates had been followed. Their repetition here is to illustrate the inherent danger of using the tax system for nonfiscal purposes.

Within the framework of a balanced budget, tax reductions obviously do not create purchasing power. The result is only to transfer purchasing power from the Government to private citizens. While this means that the private citizen can spend more because the Government is spending and taxing less, there is no net addition to purchasing power as such.

It becomes especially important, therefore, to consider tax reduction from the standpoint of the impediments to progress which exist in the present system. This subject is explored in a publication developed by the association's 300-member taxation committee, entitled "Facing the Issue of Income Tax Discrimination," released on October 7, 1955. The following is quoted from this publication, pages 20–24:

> ECONOMIC GROWTH AND TAX REDUCTION
>
> An obstacle to removal of tax barriers to economic growth is the so-called purchasing-power theory of economic progress. This is an elusive theory, which shifts grounds with the times but always has the basic design of appealing more to the emotions than to the mind. It is the old story of taking a "germ" of truth—

people cannot buy without income—and then subverting the truth, in this case by disregarding the only source of high and increasing buying power.

There is no magic formula, in America or elsewhere, for creating buying power. The abundant use of capital is the major reason the American worker earns so much more, and is why the American standard of living is so much higher, than elsewhere in the world.

Capital formation, which encompasses the twin processes of saving and investing, has a double effect in regard to employment and income. First, the process itself provides jobs and new income. Second, the plant, equipment, and other facilities produced both improve the productivity of existing jobs and provide jobs where none existed before. Here is the basic source of increased purchasing power which means increased consumption and higher standards of living.

The insincerity of those who pursue the buying-power approach for the domestic economy, in disregard of capital formation, is pointed up by the recognition of the same people that the need in the rest of the world is for more capital. It is no mystery to them why Russia seeks to advance capital formation, and why the free world looks to America for capital; the reason everywhere is found in the desire to duplicate the American story—more capital per worker, more production, a stronger economy, and a better standard of living for all.

Because of the elusive, emotional technique, it is sometimes difficult to pin down the current arguments of the purchasing-power proponents. Nevertheless, there now seems to be a vague sort of rationalization that America needs less capital in the future because it has so much in the present. Nothing could be further from the truth.

Capital formation is the balance wheel as well as the multiplier in the economy. Its importance to a healthy and growing economy is well illustrated by the bitter experience of the 1930's. The absence of capital formation did not bring on the depression, but it is an uncontestable fact that the failure first to maintain and then to revive an adequate volume of capital formation served to prolong the depression beyond all reason. The needle of inflationary deficit financing, designed to increase purchasing power and consumption, in no way offset the repressive effect of the discriminatory tax rate policy which was born in those years.

Consumption Versus Investment

Looking to tax reduction in 1956, the Nation is now confronted with a great debate over whether the intention should be "to stimulate consumption or to stimulate investment." Posing the question in this form tends to confine the debate to what should be done without attention to the situation as it exists. Use of the word "stimulate" provides an added diversion from looking at the facts.

If the purpose of the question is to get to the root of the problem, before prescribing a cure, then a proper statement would be: Should tax reduction be designed to moderate the repressive effects of taxation on consumption or on investment? Stated in this way, the answers are readily apparent.

To be repressive, tax rates have to be high and discriminatory enough to create disincentives, that is, to so penalize or punish the taxpayer as to discourage or prevent him from doing with his income what he otherwise would do. No one can seriously claim that the Federal tax system has this kind of effect on consumption expenditures of taxpayers who are not subject to the progressive rates.

On the other hand, it is impossible to consider the charts and data included in this statement without recognizing the barriers to savings and investment of the present income-tax structure. The steep climb of individual tax progression, and the high corporate rate, serve to compound the hazards and rigors of a competitive economy. Every producer and investor must take his punishment at the tax tollgate, unless and until he quits in despair. A few months ago, Dr. Arthur F. Burns, Chairman of the President's Council of Economic Advisers,[1] stated in an interview: "I don't know of a surer way of killing off the incentive to invest than by imposing taxes which are regarded by people as punitive." The present tax system is punitive.

The inappropriateness of the word "stimulate" is thus put in perspective. Just as do the words "tax incentives," it misses the point. Tax reduction does not provide motivation, but only the freedom to respond to existing motivations. The purpose of reducing the discriminatory tax rates is to permit the freer play of economic forces, not attempt artificial stimulations.

[1] U. S. News & World Report, May 6, 1955.

Present Relationship of Rates and Revenue
Individual Income Tax

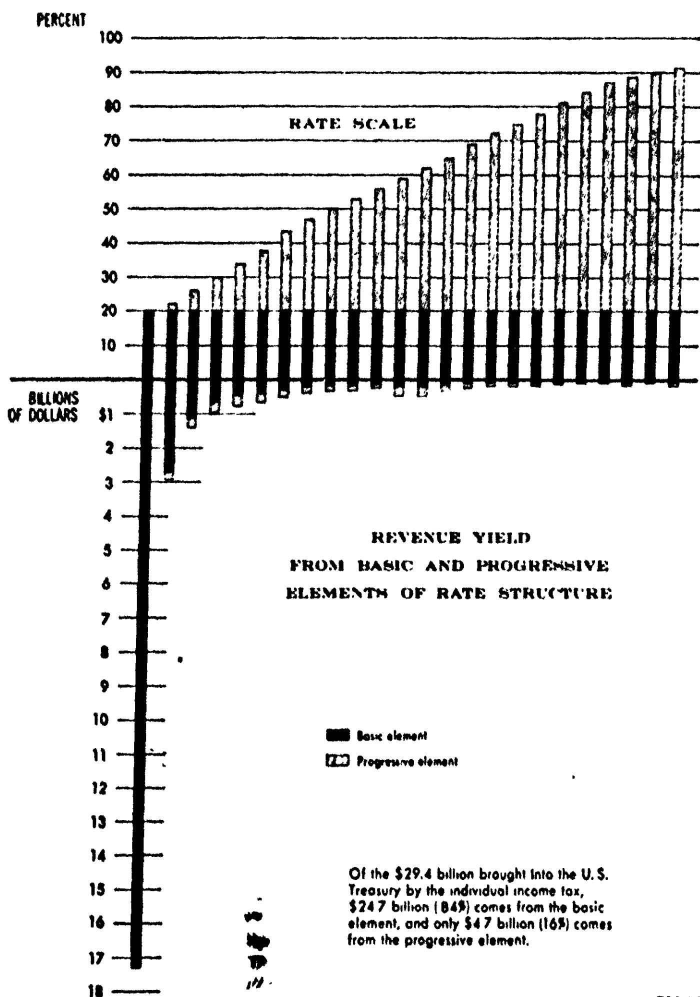


CHART I

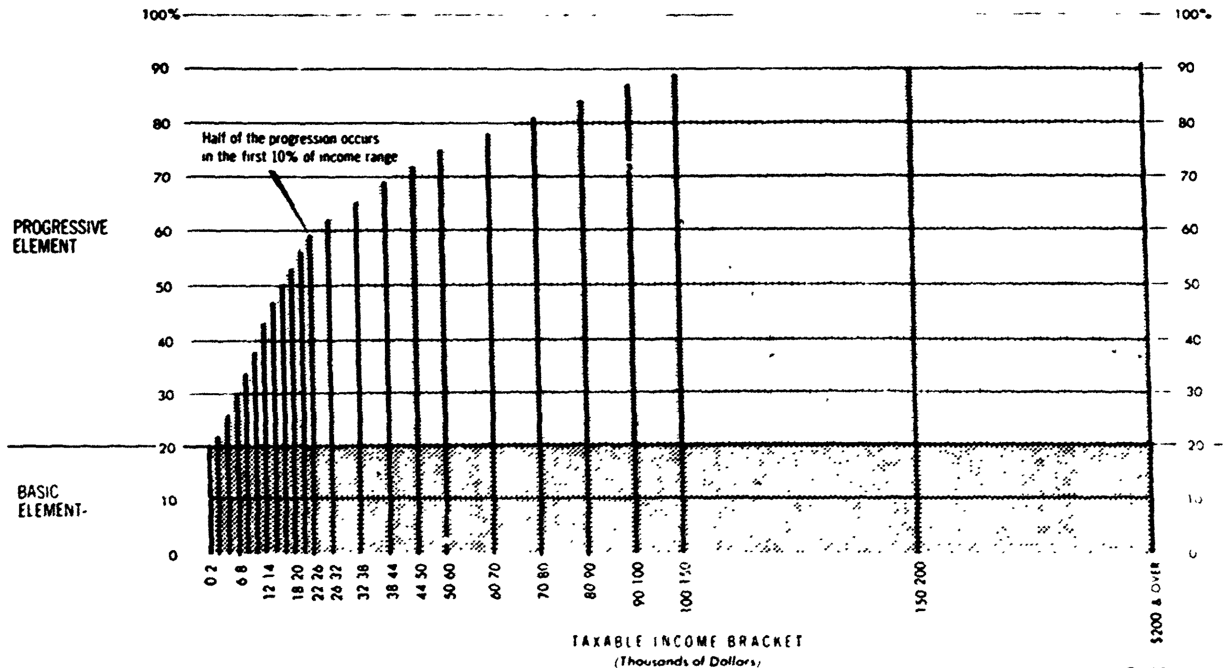


CHART II

Individual Tax Rates at the $16,000 Taxable Income Bracket

AND

DIVISION OF TAXABLE INCOME DOLLARS IN THAT BRACKET

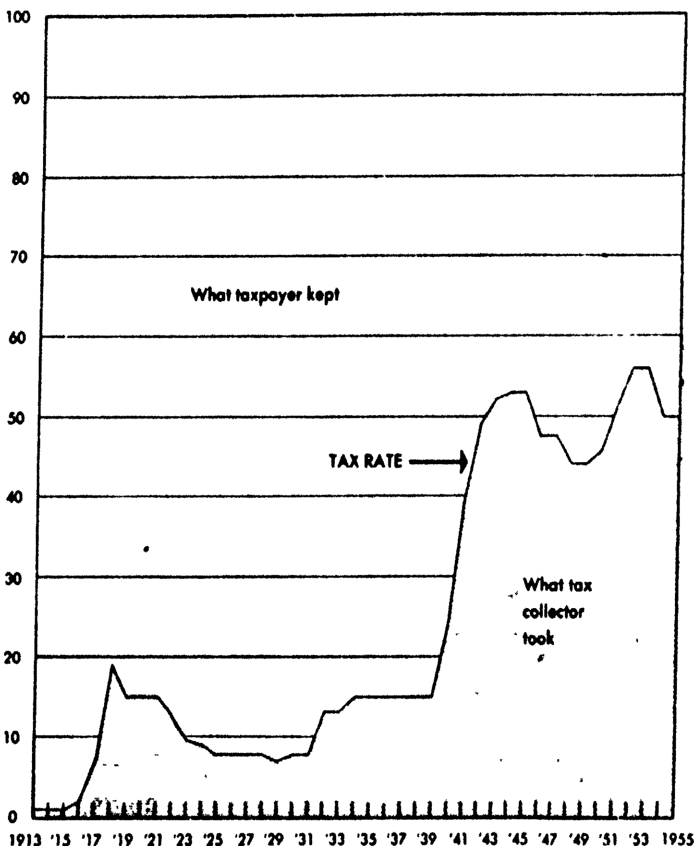
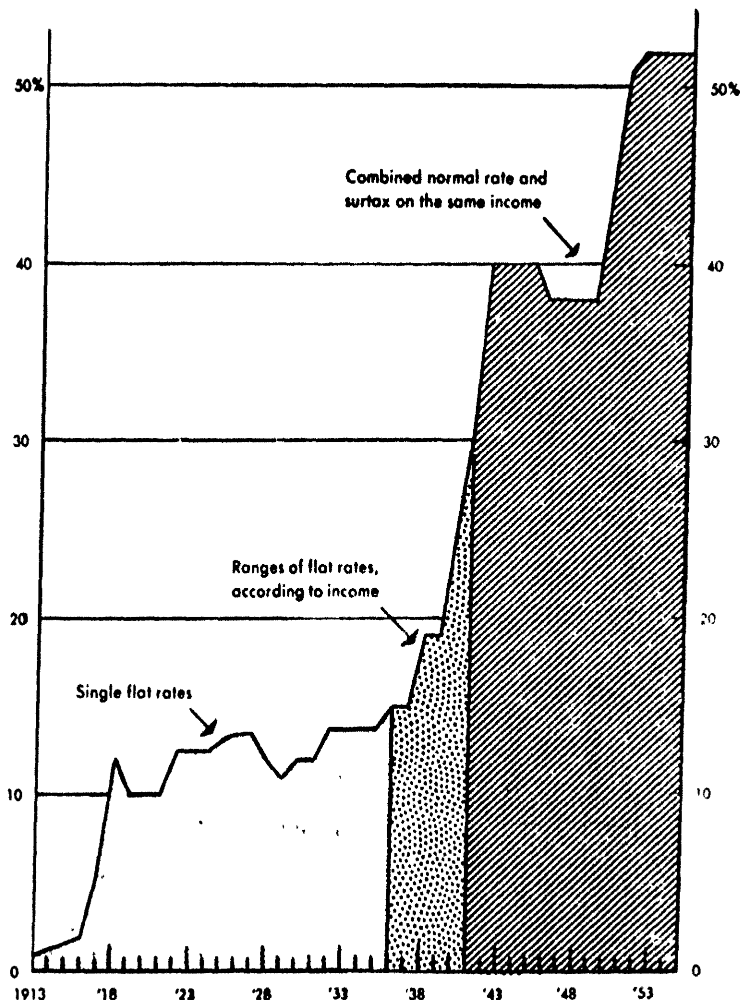


CHART III

Top Rates of Corporate Income Tax



Excludes the misnamed Excess Profits Tax of World Wars I and II and the Korean conflict

CHART IV

Illustration of Five Successive 10% Reductions in the Progressive Element of the Individual Income Tax

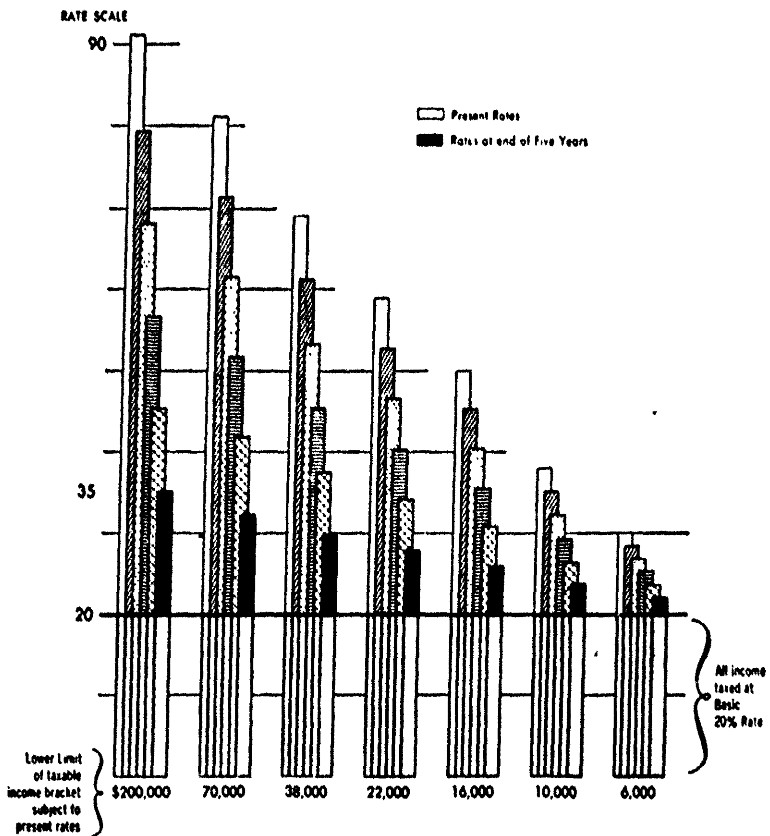


CHART V

EXPLANATION OF APPENDIX TABLE

This table was prepared originally for the NAM Federal Tax Program published in December 1953, as No. 64 in the Economic Series. It was based then on a table compiled in the Treasury and included as part of the testimony of Secretary of the Treasury John M. Snyder before the Senate Finance Committee in February 1951. "Taxable income," as used in the table, means the income subject to tax after allowable deductions and exemptions. The distribution of taxable income by income brackets gives effect to income splitting by married persons.

The increase of total taxable income that has occurred since the original Treasury tabulation was issued has been distributed among the taxable income brackets approximately, but not exactly, in proportion to the original distribution. In view of the fact that as new wage earners and other new income recipients appear, they will be found first in the lowest income brackets, there has been some disproportionate weighting of the increase at these levels.

The present tabulation is designed to show the distribution of taxable income and of income tax to accord with the budget estimate of yield for the fiscal year 1956. Refunds have been deducted in accord with the actual experience of 1952 and 1953, as reported by the Commissioner of Internal Revenue. There is also eliminated from the table for the first time both the taxable gain and the tax liability where the alternative tax on long-term capital gains attaches.

Estimated distribution of tax rates and yields by basic and progressive elements of rate structure, fiscal year 1956

[Tax amounts in millions]

Net income bracket (thousands)	Taxable income	Rates (percent)	Basic tax	Progressive element (percent)	Progressive tax	Total tax
0 to $2	$88,526	20	$17,705			$17,705
$2 to $4	13,890	22	2,778	2	$278	3,056
$4 to $6	5,494	26	1,099	6	329	1,428
$6 to $8	3,346	30	669	10	334	1,003
$8 to $10	2,321	34	464	14	324	788
$10 to $12	1,679	38	336	18	302	638
$12 to $14	1,309	43	262	23	301	563
$14 to $16	914	47	183	27	246	429
$16 to $18	765	50	153	30	229	382
$18 to $20	654	53	131	33	215	346
$20 to $22	519	56	104	36	187	291
$22 to $26	840	59	168	39	327	495
$26 to $32	827	62	165	42	347	512
$32 to $38	531	65	106	45	239	345
$38 to $44	383	69	77	49	187	264
$44 to $50	284	72	57	52	147	204
$50 to $60	272	75	54	55	149	203
$60 to $70	185	78	37	58	107	144
$70 to $80	123	81	25	61	75	100
$80 to $90	86	84	17	64	55	72
$90 to $100	62	87	12	67	41	53
$100 to $150	185	89	37	69	127	164
$150 to $200	74	90	15	70	52	67
$200 and over	210	91	42	71	149	191
Total	$123,468		$24,696		$4,747	[1] $29,443
Percent			83.9		16.1	

[1] Differs by $46 million from estimated total of $29,397 million, because of rounding.

TOO MUCH GROWTH?

All-out proponents of a socialistic tax structure are hard put to find a counterattack against the mounting clamor for relief from the discriminatory rates. However, one argument which seems to be taking shape is that we can have too much economic growth or, stated differently, it would be better if more current income were spent for immediate consumption purposes and less for economic expansion.

The first point to note is the inherent concession of the adverse effects on economic growth of the present rates, but it is illuminating to examine this argument in the light of dollar totals.

The tax reductions proposed in the 5 year plan would average just short of $2 billion annually over 5 years. This is less than 1 percent of the current annual rate of personal consumption expenditures of $240 billion.

When the same amount of tax reduction is related to investment expenditures, a quite different picture is presented. Two billion dollars is about 7 percent of the present $27.9 billion rate of investment by all business in new plant, equipment, and facilities. In recent years, the ratio of net new investment to total investment in plant and equipment only has been about 20 percent, with the balance going to replace the current wear and tear on capital facilities. Thus, only $5.6 billion is currently being invested in net new facilities; $2 billion of tax reduction would be nearly 36 percent of this figure.

Perhaps the most interesting comparison is with the amount of new venture capital employed by corporate industry. In 1954, retained earnings of corporations totaled $7 billion; and corporations raised an additional $2 billion by the sale of new stock issues. The total of this amount, $9 billion, is the seed corn of industrial expansion. $2 billion is over 22 percent of this amount.

The above figures are brought together in the following table:

Category of expenditure or investment	Amount	Annual tax saving	Ratio tax saving of expenditure or investment
	Bils. of dol.	*Bils. of dol.*	*Percent*
Consumption expenditure, 1955	$240.0	$2	0.8
Investment in new plant and equipment, 1955	27.9	2	7.2
Net new investment, 1955	5.6	2	35.7
New corporate venture capital, 1954	9.0	2	22.2

These illustrations, however, are not intended to create the impression that the total of any tax reduction would be used for new or venture investment. To some extent reduction in progression, especially in the lower ranges, would result in increased expenditure for consumption purposes by the affected taxpayers. Moreover, it is reasonably certain that part of the corporate income tax is reflected in price, and thus it is to be expected that some part of a corporate tax reduction would result in lower prices. But any such diversion of tax savings to consumption spending probably would be more than offset by increased investment induced by the moderation of disincentives. Especially there would be less reason to forego the kind of risk investments which mean so much for the future.

However, for the purpose of further illustration, it is assumed that the alternatives are an annual increase of $2 billion in private consumption spending for 5 years, or the same amount of investment spending. In other words, the spending would step up at $2 billion a year to an annual total of $10 billion in the fifth year and remain at that figure for succeeding years. The question to explore is: How soon would the sacrifice of immediate consumption for investment spending be repaid, and then surpassed, in added production and consumption?

From available data on recent experience it appears that a dollar added to existing investment in business other than agriculture will yield an annual added value of 25 cents in production of goods and services.

At 25 cents a year, in 4 years an invested dollar will have provided as much new consumption as if it had been spent originally for consumption purposes. Thereafter the annual additions are all plus values. At the end of 10 years the return is 2½ for 1.

When the original investment instead of consumption spending is repeated and increased over the years, the benefits multiply accordingly. Taking the $2 billion illustration, repeated for 5 years, the total investment is $10 billion at the end of the period, and the return in new production is $7.5 billion at that time. Thereafter the annual additions are $2.5 billion, so that the $10 billion is returned at the end of 6 years and has yielded an additional $10 billion in new production at the end of 10 years.

These figures illustrate the amazing rewards in increased production and living standards which come from saving and investing. They help explain the American story of why our Nation, with only 6 percent of the world's population, has 74 percent of all automobiles, 56.5 percent of the telephones, and nearly all of the home appliances which make the American housewife the most envied person in the world.

> It will thus be seen that the argument for restraining growth to permit more consumption is one for preventing more consumption. The argument is another manifestation of the overall design to use the tax system to control and manipulate the economy. The disastrous tax policies of the 1930's were supported by the theory that our economy had reached a stage of maturity which made it necessary to drain off excess savings of individuals and businesses. The falseness of that diagnosis has been exposed time and again, but this does not deter socialist planners from seeking the same ends for other or even contrary reasons. Always the result is the same: Planned scarcity in the name of purchasing power and consumption.
>
> Present estimates are that the population, now in excess of 165 million, will increase at a rate of 2½ million persons per year over the next 20 years. The labor force itself is expected to grow at an average rate of about 1 million persons a year.
>
> It is evident that, if there is to be more production to permit more consumption by more people, and if jobs are to be provided for the new workers, a large and increasing volume of capital formation will be required in the years ahead. It is little short of foolhardy to talk about too much growth. The Nation will surely need the maximum growth that a free unregimented economy can provide.

As the foregoing indicates, the association believes that first priority in tax reduction should go to reducing the high and discriminatory rates of income tax, both individual and corporate, which interfere with the free play of economic forces and impede economic growth. Recognizing the improbability that the necessary reductions could be achieved within a year or 2, the association has proposed a 5-year plan for orderly reduction of the discriminatory rates to a top of 35 percent. In essence, it is a plan to first apply the revenue growth increment to reducing the rates which impede growth.

More specifically, as the American economy expands, so does the amount of Federal tax revenues from a given set of rates, but in greater proportion. Over many years, good and bad together, our economic growth has averaged out at about 3 percent a year, measured by physical volume of goods and services. Assuming no more than such average growth in the next 5 years, revenue expansion is estimated at over $12 billion.

The proposal is that this revenue increase be first applied to moderating the discriminatory rates. The cost of the plan would be about $10 billion, or $2 billion less than the expected revenue growth.

Under the plan there would be 5 successive annual reductions of 16 percent in the progressive part of each tax rate, with each reduction computed on the original progression—that part of the rate above 20 percent. With the top rate reduced to 35 percent, the 50-percent rate, for example, would be reduced to 26 percent (80-percent reduction of the progressive spread of 30 percentage points). In other words, every progressive taxpayer would receive the same percentage reduction in his unfair tax burden. With 5 uniform rollbacks in each superrate, his tax bill from progression at the end of the period would be 80 percent less than at the beginning.

The corporate tax now consists of a 30 percent normal tax and a 22 percent surtax, or a combined top rate of 52 percent. Tax law now provides for a reduction of 5 percentage points in the normal tax.

The proposal is that this reduction be followed by 4 successive annual reductions of 3 percentage points each, or a total of 12 percentage points, to bring the combined top rate down to 35 percent at the end of 5 years. The 12 percentage points would be divided equally between the normal and the surtax, so that the total reductions from

present rates would be 11 percentage points in the normal tax and 8 percentage points in the surtax.

The bulk of the tax reduction under the 5-year plan would flow to the energetic and ambitious people who are the jobmakers of tomorrow.

Indirectly, the benefits of this plan would mean the most to the people whose employment and standard of living are dependent on further economic development. The benefits here can be measured in better jobs, in jobs yet to be created, and in standards of economic well-being yet to be achieved.

In every sense of the word, this plan is for the good of the Nation.

RELATIVE EMPHASIS IN TAX POLICY ON ENCOURAGEMENT OF CONSUMPTION OR INVESTMENT

William Fellner, Yale University

Summary of the Argument

Most of the current discussion of impending tax changes implies a specific assumption concerning the business conditions that will prevail when these tax changes are adopted. The economy is visualized as moving fairly smoothly on a growth path, with reasonably full use of its resources and without inflation. However, at given tax rates, the growth of the national income is expected to result in gradually increasing tax revenues relative to fiscal expenditures, and this is expected to lead to a deflationary pressure. Thus, we will reduce tax rates in order to prevent an insufficiency of effective demand, that is, of consumer demand plus investment demand. At the unchanging tax rates, we would be running into gradually increasing unemployment of labor and into excess capacity of equipment.

At first, I shall develop my conclusions from this common assumption. Subsequently, I shall make a few remarks on how the conclusions change if we modify the initial assumption concerning business conditions. In this case the conclusions change appreciably.

On my initial assumption, a reduction of the 52 percent corporate income-tax rate probably has more merit than any other type of tax reduction.

The conclusion is derived by weighing the pros and cons of various types of tax reduction. It is particularly important to compare a reduction of individual income-tax rates with a reduction of corporate income-tax rates.

A reduction of individual income-tax rates does, of course, possess great merit, but I believe that on the initial assumption which I have described these merits are outweighed by those of a reduction of corporate income-tax rates. The main merit of individual income-tax reductions, especially of reductions in the low-income brackets, is that the increase in effective demand per dollar of tax reduction has a relatively well predictable magnitude. The effect is likely to be large per dollar of tax reduction because a very high proportion of the tax

saving is likely to go into additional consumption expenditure. Merely a much smaller proportion of the tax saving from corporate tax reductions can be expected to go into additional consumption, via additional dividend payments.

However, a reduction of corporate income tax rates induces not merely additional consumption expenditure. It induces also additional investment expenditure, partly because corporations are left with more internal funds and partly because an increase in prospective profit rates, after taxes, results in increased willingness to accept business risks. The magnitude of this investment raising effect per dollar of tax reduction is less predictable than is the magnitude of the consumption raising effect of low bracket individual tax reductions. Therefore, if we want to play safe in our effort to increase effective demand by a specific magnitude, we may have to reduce corporate income taxes by somewhat more than the amount by which low bracket individual income tax burdens would have to be reduced. If we want to play safe, we may have to lower corporate income tax revenues for any given level of the national income by between 20 percent and 30 percent more. This seems safe enough. If it then turns out that we have underestimated the stimulus provided by the corporate tax reductions, we may have to rely to a somewhat greater extent on Federal Reserve restraints to prevent inflation. Admittedly, it is a disadvantage of corporate income tax reductions that the magnitude of their effect on private spending, per dollar of tax reduction, is less predictable than that of some other tax reductions.

This disadvantage is, I think, outweighed by an important advantage. The additional output called forth by corporate income-tax reductions consists of capital formation to a greater extent, and of consumer goods to a smaller extent, than does the additional output called forth by other tax reductions. This means that we are likely to get higher growth rates if we reduce the corporate income tax. At present, net capital formation accounts for a somewhat smaller proportion of total output than was the case during the 1920's or in earlier decades. There is room for some increase in capital formation relative to other constituents of the total output, and hence much can be said for considering the corporate income tax the strongest candidate for reduction.

Moreover, increased capital formation and an increased capital stock per unit of labor are likely to benefit the low-income groups by more than the equivalent of what they could obtain by tax reductions. Higher labor productivity expresses itself in higher real wage rates, and it takes merely a short time to obtain a greater increase in welfare by this method than by exempting individuals from taxpayments amounting to a small percentage of their incomes. Hence, I would argue that a growth-oriented attitude calls here for placing the main emphasis on reducing the 52-percent corporate income tax.

The assumption underlying my analysis was that of well-balanced economic conditions which threaten to become gradually unbalanced in the deflationary direction because of the gradual rise of tax revenues relative to fiscal expenditures. If we change the assumptions, the conclusions, too, become quite different. For example, if the ini-

tial condition were that of more or less acute cyclical contraction, then we should place at least as much emphasis on reducing the tax burden of the consumer as on reducing corporate taxes. In acute contraction, the incentive effect of corporate tax reductions is weak until the contraction of consumer demand is checked. If, on the other hand, the initial condition is that of inflationary pressure which the Federal Reserve finds difficult to control, then tax reductions should be postponed even if a budgetary surplus is gradually accumulating.

A More Detailed Version of the Argument

I. THE INITIAL ASSUMPTION AND INFERENCES DRAWN FROM IT

(a) Spelling out the initial assumption

At this writing, we have a high level of business activity without inflation, under conditions characterized by an approximately balanced cash budget and by a Federal Reserve policy of mild restraint. Recently, the economy has been showing a substantial growth rate, on the average perhaps 4 percent per annum. If we leave tax rates unchanged without raising Government expenditures, tax revenues will be increasing relative to fiscal spending, and the surplus will tend to grow more or less continuously. This is because in a growing economy the tax base, too, is growing and the Federal tax structure is graduated. There exists a presumption that if, with a balanced budget, the effective demand for goods and services comes out just about right, then an ever-growing excess of fiscal revenue over expenditures will sooner or later create a deficiency of effective demand, that is, a deflationary situation with unemployment and excess capacity. These consequences will show unless Government expenditures are raised in the same proportion as the tax revenue. If they are not raised in the same proportion, the deflationary impact of the ever-increasing budgetary surplus can be compensated only for a brief period by easier credit policies. These are the assumptions commonly implied in the discussion of the tax problems at hand. In the main part of my paper, I shall accept these assumptions, leaving modifications to later consideration.

The essential content of these assumptions is that we will be reducing tax rates in order to prevent the unemployment and excess capacity which would gradually develop in the absence of tax reductions. If we accept this assumption, what taxes should we reduce?

(b) The spendable-income-raising effect of tax reductions

One reason why tax reductions increase the demand for goods, and why they lead to fuller use of labor and of equipment, is that they leave consumers and business firms with more spendable income. This is true both of a reduction of individual income taxes and of a reduction of business taxes. Consumers spend more out of a higher disposable income (i. e., out of a higher income after taxes; and it is likely that the increased availability of reinvestable profits would in itself induce firms to spend more on investment goods out of their higher net profits after taxes. The second of these two statements implies that the

standards which an investment project must meet to be acceptable to a business firm are somewhat milder if the project can be internally financed than if it requires new security issues or new borrowing.

The spendable-income-raising effect of taxation, with which we shall be concerned in the present section, should be distinguished from the favorable incentive effect of certain tax reductions. This incentive effect, to which I shall turn later, operates not through leaving the public with more spendable income but through raising the profit prospects for future ventures. Staying, for the time being, with the spendable-income-raising effect of tax reductions (rather than with the incentive effect), we should recognize that a reduction of the tax burden of low-income consumers has a large and quantitatively fairly well predictable expenditure-increasing effect per dollar of tax reduction. If income-tax exemptions were raised, or if by some other method mainly the lowest taxable brackets were allowed to benefit from the tax reductions, most of the tax savings of these individuals would go into consumption expenditures. The high income groups would spend a much smaller proportion of their tax savings on consumption. The expenditure-raising effect of a reduction of the corporate income tax via an increase of reinvestable net profits would presumably be of intermediate magnitude per dollar of tax reduction. This is because not all dividend recipients belong in the very high income groups, and also because it is likely that the corporations themselves would spend part of their tax savings on investment (quite aside from the incentive effect, that is, merely because more internal funds would be available.)

However, it is questionable whether we should pay much attention to the height and quantitative predictability of the expenditure-raising effect per dollar of tax reduction. This we should do only if we are aiming in a mechanical fashion at the highest possible budgetary surplus (or lowest possible deficit) compatible with calling forth the consumption and investment required for full use of our resources. Such an objective would call for reducing those taxes whose spendable-income-raising effect creates a quantitatively predictable addition to the expenditures of the public, and the same objective would call for favoring those tax reductions which go only in small part into additional personal savings. If we should be led by this objective, the tax reductions would not be those which are most conducive to rapid growth.

We have just seen that by raising individual income-tax exemptions, and generally by reducing the tax burden on low incomes, a very high expenditure-raising effect can be achieved per dollar of tax saving, and that the magniture of the effect is relatively predictable. We have seen also that in the event of a reduction of the corporate income tax, and especially in the event of a reduction of the individual income tax on high incomes, the magnitude of the expenditure-raising effect, per dollar of tax saving, is in all probability less great if we limit ourselves to that part of the effect which derives from an increase in spendable and reinvestable net incomes. It is true that a reduction of the corporate income tax also has a further expenditure-raising

effect because it improves the profit prospects for future ventures, and thus it increases the willingness to accept risks, but this incentive effect is quantitatively less predictable than the effect which derives from an increase in spendable net profits. Hence, if we are aiming at a high and relatively predictable expenditure-raising effect per dollar of tax saving, we should presumably favor a reduction of the individual tax burden on the low-income groups. This will give us the consumption plus investment expenditures required for full use of our resources by the method yielding the highest budgetary surplus (or lowest deficit) compatible with the objective of full utilization. But a sufficient reduction of the corporate income tax will also give us the consumption plus investment expenditures required for full utilization, although the magnitude of the required tax reduction is quantitatively less predictable. If the objective of raising consumption plus investment expenditures to the required size is achieved by a sufficient reduction of the corporate income tax, then the total expenditure and output will consist of investment (net capital formation) to a larger extent, and of consumption to a smaller extent, than if the individual tax burden of the low-income groups is reduced. Hence, growth rates would presumably be higher in the event of a sufficient reduction of the corporate income tax than in the event of individual income-tax reductions.

(*c*) *The incentive effect of tax reductions*

While the problem of tax shifting is exceedingly complicated, it is reasonable to assume here that the corporate income tax is not fully shifted back and forth or fully passed on, in the sense that a reduction of the tax would not express itself fully in price reductions. A reduction of the corporate income tax would express itself in good part in a higher rate of net profit for any given investment project, and thus it would lead to additional investment. There would be a tendency toward greater capital intensity, in other words, toward using more capital per unit of labor and also per unit of output. This is because of the incentive effect: Risky projects which previously were insufficiently profitable would now become sufficiently so. To lower corporate income taxes there corresponds, other things equal, a higher rate of investment relative to consumption and thus presumably a higher growth rate.

This same reasoning applies to some extent also to a reduction of the individual income tax burden on high incomes. But the incentive effect is likely to be weaker here than for the corporate income tax. In the present circumstances, it seems reasonable to assume that management's appraisal of costs, future demand, and business risk limits investment more effectively than does the willingness of individual income recipients to supply firms with capital for risky ventures.

Returning now to the corporate income tax, we may conclude that if gradually growing tax revenues relative to fiscal expenditures should threaten to produce underutilization, a sufficient reduction of the corporate tax would create the additional demand required for the full use of all resources; and that the growth rate in such circumstances would presumably be greater than if full utilization were restored

by a primary stimulus to consumption. In the event of corporate tax reductions, even the spendable income-raising effect is to a relatively great extent an investment-raising effect, and merely to a smaller extent a consumption-raising effect; and the incentive effect is, of course, inherently an investment-raising effect. However, reliance on reduction of the corporate income tax involves more uncertainty concerning the amount of additional demand produced per dollar of tax reduction.

II. CONCLUSIONS BASED ON INITIAL ASSUMPTION

The following conclusion emerges: The growth rate would presumably be highest if the corporate income tax were reduced. But if this policy were adopted to prevent the accumulation of large and deflationary tax revenues, then it would be necessary to "play safe" in the sense of reducing tax revenues sufficiently to create the required additional demand even in the event that the demand-raising effect of the tax reductions should turn out to be smaller per dollar of tax reduction than the demand-raising effect of tax reductions on low incomes.

This is another way of saying that the policy of reducing the corporate income tax may conflict with attaining the highest budgetary surplus or lowest budgetary deficit compatible with full utilization. Yet, since the magnitude of the incentive effect achieved by reducing the corporate income tax is unpredictable, it might turn out that the additional demand per dollar of tax reduction is just as high as, or higher than, the additional demand obtained by reducing taxes on low incomes. If this should turn out to be the case, a "safe" reduction of the corporate income tax would lead to inflationary pressures which would have to be held in check by Federal Reserve restraints.

To this I might add two statements based partly on very rough numerical appraisals and partly on individual judgment. One is that I would disregard the possibility that a reduction in the corporate income tax would give a very much smaller increase in effective demand per dollar of tax saving than a reduction in the income tax burden on the low income groups. I think it is safe enough to assume that a cut in the corporate income tax revenue by, say, $1.20 to $1.50 would yield at least as much additional investment plus consumption expenditure as a cut in the low-bracket individual income-tax revenue by $1.

The other statement is that, in the range of choice with which we will be faced here, I consider it a more important goal to get somewhat higher growth rates than to get the highest fiscal surplus or lowest fiscal deficit compatible with the full use of resources. Also, I would take into account the fact that higher growth rates benefit the low- as well as the high-income groups. Therefore, a policy lowering the individual tax burden of the relatively low-income groups at the expense of the growth rate which could otherwise be achieved would give the low-income groups merely a very temporary benefit.

A policy reducing the individual income-tax burden of the high-income groups would serve the same purpose as a policy of corporate tax reductions, but at present it would probably serve this purpose less

efficiently. As long as corporate taxation is at its present level, high-bracket individual tax cuts are unlikely to be the most efficient fiscal stimuli to investment; and they are also, of course, not the most efficient stimuli to consumption.

My conclusion, therefore, is that in the combination of policies which for political reasons is likely to become adopted a reduction of the corporate income tax should weigh as heavily as is politically feasible. The magnitude of the tax reductions will presumably not be so great as to make it appear likely that by somewhat underestimating the demand-raising effect of the tax cuts we would become exposed to a serious inflationary pressure. If by somewhat underestimating the demand-raising effect we should expose ourselves to a small inflationary pressure, then Federal Reserve policy should be capable of taking care of this.

III. OTHER ASSUMPTIONS

As was said before, the main section of this paper is based on the assumption that the economy would be growing rather smoothly, with reasonably full use of its resources, were it not for the fact that at given tax rates fiscal revenues are rising in relation to fiscal expenditures and thus a deflationary pressure threatens to develop. Tax reductions are undertaken in order to prevent the gradual emergence of unemployment and of excess capacity; that is, to avoid a deficiency of demand relative to the requirements of full utilization.

Merely a few brief comments will be made to indicate how the results of the analysis change if we modify the initial assumptions. They do change appreciably.

(*a*) It is conceivable that the tax reductions are introduced at a time when the economy is in a cyclical stage of more or less severe contraction. In the event of severe cyclical contraction, it is desirable to reduce all taxes, and a reduction of the individual tax burden on the low- and middle-income groups may even be of greater significance than a reduction of the corporate income tax. This is because the incentive effect of reduced corporate taxes may not take hold at all as long as the contraction of consumer demand is not stemmed.

(*b*) It is conceivable that at the time when changes in tax policy are adopted there will be unemployment of labor but no excess capacity in equipment. This situation would call for very unpopular policies. Such a situation could be caused only by a shortage of capital equipment relative to the labor supply, and therefore the remedy would have to consist of lowering the level of consumption and at the same time raising the level of saving and of capital formation. In other words, the taxes of the high-consumption groups would have to be raised, and the taxes of the high-saving groups and of the investing groups would have to be lowered. Excessive "automation" might in principle lead to this situation, provided that real wage rates continue to rise (or do not decline). But it would be very pessimistic to anticipate such a situation, because automation has been going on for centuries in some form or another without normally having led to

an excess of the labor supply relative to the capital stock. Indeed, the process has been compatible with a steeply rising secular trend in real wage rates.

(c) It is conceivable that at the time when our tax policies are reconsidered we will be faced with an inflationary pressure, or that we will be in a situation where strongly restrictive credit policies will have to be used to avoid an inflationary pressure. In such circumstances, tax reductions should be postponed. If the Federal Reserve should be incapable of holding the line without further tax increases, it might even be necessary to raise taxes.

THE DECLINING ROLE OF BUSINESS INVESTMENT IN A GROWING ECONOMY

Stanley H. Ruttenberg, Congress of Industrial Organizations

The question placed before us by the committee is whether the Federal Government's tax policy should encourage consumption or investment. Behind this question, there is, I believe, general agreement on the need for continued economic growth. To pose the committee's question in another way, Should tax policy place greater emphasis on consumer markets or on business investment in the attempt to sustain continued economic expansion and full employment?

It is our firm conviction now, as in the past 20 years of CIO statements on taxes, that the Government's tax policy should place its emphasis on the need for a continuing expansion of consumer markets, in the absence of pressing Government commitments, such as in the case of all-out war. This viewpoint is based, in part, on considerations of equity. But it is also based on our view of the American economic system and its requirements in the middle of the 20th century.

The American economic system, as we have all said many times, is a dynamic one. It is and has been a system in which growth and change are possible and are taking place. As I see it, the national economy today is quite different from what it was some 50 or 90 years ago, and those who legislate and administer our tax policy should recognize these changes.

In support of the theory of encouraging consumption, many representatives of labor, including myself, have appeared before congressional committees to advocate tax policies based upon the well-known and tested principle of taxation according to ability to pay. We have argued (1) for more equitable distribution of the tax burden; (2) for exemptions that would permit the maintenance of a decent American standard of living; (3) for the closing of loopholes, both legal and illegal, which permit the wealthy individuals and corporations to avoid their equitable share of taxation; (4) for a more progressive individual income rate structure; (5) for the elimination of excise taxes, except those regulatory in character; (6) against sales taxes or manufacturers' excise taxes or any type of tax on consumption; (7) for a corporate tax structure designed to encourage the development and expansion of small businesses.

I shall not repeat the detailed, sound arguments for these policies, because the records of the House Ways and Means Committee and the Senate Finance Committee contain ready references to our stand on these issues.

Today, I should like to underscore our past support for encouraging consumption by developing the following thesis: The role of capital investment has been declining in importance in the American economy—that is, new plant and equipment have proved to be not only labor saving, but also capital saving, so that output has risen faster than business investment. This thesis is based on the studies of the National Bureau of Economic Research by Goldsmith, Creamer, Kendrick, and Borenstein, others by Prof. Wassily Leontief, as well as the Harvard Business School study on the effects of taxation by Butters, Thompson, and Ballinger.

With the support of their findings, I shall indicate that mass-production industries have been and are developing rapidly even though capital investment's importance or its share of the total gross national product has been declining. With such a development, the relative shares of either government or consumer expenditures must increase. Since we are all interested in holding the role of Government expenditures to the minimum, economic policy must be directed toward encouraging, stimulating, and creating incentives to increase consumer spending. One way to accomplish this objective is to reduce the tax burden on the great mass of taxpayers.

CHANGING ROLE OF THE AMERICAN ECONOMY

The American economy has been changing from the private capital-formation-centered economy of the post-Civil War decades to one that is based to an increasing degree on personal consumption and consumer markets. In the national economy today, the consumer is a determining factor. The dollar volume of business investment depends increasingly on the state of consumer markets. Actual and anticipated consumer expenditures for goods, services, and housing provide much of the spark for economic growth and likewise can provide much of the braking force for stagnation and decline.

In an economy where consumer markets are a major motivating force, tax policy—and economic policy, generally—should provide for expanding consumer activities. The alternatives to such a set of consumer-oriented policies, as I see them, are either a willingness to accept a high and growing degree of Government intervention and participation in the economy, or an acceptance of long-run stagnation, interspersed with periods of slow growth.

This is not meant to deprecate the importance of business investment in the process of economic expansion. Nor is this meant to suggest that Government policy be directed toward depressing private capital investment. I do believe, however, that business investment in the American economy is no longer the key motivating factor. While business investment may have been the major motivating force for economic growth some 50 or 90 years ago—in the era when the basic industrial and transportation structure of the Nation was estab-

lished—I do not believe that this is the case today. The growth factors within the system have been changing—with changes in technology and income levels, as well as in the accompanying developments of mass production, mass distribution, and consumer services. Business investment, as I see it, has been declining somewhat from its previous key role in our national economic development and is, to a growing extent, dependent on the actual and anticipated state of consumer markets.

An economy in which the basic steel industry, for example, will sell this year approximately 50 percent of its output for the production of automobiles, consumer durables, and housing is quite different from an economy in which the railroads were a major steel consumer. An economy which is as dependent on the consumer durable goods industries and housing as the American economy is today differs considerably from the economy of earlier days, when the developing railroads were a major factor for growth.

The rise of the consumer durable goods industries in the past 30-odd years—and there dependence on mass markets—seems to me to be an indication of the growing importance of consumer activities in the national economy. Between 1900 and 1948, for example, the real value of consumer holdings of durable goods rose more than 300 percent. In addition to this significant rise in the value of consumer holdings of durable goods, there has been a changing relationship between the value of consumer durables and dwellings, on the one hand, and the value of the structures and equipment owned by business, on the other. In 1900, according to Raymond W. Goldsmith's study of national wealth for the National Bureau of Economic Research, the values were about equal; by 1948, the value of consumer dwellings and durables was 30 percent greater than the value of business plant and equipment.

Furthermore, despite the extraordinary rise in the dollar volume of business plant and equipment expenditures since 1946, they have taken a smaller part of private gross national product than in the 1920's. Business investment in new plant and equipment has continued to be labor-saving, as in the long-run past, but since World War I, it has tended to be capital-saving as well. Improvements in technology in recent years have resulted in increases in both man-hour output and capital productivity. Total output has tended to expand at a more rapid pace than business investment in new plant and equipment.

Economic policy, in general, and tax policy, specifically, must take these changes into consideration. Tax policy should not be based on propositions that are reported to be sound simply because they may have been relevant 50 or more years ago. Tax policy today must be based on the American economic system of 1955, and not on reports of the way the system operated in the 1870's and 1880's.

The great domestic economic problem before us, as I see it, is how to sustain full employment and economic expansion at present and in the period ahead. To achieve these goals, I believe that it is essential to maintain strong and expanding consumer markets, which are the major stimulus in our present economy for a high and rising

dollar volume of business investment and for economic growth. Tax policy, therefore, should be directed toward increasing the incentives of consumers to buy. This becomes a far more important stimulating incentive than those designed to increase business investment.

FACTORS AFFECTING BUSINESS INVESTMENT

The high dollar volume of business investment in new plant and equipment in the years since the end of World War II has contributed, in part, to the generally high levels of production and employment during most of this period.

But these highest levels of business investment in the Nation's history have not been in response to business tax rates, but for the most part, in response to general market conditions and to consumer market conditions, specifically.

Business expenditures for new plant and equipment were $5.5 billion in 1939, when the corporate tax rate was only 34 percent. In the 4-year period 1946–49, such business outlays were at an annual average of $19.2 billion, or 249 percent greater than in 1939. The corporate tax rate in those years immediately following World War II, however, was 38 percent.

In the following 4-year period, 1950–53, business outlays for new plant and equipment rose to an annual average of $25.3 billion. The corporate tax rate in 1950, however, was 45 percent; in 1951, 47 percent; and in 1952–53, it was 52 percent; in addition, from mid-1950 to the end of 1953, there was an excess profits tax of an extra 30 percent. In 1954, after the termination of the excess profits tax, business expenditures for new plant and equipment declined below their 1953 peak.

Business investment and corporate tax rates

	Business expenditures for new plant and equipment	Corporate tax rate		Business expenditures for new plant and equipment	Corporate tax rate
	Billion	*Percent*		*Billion*	*Percent*
1939	$5.51	34	1951	$25.64	[2] 47
1946	14.85	38	1952	26.49	[2] 52
1947	20.61	38	1953	28.32	[2] 52
1948	22.06	38	1954	26.83	52
1949	19.28	38	1955 [3]	27.90	52
1950	20.60	[1] 45			

[1] Plus 30 percent excess profits tax from mid year.
[2] Plus 30 percent excess profits tax.
[3] Estimate.

Business investment in new plant and equipment reached record heights in years when corporate taxes were at their highest peacetime levels. With corporate tax rates rising during the post-World War II period, including the excess-profits tax from mid-1950 through 1953, and with straight-line depreciation, except for defense-related new plant and equipment after mid-1950, business investment reached its highest dollar volume. These facts underscore the contention of the

Harvard Business School study on the effects of taxation—by J. Keith Butters, Lawrence E. Thompson, and Lynn L. Ballinger—that the recent tax structure has not materially affected the flow of business investment in new plant and equipment nor undermined the normal development of the economy.

I do not mean this to be construed as an argument for ever-increasing corporate tax rates, for it is likely that under generally normal circumstances, corporate tax rates could possibly be pushed to heights that would depress business investment in new plant and equipment. But the high corporate tax structure of the post-World War II years apparently did not have a depressing effect. This was true, I believe, because business investment tends to be stimulated much more by the demand for goods and services than by tax rates or tax concessions.

Business investment in producers' durable equipment, for example, fell 72 percent between 1929 and 1933, but not because of a high and rising corporate tax structure. The demand for goods and services generally had declined sharply during that period and businessmen tended to withhold outlays for new durable equipment until actual and anticipated consumer demand would increase. Not until 1940, with a rise in both consumer and Government demand, did business investment in new producers' durable equipment reach a level that approached the one attained in 1929.

The decline in business outlays for new plant and equipment from $22.1 billion in 1948 to $19.3 billion in 1949 did not occur in response to a change in the corporate tax structure, since no such change occurred in those years. The decline occurred, as I see it, in a period of inventory reduction, following inflationary price rises, because the productive ability of the economy by late 1948 and early 1949 had outstripped the demand for goods and services.

I am not saying that the combined demand of Government and consumers fell in that period, since it did not drop. In fact, Government expenditures rose $7 billion between 1948 and 1949, and personal consumption expenditures increased by $3 billion. But the buildup of excessive inventories indicates to me that these increases in Government and consumption expenditures, in combination, were not great enough or rapid enough to keep pace with the economy's ability to turn out a rising volume of goods and services.

The decline in business expenditures for new plant and equipment, as well as the inventory reduction of 1949, did not occur because of either corporate tax changes or a drop in Government or consumer spending, but rather because demand by Government and consumers, in combination, did not rise sufficiently in the light of the economy's capacity to produce.

In 1954, business expenditures for new plant and equipment slumped again. In this period there was a change in the corporate tax structure; the excess-profits tax was terminated at the end of 1953. But this change should have resulted in a rise in business investment, if those who believe that business investment responds directly to changes in the corporate tax structure are correct.

After mid-1953, Federal Government expenditures started to decline, and although personal consumption expenditures declined in only one quarter, effective demand was not great enough to prevent either inventory liquidation or a decline in business outlays for new plant and equipment. The process of inventory reduction after mid-1953 was a reflection, as I see it, of the failure of demand to keep pace with the economy's productive ability. In 1954, as in 1949, business investment declined not because of changes in the corporate tax structure, but because the combined effective demand of Government and consumers failed to rise sufficiently to keep market demands, generally, abreast with the capacity of the economy to produce an increasing volume of goods and services.

By the second quarter of 1955, business outlays for new plant and equipment started to pull out of the slump. But this turn-around in business investment was preceded by a sharp increase in personal consumption expenditures. The May 1955 issue of the First National City Bank Newsletter states:

> Plans for investment, especially the longer term plans, reflect not only the optimism stirred up by the spurt in sales but the belief that conditions over an extended period will be favorable for the profitable utilization of the new facilities.

In commenting on the general improvement in economic activity since the end of 1954, the bank's newsletter states:

> Fundamentally it was a recovery based on consumers ability and willingness to buy. By the summer of 1954 and the opening months of 1955, consumers boosted their rate of spending on goods and services by more than $7 billion. They increased their purchases of new homes by $2 billion. As a result of the increase in sales and output, businessmen stopped cutting back their inventories, thus increasing their rate of spending by nearly $5 billion. These changes together were enough to account for the entire upswing.

The rise in business investment in new plant and equipment occurred in the second quarter of 1955, after the general improvement in economic activity had become apparent. This is another indication, as I see it, that business investment tends to rise and fall in response to the expected profitable operation of new plant and equipment, which means in response to the actual and anticipated demand for goods and services.

I think that the record of these past 2 or 3 decades presents sufficient evidence of the marked tendency of business investment in new plant and equipment to respond much more directly to market demands and market expectations than to the corporate-tax structure.

The national economy does not revolve around business investment in new plant and equipment, as Secretary of the Treasury George Humphrey apparently believes. The dollar volume of business investment, rather, tends to depend on the state of consumer demand.

As I see it, the record of the past several decades clearly indicates the need for continuing expansion of consumer markets along with the economy's improving productive ability, if high levels of production and employment are to be sustained without advances of Government spending.

EFFECT OF TECHNOLOGICAL CHANGE UPON DECLINING ROLE OF BUSINESS INVESTMENT

Technological developments have been changing the character of our economy and society. From the relatively underdeveloped agricultural economy of a hundred and more years ago, we had become a highly industrialized nation by 1900. From the handicraft and small factory industries of pre-Civil War years, we had progressed, by the 1920's, to the mass production of consumer durables.

The substitution of mechanical power for human and animal power, accompanied by the substitution of machine production for the handicrafts, has meant a fairly constant and rapid increase in man-hour output during the past hundred years and more. Further changes in technology since World War I have brought forth mass production and the rapid growth of consumer durable goods industries that have necessitated expanding mass markets and the mass distribution of goods and services.

The major goal of business investment today is no longer the establishment of an industrial base and the production of an increasing amount of machinery, but through automation an expansion of output of existing and new products through continuing innovations and cost-reducing improvements in production, work flow, materials handling, and distribution. Rapid improvements in consumer purchasing power, along with the economy's sharp increases in productive efficiency, have become a prime requisite for the continued and orderly growth of an increasingly efficient productive system.

The threat to the continued progress of the economy has become not so much a drop in business investment, as the possible failure of consumer markets—the economy's mass consumption base—to expand with sufficient rapidity to warrant a rising dollar volume of business investment in new and improved plant and equipment. Technological developments have been compelling a mass distribution and continuing expansion of consumer purchasing power as the means for maintaining the national economy on an even keel.

Technological developments have also been changing the role of business plant and equipment expenditures within the national economy.

BUSINESS INVESTMENT—CAPITAL SAVING FACTOR ADDED TO LABOR SAVING

Business investment in new plant and equipment, in the past 30 to 40 years, has tended to be capital saving, as well as labor saving. The productivity of capital, as well as of labor, has been rising.

A dollar spent on new plant and equipment now generally tends to return a greater real output than a similar dollar's worth of capital investment (at constant prices) 30 or more years ago. As a result, total output has been rising at a more rapid rate than business investment in new plant and equipment. Despite all-time record sums spent on new plant and equipment since 1946, the business capital investment share of total output available for private use has been somewhat lower than in the 1920's.

Relatively smaller increases in business investment in new plant and equipment now produce a larger volume of output than was true

four or more decades ago. The successful drive toward cost-reducing plant and equipment has been reducing the relative importance of business investment in the national economy.

Unfortunately, the increasing productivity of business investment in new plant and equipment has somehow evaded public attention. Colin Clark, in an article entitled "The Declining Importance of Capital" in the Listener (March 10, 1955, issue of the BBC publication), recently said—

> The idea of capital investment as a vehicle of technical change, of an endless substitution of capital for labor—

has grasped the minds of economists very firmly. However—

> they have found it difficult to believe (some prominent economists find it difficult to this day) that there could be such a thing as capital-saving inventions.
>
> Such an idea, however, is commonplace in the engineering world. Ask any designing engineer, and he will tell you that it is always his purpose to design each piece of new equipment to give more output than the old, for the same capital cost; and he generally succeeds in doing so. * * *
>
> Capital-saving inventions are one of the most striking features in the modern world, and probably account for a good deal of the observed decline in the ratio of capital requirements to output.

The trend toward the rising productivity of business investment in new plant and equipment has been going on for several decades, although little, if any, attention has been paid to it by Government officials responsible for economic policy. In his article, Machines and Men, in the September 1952 issue of Scientific American, Wassily Leontief points out that the rise of man-hour output in the early period of industrialization—

> seems to have been accompanied by a corresponding increase in capital investment. Between 1880 and 1912 the amount of machinery and of other so-called fixed investment per unit of output rose by 35 percent while the man-hour input (employed labor force times the number of hours worked) fell 40 percent. Then the ratio of investment to output began to drop. We introduced more efficient machinery rather than just a greater quantity of it.
>
> The amount of capital needed for each unit of output has actually been reduced in recent years—

Leontief states—

> and the installation of automatic machinery will further reduce it.

Several detailed studies, now completed or in progress, point to the same conclusion—that the productivity of capital has been rising and that the share of business capital investment in the economy's gross national product has been declining.

In the 35th Annual Report of the National Bureau of Economic Research, issued in May 1955, there is a report on work in progress on productivity by John W. Kendrick. A graph, accompanying Kendrick's report, indicates that the productivity of capital in the national economy (output per unit of capital) in 1953 was considerably greater than in 1899; the graph further indicates that the productivity of capital in the national economy rose substantially from 1914 to 1948, and slipped slightly between 1948 and 1953, in the years of extraordinarily high levels of new plant and equipment expenditures.

In his report, Kendrick indicates his finding of the rising productivity of both capital and labor in recent decades.

> Between the years 1919 and 1953—

Kendrick states—

> output grew significantly in relationship both to capital and to labor.

Kendrick's findings, as indicated in the National Bureau's 1955 report, tend to substantiate other recent studies by that same organization's economists.

In his introduction to Daniel Creamer's "Capital and Output Trends in Manufacturing Industries, 1880–1948" (National Bureau of Economic Research, 1954), Simon Kuznets states:

> Dr. Creamer's major finding concerning trends in the capital output ratio in manufacturing is that a significant rise in this ratio from 1880 to about 1909-19 was followed by a definite and substantial decline to the most recent date studied by him, 1948. Of course, the absolute volume of capital in manufacturing, measured at constant prices, rose throughout the period. But during the first part the relative increase in the volume of capital was greater than in output, so that the capital output ratio rose; after 1909-19, the rise in the volume of capital was significantly lower than that in the volume of output, so that the capital output ratio dropped * * *
>
> * * * this upward movement of the capital-output ratios to the World War I decade and their decline since then are found not only for manufacturing as a whole, but for practically all major industrial subdivisions that can be traced continuously in the available data. The finding is also confirmed whether we deal with total capital or with working capital and fixed capital separately, and for the recent period the decline in the ratio is observed whether we take fixed capital net or gross of accumulated depreciation. The finding is further confirmed with all the possible variations in the denominator: When we take the ratio of capital to gross value of output or to value added in manufacturing.

Creamer writes:

> The amount of capital invested per dollar of output rose steadily from 1880 to 1914, according to the record of reported values * * *. The amount of capital invested per output dollar began to fall in 1914 and continued until 1948 * * *.
>
> * * * In the earlier decades an increasing fraction of a dollar of capital was used to produce a dollar of output; in more recent decades a decreasing fraction of a dollar of capital has been sufficient to produce a dollar of output. This is consistent with the interpretation that in the earlier decades capital innovation on balance probably served more to replace other factor inputs than to increase output. More recently the balance has been in the other direction—capital innovation serve more to increase the efficiency of capital, hence to increase output, than to replace other factor inputs

In discusing the ratio of output to fixed capial alone (plant and equipment, excluding working capital), Creamer was able to extend his study beyond the 1948 cut-off point to 1951. Of his findings for 1948–51, when new plant and equipment expenditures soared to extraordinary heights, Creamer states:

> The use of the fixed capital-output ratio enables us to extend the series beyond 1948 in order to see the effect on the ratio of the 20 percent expansion in the stock of fixed capital in 1929 prices that occurred between 1948 and 1951. Despite this rapid rise in the stock of fixed capital, the ratio of fixed capial to output has remained at about the 1948 level. Presumably this would also be true for the total capital output ratio.

The rising productivity of capital in the mining industries—parallel to the rising productivity of capital in manufacturing—is indicated in Israel Borenstein's study Capital and Output Trends in Mining Industries, 1870–1948 (National Bureau of Economic Research, 1954). Of his findings for the 78-year period, Borenstein writes:

> We find that in each mining industry, up to a certain point in time, an ever-increasing stock of capital—the latter defined as the net value of fixed and working assets—was employed in order to extract a dollar's worth of mineral. There-

after the reverse has been true. The pattern is clear when capital is measured in book values and product at man-hour price values, but is particularly marked when the values of capital and product are adjusted for changes in price level. On this basis, the turning points in the ratio of capital to product for the different industries occur between 1909 and 1929—in the majority of case around 1919.

In his introduction to Borenstein's study, Simon Kuznets states that—

the major trends in the several aspects of the growth of mining parallel those found by Dr. Creamer for manufacturing. In manufacturing, also, the trend in the capital output ratios was generally upward until about 1919 and distinctly downward thereafter.

The rising productivity of capital—indicated by Creamer, Borenstein, Kendrick, Leontief, and others—means that output has been rising faster than business investment since about the time of World War I. It means further, as Colin Clark puts it, that the economic role of capital investment has been declining in importance.

As a result of its increasing productivity, the business investment in new plant and equipment share of the Nation's total output has been declining. In 1952, the Department of Commerce indicated in its publication, "Markets after Defense Expansion," that despite the high dollar volume of business fixed capital investment after World War II, such investment accounted for a smaller share of the Nation's total output available for private use (gross private product) than in the 1920's.

Business plant and equipment expenditures as a percent of gross private product in constant (1939) dollars[1]

Years:	Percent
1920's	10.4
1930's	6.9
War period, 1940-45	5.4
1946-52	9.8

[1] Markets After Defense Expansion, Department of Commerce, 1952.

This decline in the share of the gross private product accounted for by business expenditures for new plant and equipment is also clearly shown in a graph in the February 1954 issue of the Capital Goods Review, published by the Machinery and Allied Products Institute. The graph—from 1910 to 1953—shows that despite an extraordinarily high dollar volume in the post-World War II years, the share of new plant and equipment investment in the gross private product from 1946 to 1953 was below predepression levels. This capital-goods-industry publication states with great timidity:

When we put plant and equipment expenditures together, we find the postwar percentages of gross private product about the same at constant prices * * * (as) the predepression level * * *. So far as these figures can be relied on, we may conclude that the postwar percentages for plant and equipment combined have been close to, if not indeed a little below, those suggested by predepression experience.

In other words, even the extraordinarily high dollar outlays for new plant and equipment in the post-World War II period have not been capable of raising above predepression levels the percentage share of total output going to such outlays. As a result of the rising productivity of capital, total output has been increasing faster than business investment, even in the years since 1946.

With the productivity of capital having risen during the past 4 decades, with the likelihood that it will continue to rise with the spread

of automatic machinery, and with a declining percentage of gross private product accounted for by business outlays for new plant and equipment—where will we find the necessary markets for the growing volume of goods and services produced by an increasingly efficient economy in which both labor and capital productivity are rising?

WHAT ARE THE ALTERNATIVES?

In the light of these changes in the character of the national economy, I think that the alternative policies are clear. With a declining percentage of output going to business outlays for new plant and equipment, even in years of very high dollar volumes of business investment, an increasing share of the economy's growing output must be sold in areas outside of the business sector. If we are agreed on the necessity for maintaining continuing economic growth and high levels of employment, additional and increasing stress must be placed on the need for growing consumer or Government markets or both.

Should we wish to avoid reliance on high and rising levels of Government expenditures in the period ahead, then we must face up to the necessity of placing increasing emphasis on consumer expenditures for goods, services, and housing. If Government is not to fill the gap left by the declining share of business new plant and equipment investment in the economy, consumer spending must do so.

We in the CIO have called attention to this problem previously. For example, in June 1953, with the prospect of reduced defense expenditures before us, we declared in our CIO publication, Maintaining Prosperity:

> Business investment cannot be expected to offset declining defense spending in this period. Expenditures for new plant and equipment—which are now at record peaks and have been at high levels since 1946—may fall somewhat in the years ahead. And even small increases in dollar outlays would not raise the business investment share of rising national production.
>
> The national economy is now more dependent on consumer spending than in the past. The capital investment share of total private output has been less in the post-World War II period than in the 1920's, despite record business outlays since 1946. This trend indicates that as a percentage of total output available for private use, business investment may never return to the levels of the 1920's or earlier prosperous periods. Fixed capital is becoming increasingly efficient. A dollar spent now on new plant and equipment generally returns a greater real output than a similar dollar's investment in the past. The productivity of fixed capital, as well as labor, is increasing. Markets for the rising output must rest on a widening mass-consumption base.

The changes in the national economy, discussed in this paper, make it clear, in my opinion, that our economic system has been developing from a business investment-centered economy to a consumer-oriented economy. Tax policy must encourage personal consumption expenditures to an increasing extent in the years ahead, if we are to avoid rising levels of Government expenditures.

After four decades of the rising productivity of capital and the declining economic importance of business investment, it is high time that Government economists and economic policy legislators and administrators face up to the simple reality that the American economy of 1955 is considerably different from what it was in 1880 or 1900.

Business investment in new plant and equipment plays an important role in the process of economic growth. But that role is declining in relative importance. The growth of mass production, of the consumer durables industries, and of consumers services makes busi-

ness investment—and the continued growth of the national economy—increasingly dependent on the state of consumer markets. The declining share of business plant and equipment outlays in the national output available for private use—as a result of the rising productivity of capital—makes it necessary for the consumer sector to fill the gap, if increasing Government expenditures are to be avoided.

Should consumer markets fail to expand sufficiently, I think that the commitment of the Government to maintain high levels of employment, under the Employment Act of 1946, will necessitate increases in Government expenditures in the period ahead. As I see it, the policy alternatives are to encourage the growth of consumer markets or to accept rising levels of Government spending, since the alternative—economic stagnation and large-scale unemployment—is unthinkable.

STIMULATION OF CONSUMPTION BY DIRECT TAX CUTS

Tax policies designed to grant an increasing degree of special privilege to business investment will not and cannot produce long-run economic growth and stability. What is required is not additional tax privileges for business and wealthy investors, but direct tax cuts for the great mass of taxpayers through exempting from taxes a larger share of their income. This would result in expanding consumer markets that will make it profitable for business to invest in new and more efficient plant structures and machines. Such tax cuts would insure consumer markets that will grow fast enough to absorb the increasing available output.

Furthermore, the high liquidity of business generally and the fact that it does not rely to any significant degree on equity financing for new investment, is a clear indication that corporate business does not require the further extension of tax loopholes and tax privileges. Corporate enterprise, generally, has the available funds needed to sustain the overwhelming proportion of plant and equipment expenditures. Additional funds are available from the banks, insurance companies, and other investment sources, including the personal savings of wealthy investors.

Corporate investment, in the post-World War II years, has been financed overwhelmingly from internal sources—rising levels of undistributed profits plus depreciation allowances. In the years since 1946, some 65 to 80 percent of corporate new plant and equipment outlays have been financed from internal funds. The issuance of net new common and preferred stock has accounted for merely about 5 or 10 percent of corporate plant and equipment outlays since the end of World War II; borrowed funds have accounted for an additional 15 to 25 percent of such investment.[1]

It has been said many times in the past that a mass-production economy requires mass consumption. Recognition of the changes in the character of the economy in the past four decades underscores the need for a continuing expansion of consumer markets, to provide a

[1] Certainly, business generally does not require Secretary of the Treasury George Humphrey's special solicitude and the special tax privileges for business and wealthy families which he has consistently advocated since he took office. Mr. Humphrey's tax policies are not merely grossly inequitable. His tax policies—and his fiscal policies, in general—are based on a false conception of the process of economic growth and development in America today. As a result, the administration's tax and fiscal policies of the past 3 years present a threat to the continued long-run growth and stability of the national economy.

widening mass-consumption base for economic growth. The Nation's tax policy must make as one of its major goals the continuing growth of consumer markets. This can best be attained by increasing the personal individual income-tax exemptions, thus permitting American families to have, exempt from taxation, an amount equivalent to what is needed to maintain a decent American standard of living. To this end I would recommend an increase during the coming session of Congress in individual income-tax exemptions of at least $200 per person.

THE NEW LOOK IN TAX AND FISCAL POLICY

PAUL A. SAMUELSON, Massachusetts Institute of Technology

I

There is much talk about taxes. When I flick on the dial of my radio in the morning, I hear a Congressman quoted on how our high level of taxes is ruining the Nation or a Senator's tape-recorded alarm over the unfair burden the poor man has to carry because the administration has been favoring big business. My morning paper at breakfast brings me the view of its editor that the United States has been pursuing unsound fiscal policy for the last 25 years. Scratch the barber who cuts my hair and you find a philosopher ready to prescribe for the Nation's monetary ills.

This is as it should be. We expect sweeping statements in a democracy. We hope that out of the conflict of extreme views there will somehow emerge a desirable compromise. Yet such sweeping statements have almost no validity from a scientific, or even from a leisurely commonsense point of view: spend as little as a year going over the factual experience of American history and of other economies, devote as little as a month to calm analysis of probable cause and effect, or even spend a weekend in a good economics library—and what will you find? Will you find that there breathes anywhere in the world an expert so wise that he can tell you which of a dozen major directions of policy is unquestionably the best? You will not. Campaign oratory aside, the more assuredly a man asserts the direction along which salvation is alone to be found, the more patently he advertises himself as an incompetent or a charlatan.

The plain truth is this, and it is known to anyone who has looked into the matter: The science of economics does not provide simple answers to complex social problems. It does not validate the view of the man who thinks the world is going to hell, nor the view of his fellow idiot that ours is the best of all possible tax systems.

I do not wish to be misunderstood. When I assert that economic science cannot give unequivocal answers to the big questions of policy, I do not for a moment imply that economists are useless citizens. Quite the contrary. They would indeed be useless if any sensible man could quickly infer for himself simple answers to the big policy questions of fiscal policy. No need then to feed economists while they make learned studies of the obvious. It is precisely because public policy in the tax and expenditure area is so complex that we find it absolutely indispensable to invest thousands of man-years of scholarly time in scholarly economic research in these areas.

Make no mistake about it. The arguments that we all hear every day of our lives on the burning partisan issues have in every case been

shaped by economists—by economists in universities, in business, in Government, and by that rarest of all birds, the shrewd self-made economist. What economists do not know about fiscal policy turns out, on simple examination, not to be known by anyone.

II

With this necessary preamble out of the way, let me record the general views that studies have led me to, about the current state of our fiscal system. This will clear the way for a more detailed analysis of taxes and growth, taxes and stable full employment, taxes and equity, taxes and the level of public expenditure programs.

Here then are the major facts about our system as I see them.

(1) The postwar American economy is in good shape. There is nothing artificial or unsound about its underpinnings. For more than a decade we have had generally high employment opportunities. Our production efficiency has been growing at a steady rate that compares well with anything in our history or in the history of countries abroad. For all this we must, in our present-day mixed economy, be grateful to both public and private institutions.

(2) The existing structure of Federal, State, and local taxes is in its broad features highly satisfactory. Repeatedly at the polls and through all the legitimate processes of government, the citizens of this Republic have indicated that they want our present type of fiscal structure—its substantial dependence at the Federal level on personal and corporate income taxes, its eclectic dependence on selective excises, on payroll levies for social security, on property and sales taxes at the local levels. If the consensus of citizens in our democracy were to be other than it is—toward less or more equalitarianism, toward less or more local autonomy—there is no reason that the careful analytic economist can see why our fiscal system is not capable of being altered in the desired direction. In other words, there is nothing in the mechanics of a modern economy which makes it impossible or difficult for the citizenry to get the kind of a tax system that they want; our tax system has plenty of give, plenty of room for adaptation and change.

All the above does not imply that we are living in a new era of perfection. The American economy now faces, and will continue to face, many tough problems, many hard decisions. And, to be sure, there are numerous imperfections, inconsistencies, and loopholes in the present tax structure; these do need improving.

What the optimistic diagnosis of the modern-day economist does contradict is the following:

(1) The view that America has long since departed from an orthodox fiscal policy and that it is only a matter of time until a grim Mother Nature exacts retribution from us for our folly in departing from the narrow line of fiscal rectitude. (This is a philosophical position that any dissenter from current trends is free to assume; but it is not a factually verifiable view about reality that dispassionate study of statistics and facts can substantiate.)

(2) The view, shared in by the extremes of both left and right wings, that our economy generally is moving in unsound directions so that we must ultimately end up in some unnamed disaster or convulsion. (In terms of business-cycle stability and efficient growth, the

United States has in the last dozen years dramatically refuted the sour expectations both of those who look back on a fictitious past golden age and of collectivists who look forward to a golden age that only a revolution can usher in.)

III

Turning now to the goals of any tax system, we can ask: What tax structure will give us the most rapid rate of growth? What tax system will give us the highest current standard of living? What tax structure will make our system most immune to the ups and downs in employment and prices that make American families insecure? What tax structure will realize most closely the community's sense of fairness and equity? What tax structure will have the least distorting effects on our use of economic resources, instead of maximizing the efficiency with which we produce what our citizens most want?

Upon careful thought it will be obvious that there cannot exist a tax system which will simultaneously maximize these five quite different goals of social life.

It is easy to see that high current living standards and rapid growth of our ability to produce are conflicting ends: you have only to look at a collectivized society like the Soviet Union, which decides to sacrifice consumption levels of the current generation in favor of a crash program of industrialization; you have only to reflect that historically in the slums of Manchester working families might have lived longer in the 19th century if England and the other nations had during the industrial revolution slowed down their rates of material progress; you have only to consider the problem of conserving scarce exhaustible natural resources to realize that every society must all the time be giving up higher future resource potentials in favor of keeping current generation consumption as high as it is.

You can imagine a society that decides to devote its income in excess of the bare physiological existence level 100 percent to capital formation. You can imagine it—but there never has been such a society. Nor would any of us want to live in such a one. It should be obvious, therefore, that no sane person would ever seek a tax program which literally maximized our rate of economic growth. (Yet how many times over the chicken a la king have we all heard speakers reiterate this nonsensical goal.) It is just as obvious that no sane person would want to maximize present living levels if this meant eating up all our capital on a consumption bender that would leave us an impoverished Nation.

There is no need to go through all the other pairs of the five listed goals to show their partial incompatibility. If we are willing to frame a tax system that strongly favors thrifty men of wealth, we may thereby be able to add to our rate of current growth; if we encourage a gentle rate of inflation, we may be able to increase the profits in the hands of the quick-reacting businessman, perhaps thereby stepping up our rate of growth. So it goes, and one could easily work through the other permutations and combinations.

But not all of our five goals are necessarily competing. Some when you realize them, help you to realize the others. If we succeed in doing away with the great depressions that have dogged the economic record, we may thereby add to our rate of growth. If we shape a graduated-tax system that enables lower income groups to maintain

minimum standards of life, we may ease the task of stabilizing business activity. If we replace distorting taxes by less distorting alternatives, the fruits of the resulting more efficient production can add to our current consumption and to our rate of progress in capital formation.

I shall not prolong the discussion of the degree to which the diverse goals of tax policy are competing or complementary. For it will turn out that we can formulate proper policies without having to measure these important, but complicated, relationships.

IV

Upon being told by the economist that it is absurd for Congress to aim at the most rapid rate of growth possible and that it is equally absurd for Congress to aim at the highest possible current level of consumption, the policymaker may be tempted to say: "I understand that. Won't you therefore as an economist advise us as to just what is the best possible compromise between these extremes?"

A good question but, unfortunately, not one that the expert economist can pretend to give a unique answer to. If he is honest, he must reply: "The American people must look into their own hearts and decide on what they consider to be the best compromise rate of growth."

Just because I have advanced degrees in economics and have written numerous esoteric works in the field, I am not thereby empowered to let my personal feelings, as to how much the present generation ought to sacrifice in favor of generations to come, become a prescription for society. It would be as presumptuous for me to offer such specific advice as to let my family's notions about dental care determine how much the typical American family ought to spend on toothpaste. But it is legitimate for me as an economist to say this: "Whatever rate of capital formation the American people want to have, the American system can, by proper choice of fiscal and monetary programs, contrive to do." This can be shown by an example.

Suppose the vast majority of the American people look into the future or across the Iron Curtain at the rate of progress of others. Suppose they decide that we ought to have a more rapid rate of capital formation and technological development than we have been having recently. Then the economist knows this can be brought into being (*a*) by means of an expansionary monetary policy that makes investment funds cheaper and easier to get. Admittedly, such an expanded investment program will tend, if it impinges on an employment situation that is already full and on a price level that is already stationary, to create inflationary price pressures and overfull employment—unless something is done about it. What would have to be done about this inflationary pressure? Clearly (*b*) a tight fiscal policy would be needed to offset the expansionary monetary policy: By raising taxes relative to expenditure, we would reduce the share of consumption out of our full employment income, releasing in this way the real resources needed for investment. (It should be unnecessary to go through the reverse programs which would be called for if the national

decision were to slow down the rate of capital formation as compared to that of recent years.[1])

From these remarks it will be clear that economic science is not only neutral as to the question of the desired rate of capital accumulation—it is also neutral as to the abilty of the economy to realize any decided-on rate of capital formation.

I repeat: With proper fiscal and monetary policies, our economy can have full employment and whatever rate of capital formation and growth it wants.[2]

V

The optimistic doctrine that our economy can have stability and the rate of growth it wants may seem rather novel. Perhaps even a little shocking. But there are worse surprises yet to come.

The reader may think that my argument rests on something like the following reasoning:

> Suppose that political party R is more concerned with progress than political party D, which shows a greater concern for the little man, with security, and with current consumption. Then if the Nation gives its approval to the general policy goals of R, the Government will have to change its emphasis away from reducing taxes on individuals—particularly rapid-spending lower-income people; and it will have to change its emphasis toward reducing taxes on business, in an attempt to bolster the incentives toward investment. In short, it is by changing the qualitative pattern of taxation, by sacrificing equity to incentive, that the community succeeds in getting higher levels of capital formation when it desires such higher levels.

I predict that much of the testimony before this subcommittee will proceed along these lines. Certainly much of the political discussion of the last 3 years, when it has had the courage to be frank, has been along these lines.

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[1] The fact that variations in the overall deficit or surplus of the Government can, if properly reinforced by monetary policy, determine the rate of society's capital formation puts a sobering responsibility on democratic governments. Ordinarily, we assume that each individual is to be the best judge of whether he will spend the income society leaves him after taxes on more butter or on more margarine. We do not ordinarily assume that I, as an individual, am free to determine the amount of smoke my chimney can eject into the public air; I am willing to enter into a compact with my neighbors whereby we all decide democratically how our liberty or license is to be curbed in order to further the good of each one of us. A nation's saving seems to be treated by most 20th century nations as something in between these 2 polar cases: to some degree we all act as if we consider ourselves trustees for future generations, and we desist from using up all the irreplaceable resources of nature. In both the advanced and the underdeveloped parts of the globe, citizens act at the polls as if they do not completely approve of the saving-investment decisions that they would make in private life; they reinforce and alter these decisions by voting public fiscal and monetary policies which increase (or decrease) the capital formation which private thrift would by itself dictate. Why do they do this? Often they do so implicitly. But often explicitly because, technically speaking, they attach qualified weight to their own changeable ex ante indifference curves between present and future. If full ethical primacy were to be given to these indifference curves and if short-run irregularities were ignored, the proper goal of social policy might be a constantly balanced budget accompanied by an active monetary policy that maintains full employment.

[2] Space does not permit me to give the needed qualifications to this simplified exposition. I have elsewhere explained at some length what might be called the important neoclassical synthesis, which combines the essentials of traditional economics pricing theory with the essentials of the modern theory of income determination and which underlies the asserted proposition. See my chapter entitled "Full Employment Versus Progress and Other Economic Goals," appearing in (Max F. Millikan, editor) Income Stabilization for a Developing Democracy, Yale University Press, 1953, pp. 547–580. Also see my related discussion entitled "Principles and Rules in Modern Fiscal Policy: A Neo Classical Reformulation," in Essays in Honor of John Williams, the Macmillan Co., New York, 1951, pp. 157-176. The third edition of my Economics, McGraw-Hill, 1955, ch. 29 (Interest and Capital), contains an elementary exposition to show how fiscal and monetary policy interact in the determination of alternative mixes of consumption and investment at full employment.

But this is not at all the train of thought that I wish to emphasize in my testimony. I want to cap the daring doctrine that an economy can have the rate of capital information it wants with a doctrine that may seem even more shocking. Naturally, I cannot here develop all of the underlying reasoning, nor give all the needed qualifications. But I do in advance want to stress the earnestness with which I put it forward, and to underline that it does spring from careful use of the best modern analyses of economics that scholars here and abroad have over the years been able to attain. The doctrine goes as follows:

A community can have full employment, can at the same time have the rate of capital formation it wants, and can accomplish all this compatibly with the degree of income-redistributing taxation it ethically desires.

This is not the place to give a detailed proof of the correctness of this general proposition. It will suffice to illustrate it with two extreme examples.[3]

In the first, suppose that we desire a much higher rate of capital formation but stipulate that it is to be achieved by a tax structure that favors low-income families rather than high-income. How can this be accomplished? It requires us to have an active expansionary policy (open-market operations, lowering of reserve requirements, lowered rediscount rates, governmental credit agencies of the FHA and RFC type if desired) which will stimulate investment spending. However, with our taxes bearing relatively lightly on the ready-spending poor, consumption will tend to be high at the same time that investment is high. To obviate the resulting inflationary pressure, an increase in the overall tax take with an overly balanced budget would be needed.

Alternatively, suppose the community wants a higher level of current consumption and has no wish to make significant redistributions away from the relatively well-to-do and toward the lower income groups. Then a tighter money policy that holds down investment would have to be combined with a fiscal policy of light taxation relative to expenditure. But note that in this case, as in the one just above, any qualitative mix of the tax structure can be offset in its effects by appropriate changes in the overall budget level and in the accompanying monetary policy.

VI

My discussion has covered a great deal of ground and has necessarily been brief. But I shall be glad to enlarge on the subject if that should be desired.

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[3] I do not recall ever seeing mathematical economics in congressional committee hearings. This drought can be ended by the following brief proof of the reasoning underlying my basic proposition. To the initiated the symbols will be almost self-explanatory; to the uninitiated no harm is meant.

Let Y = real national product, y = disposable income in real terms = Y − taxes. Let I and C stand for investment and consumption, G for Government expenditure on goods and services. Let i stand for the cost (and the availability) of borrowing for investment purposes. Let m be a parameter indicating the degree to which the tax structure is income distributing toward the poor and, possibly harmful to investment incentives: the tax structure can be summarised by $T=T(Y,m)$. Our whole system can be defined by the conditions:

$$Y=C(y,m,\ldots.)+I(Y,i,m,\ldots.)+G, \text{ where } y=Y-T(Y,m)$$

For prescribed levels of G and m, there will always be a level of i and a level of the tax function T that simultaneously leads to full employment and to any desired ratio I/Y. (The dots in the functions will permit one to add stocks of wealth or money as further variables and also to make various wage and price level assumptions.)

TAX POLICY FOR GROWTH AND STABILITY

EMERSON P. SCHMIDT, Chamber of Commerce of the United States

LIMITS OF STUDY

In his opening statement on May 24 before the invited participants, Chairman Wilbur D. Mills stated that there are "three distinct facets of taxation—political, economic, and technical." He stated that this inquiry was to be concerned with neither the political nor the technical aspects.

Rather, the aim was to be economic analysis of the tax structure as it relates to short-run stabilization and long-run economic growth. He indicated this may include effects on (*a*) the distribution of real income and levels of consumption, (*b*) on investment, (*c*) on managerial and labor effort, and (*d*) incentives. A third section was to deal with certain special phases such as: capital gains, depreciation, taxation of small business, and several other items.

The basic question for concern, however, is to be: What should be the relative emphasis upon direct stimulation of consumption and investment?

This limits the study, therefore, to analysis of the effects of taxation upon consumption and investment. Since taxation can only have deterring effects, it will be an analysis of the relative importance of these deterrents.

Final incidence of any tax is unknown

Little is known with finality about the incidence of a tax system or tax structure. The careful student is likely to avoid dogmatic conclusions as to the impact of any specific tax or group of taxes, or even the tax structure as a whole. A short-run tax impact may differ entirely from the longer run impact. Although the incidence of any tax measure may not be easily ascertained, the functions of taxation are relatively clear.

Primary functions of taxation

There are two schools of thought concerning the primary function of taxation. One group holds to the idea that taxes ought to be used primarily for the purpose of raising revenues sufficient for the operations of essential Government services. A second group believes that the tax structure ought to be used primarily to effect changes in the social structure of the Nation and only secondarily to raise funds necessary for governmental operations. Those in the first group will be identified by their concern over setting taxes at levels where a maximum of revenue will be derived over the long run. Those of the second persuasion will be identified by their concern over other considerations—protecting domestic industries against foreign competition, eliminating the problems of large inheritances and cutting down on "family fortunes," reconstructing the income pattern of the people of the United States, changing the investment pattern of the Nation's corporations, and many similar matters of social rather than fiscal concern. The case of attempted revision of the business structure through favorable treatment of cooperatives is a prime example.

Successive administrations in Washington and congressional committees have wrestled with the problem of the taxation of cooperative

enterprises. It's generally agreed that the cooperative is a legitimate form of doing business. But it escapes certain taxes which are levied on the corporate form of doing business. If the disparity between the tax burden on cooperatives and corporations is not corrected, we will drive more and more businesses into the cooperative form. Corporations are paying about one-third of the National Government tax take. It has been argued that the only real, final solution to this problem is the abolition of the corporate income tax. This committee ought to give consideration to this problem. While we do not recommend such a step at this time, the situation nevertheless suggests that a reduction in the corporate tax is one way to try to help to put the corporation and the cooperative on a more equitable basis of fair play and equality. To discriminate against one convenient and useful form of doing business and providing jobs is contrary to the American spirit of equal opportunity and fair play.

Whether taxes are viewed primarily for the purpose of raising revenues or for social purposes, it is generally agreed that the effect of the tax structure on the private economy should be watched. This brings us to the basic question: Should the relative emphasis be on direct stimulation of consumption or investment?

In a growing economy, rising consumption and investment are equally necessary. Without rising consumption, there will be no new investment to meet demand for goods consumed. Without investment, there will be no new income to generate consumer demand.

Throughout the 1953–54 recession, the almost uninterrupted advance in personal income, manufacturing wages, and other aggregates primarily associated with consumption expenditures would suggest that consumer demand is in a healthy position now. But the many dampening influences on investment to meet that demand need to be examined.

The development and growth of industry which we all anticipate will place great pressures upon the capital market. Spectacular innovations in automation and the harnessing of atomic and solar energy will create tremendous demands for investment capital. Therefore, a tax system which thwarts or hinders saving, investment and risk-taking is likely to be viewed with increasing criticism, as the need for financing these developments is more clearly comprehended.

Ability-To-Pay Principle

It took the 16th amendment to override the principles of the Founding Fathers with respect to taxation. Apparently, they believed that no one should pay any bigger portion of his property or income than others do.

Today our progressive income tax takes as high as 91 percent from the upper income-tax bracket. The greatest evil of the ability-to-pay principle is that with some people it has become a fetish. They have come to test every tax by that principle. However, even if one is committed to the progressive tax idea, it is not necessary that every tax be progressive. Many would be willing to settle for a tax system which is mildly progressive as a whole with perhaps an upper limit of 50 percent. But as it presently exists the progressive income tax, with high marginal rates, does discourage work, effort, and, particularly, risk taking. Innovators and the risk takers are tremendously

important individuals in our society. We ought not to penalize effort, ingenuity, diligence, and success. The ability-to-pay principle is, in many respects, foreign to our traditions. Even the Christian ethic put the emphasis on the tithe, each paying a similar portion of his income and everyone being responsible for paying something; even the widow's mite was welcome. Under a proportional tax system, a man earning $5,000 might pay 10 percent, while one earning $10,000 would similarly pay 10 percent. He would pay twice as much but not 5 to 10 times as much.

A tax on income, particularly when the marginal rates are high, tends to discourage effort. A sales or excise tax probably stimulates effort because if things we want cost a bit more we may have to work a little harder or a little more ingeniously in order to earn enough income to buy the things we want.

Of the $87 billion of taxable income after taxes in 1953, $62 billion were in the lowest income bracket of $0 to $2,000, or over 70 percent. Confiscation of all income in brackets above $10,000 would have yielded only about $4.7 billion as shown by the accompanying table.

Estimated distribution of taxable income, tax liability, and income after tax[1]

[Calendar year 1953 income level]

Taxable income brackets (1)	Taxable income (2)	Rate schedule, 1954 rates (3)	Surtax and normal tax (4)	Taxable income after tax[2] (5)	Additional revenue derivable from confiscation of all taxable income over levels indicated by lower limit of brackets[3] (6)
Thousands	*Millions*	*Percent*	*Millions*	*Millions*	*Millions*
0 to $2	$77,664	20	$15,533	$62,131	$86,958
$2 to $4	15,013	22	3,303	11,710	24,827
$4 to $6	5,907	26	1,536	4,371	13,117
$6 to $8	3,481	30	1,044	2,437	8,746
$8 to $10	2,403	34	817	1,586	6,309
$10 to $12	1,755	38	667	1,088	4,723
$12 to $14	1,410	43	606	804	3,635
$14 to $16	963	47	453	510	2,831
$16 to $18	822	50	411	411	2,321
$18 to $20	675	53	358	317	1,910
$20 to $22	533	56	298	235	1,593
$22 to $26	852	59	503	349	1,358
$26 to $32	862	62	534	328	1,009
$32 to $38	563	65	366	197	681
$38 to $44	401	69	277	124	484
$44 to $50	295	72	212	83	360
$50 to $60	316	75	237	79	277
$60 to $70	215	78	168	47	198
$70 to $80	172	81	139	33	161
$80 to $90	140	84	118	22	118
$90 to $100	97	87	84	13	96
$100 to $150	267	89	238	29	83
$150 to $200	153	90	138	15	54
Over $200	431	91	392	39	39
Total	115,391		28,432	86,958	

[1] Details will not necessarily add to totals because of rounding.
[2] By subtraction.
[3] Derived from cumulating column (5) from highest income bracket to the indicated level.

NOTE.—If the maximum rate in the above schedule were 50 percent for incomes in all brackets above $18,000, the revenue loss would be $1,076 million.

Source: Tax Foundation.

Income Tax May Slow Progress

The steeply graduated personal income tax, applying also to the proprietors of more than 3 million unincorporated businesses and millions of farmers, constitutes a heavy drain upon what might have become additional venture capital. The estate and gift taxes drain additional portions of potential venture capital.

Venture capital versus debt financing

The present tax structure has often been criticized on the grounds that it tends to dry up venture capital. There seems to have been a tendency on the part of Government tax theorists to stress the importance of debt financing to the exclusion of equity financing. Since there is an important principle involved here, it may be well to look into the various aspects of that notion.

For any given business enterprise, the investor in capital stock (or other form of ownership) is in a less safe position than the investor in bonds (or other form of creditorship). Talk about the present-day problem of equity financing (as against debt financing) has to do with getting investors to take the more venturesome position—to provide the venture capital which takes on the risks only thus avoidable to the bondholders (or other creditors).

If debt financing is predominant over equity financing, our economy is thereby made increasingly vulnerable to a down-spiraling recession.

Historical facts show clearly no cumulative recession movement has ever developed because of a preponderance of equity capital over debt financing. The opposite conclusion is amply supported by our past experience as well as by common sense.

Only with debt financing—and never with equity financing—can we associate the contagion of difficulties called to mind by such terms as "insolvency" or "bankruptcy," each failure to pay debts making it more likely that the creditor, in turn, will find it impossible to meet his obligations and maintain his economic activity.

Emphatically stated, ample provision of risk-taking venture capital is an essential requisite of a vigorously dynamic, expanding economy. An increasing proportion of equity investment as compared to debt financing lessens our vulnerability to down-spiraling recession. Conversely, an increasing proportion of debt or creditor investment increases our vulnerability.

Any reduction in the volume of risk-taking investment should, therefore, be cause for serious concern.

The fate of equity capital under present tax structure

Suppliers of equity capital have lost ground relative to other groups. In 1939 dividends represented 5.2 percent of national income; in 1953 they were only 3 percent of national income. This is a drop of more than 40 percent.

And yet this was at a time of high prosperity and high savings. The high savings of the postwar years have been channeled into outlets other than corporate securities—primarily into cash, bank deposits, Government bonds, and private insurance and pension reserves. To be sure, much of the savings thus allocated are reinvested by banks, insurance companies, and other institutions, but this provides primarily loan capital rather than risk or venture capital.

Interest paid on loan capital is deductible from the tax base. Except for corporations earning $25,000 or less, corporate earnings are subject to a tax rate of 52 percent. The cost of raising equity capital may be almost three times as heavy as raising the same amount by a bond issue.

The following table brings out the difference in cost to two companies raising $5 million additional capital. Each company is assumed to have started with a capital of $5 million. Company A raised another $5 million by the sale of stock and Company B by the sale of 3-percent bonds. It is assumed that each company after the flotations earns $1 million before taxes. Each corporation pays 7 percent on its stock outstanding.

Capital costs: Equity versus debt

	Company A equity financing	Company B debt financing
Capital structure (after flotation)		
Bonds 3 percent coupon	0	$5,000,000
Common stock	$9,500,000	4,500,000
Surplus	500,000	500,000
Total capital	10,000,000	10,000,000
Earnings for current year		
Before taxes and fixed charges	1,000,000	1,000,000
Less: Bond interest	0	0
Before Federal income taxes	1,000,000	850,000
Less income taxes (52 percent)	520,000	442,000
After Federal income taxes	480,000	408,000
Less dividends on common stock at 7 percent	665,000	315,000
Balance transferred to surplus	−185,000	93,000
Charges applicable to new capital:		
Interest on bonds	0	150,000
Additional income tax	78,000	0
Dividends on additional stock	350,000	0
Total	428,000	150,000
As a percentage of new capital raised ....percent	8.56	3

Because the bond interest is deductible before the corporate tax is applicable to the remaining income, the new $5 million of capital of Company B cost it only $150,000 or 3 percent, while the cost of the equity capital to Company A is $428,000 or 8.56 percent.

From this point of view corporations might prefer debt financing to stock financing. Yet corporate management, with some exceptions as in utilities and railroads, generally shies away from debt because of the resulting rigidity in the cost structure and the danger of insolvency in case of reduced production and soft markets for the output of the concern. Furthermore, only well-established promising enterprises can raise loan capital in substantial amount. Others usually must rely on venture capital.

The lack of venturesomeness and the lack of venture capital militates heavily against smaller and new enterprises. It may encourage mergers. Yet it is on the smaller and new enterprises that we must rely heavily for expansion of job-making facilities.

Most corporations try to avoid long-term financing and many of them could borrow very little on a long-term basis. Thus their chief

source of funds is plowed-back earnings. This means that the economic growth of our country is heavily dependent upon profits after taxes and upon the willingness of stockholders to forego dividends. With all the untapped savings within our economy, our economic growth should not be thus severely restricted.

A faulty tax structure or excessive tax burdens are not the only factor in growth

A faulty tax structure may be only one of many reasons for inadequate saving, investment, or growth. Sound political foundations, an economic system based on free choice of the ultimate consumers, and favorable environmental factors are all equally important to the Nation's development and growth. Such things as constitutional stability, the sanctity of private property and of contracts, the right to work without fear—protection against labor violence and class struggle ideology, sound monetary and fiscal policies—all of these and many more govern our Nation's pattern of evolution.

But the tax structure is important. With the tax burden running close to one-third of our national income ($95.7 billion tax load on a national income of $300.2 billion in fiscal 1954) it seems obvious that both the total tax take and the structure of the tax system have innumerable and significant effects on the allocation of human and other resources, on risk taking, on innovation, on enterprise and effort, on the price structure and the general level of prices.

Is the tax structure overbalanced?

Is undue weight being placed upon corporate and personal income taxes as a source of revenue? This is a question that is becoming increasingly important. Today the Government in Washington collects 80 percent of its revenue through income taxation.

Britain places relatively twice as much emphasis on excise and similar taxation as does the United States. The same is true in Canada. Serious consideration ought to be given to reducing the maximum taxes on income both at the individual and corporate level. When the rate goes up to 91 percent in the higher brackets, it is perfectly obvious that the incentive to take on additional work or additional risks must decrease.

All these matters are mentioned also to suggest the importance of reducing taxes generally and, particularly, the taxes on income.

Avoidance a problem with excessive or unfair taxes

Onerous taxes generally start immediate reactions among individuals to avoid their burdens. In France organized resistance has brought tax collections to a virtual stop in entire communities and districts. Resistance to tax payments has spread throughout many countries, sometimes overt and sometimes by indirection. It is increasing in the United States. The Governor of Alaska has requested a 20-year holiday from our national tax levies. The governor of one of our States has urged refusal to pay taxes because of alleged unconstitutional appropriations and expenditures.

Because of the very high personal-tax rates, increasing attempts are being made to develop nontax income. The tremendous growth in fringe benefits, the growth in executive compensation in the form of pension programs, stock options, etc., are in part explained by the high tax rates. An employer can give an employee "free" hospital

or medical care coverage at a premium cost of, say, $100 a year. But this may very well be the equivalent of a salary increase of 2 or 3 times that.

The higher the tax rate goes, the more we will find attempts made to circumvent them. For this reason, if for no other, all efforts of reducing the size of Government expenditure need all the support we can give them.

The current flight of capital an aspect of tax avoidance

The degree to which business has moved into Puerto Rico because of the tax haven provided there is an old story and well known. Throughout the entire world there are many such havens. More and more countries, particularly small ones, are attempting to provide such. Bankers, consultants, and lawyers, report an increasing number of inquiries on the possibilities. The tax havens overseas are themselves competing for corporate citizens from the United States.

A corporation organized under the laws of a foreign country does not have to pay United States taxes on earnings from sources outside the United States. Some countries have extremely low taxes, or none at all, on income earned outside their borders. When these two are put together there may be a substantial tax advantage. Many thousands of United States corporations and individuals and thousands more European companies are set up in tax havens.[1] Lichtenstein has for many years been such a tax haven. Nearer the United States are Nassau and Bermuda, Honduras and Curacao. Panama is said to domicile some 10,000 United States, European, Latin American, and even Japanese companies. Shipping lines have long been that nation's best-known tenants, registering their tonnage under the Panamanian flag. But manufacturers, traders, contractors, and, in fact, anyone concerned with international business may be able to make use of Panama. Numerous other such havens might be mentioned.

A novel approach to the Government revenue problem

It has occurred to some students of "liberalism," that in a truly free associative society, taxes might be placed on a voluntary basis—that is, the Government would get its revenue on the same basis as the community chest or the Red Cross. Each individual would pay the Government what he felt the Government services were worth. They ask the rather penetrating question: What's government worth to you?

This is a very provocative question. To some it may open new channels for thought. But there's a principle here that may be worth investigating. To the analyst of economic affairs it seems clear that every time the Government reduces the scope of its operations and turns an activity forward to private enterprise, it is, in effect, putting taxes on a voluntary basis. That is to say, from then on the free-choice consumer is in a position to determine whether or not he wants to spend his money for that particular service. In other words, the idea of moving toward "voluntary taxes" is not quite as fantastic as it might appear on the surface.

Reducing the tax load by eliminating subsidies

Actually, the biggest problem with taxation is not just the structure, but the "take" itself. Any time the National Government takes one-third of the national income, it is obvious that the extraction of this

[1] Business Week, October 1, 1955, p. 122.

from the citizens is bound to be a noticeably painful process. No way can ever be found to make such a large bite "painless." The question arises as to whether or not the pressure for some of the Government spending programs may not actually be derived from the weight of individual and business taxes. Unquestionably, there is a connection. Therefore, the tax student may find it worthwhile to look at the following long list of Government lending and loan-guaranteeing agencies and programs and, while so doing, ask himself the question: Is the pressure for these caused by excessive business and personal taxes?

I. Commercial, industrial, and financial loans
  - Small Business Administration
    - Bank participation loans
    - Direct loans
    - Disaster loans
  - Treasury
  - The Federal Reserve System
    - Loans to established commercial and industrial businesses
    - V-loans
  - Federal home-loan banks
  - Defense Minerals Exploration Administration
  - Maritime Administration

II. Agricultural loans
  - Farm Credit Administration
    - Federal intermediate credit banks
    - Federal land banks
    - Banks for cooperatives
    - Production Credit Corporation and associations
  - Rural Electrification Administration
  - Farmers' Home Administration
    - Production and subsistence loans
    - Farm ownership and insured mortgage loans
    - Soil and water conservation loans
    - Emergency loans
    - Special livestock loans
  - Commodity Credit Corporation
    - Price support
    - Farm storage facility loans

III. Housing plans
  - Slum clearance and urban renewal projects
  - College and university loans
  - Planning loans to State and local bodies
  - Public Housing Administration
  - Federal Housing Administration
    - Property improvement loans and nonresidential structures
    - Home mortgage insurance
    - Cooperative housing
    - Rental housing
    - Housing for servicemen

IV. Veterans' loans
  - Real-estate loans
  - Non-real-estate loans
  - Direct loans

V. Loans to Indians, Eskimos, and Aleuts

VI. International loans

In its studies the subcommittee might be well advised to endeavor to trace the relations between this growth and the high levels of taxes on business and individuals.

Conclusions and Recommendations

Our labor force will soon be growing at the rate of about 1 million per year. In addition, the rise of efficiency and the release of workers from declining industries adds many other hundreds of thousands of

workers for whom new jobs must be found. It takes some $13,300 on the average to create each new job in industry.

The necessary investment in job-making facilities will take place only if:

(*a*) The investment funds are available, and

(*b*) The incentive to make the investment is strong enough.

Any threat to the safety of the investment, or to its earning power, impedes such investment.

Investors should be willing to assume the ordinary risks of business such as vigorous competition, shifts in consumer taste and demand, and the possibility that the venture—in the light of hindsight—may have been unwise.

But if, in addition, a militant aggressive labor union backed by Government subjects the enterprise to strikes, to uneconomic labor costs, and to inefficient methods of operation and disturbed morale, the incentive to investment is impaired. If the Government subjects the businessman to a plethora of rules, regulations, and directives and burdens him with a mountain of paperwork, again the incentive to invest is impaired. If the Government subsidizes competitors, or enters into business operation itself, or even threatens to do so, investment is still further impaired.[2] Finally, if the Government absorbs an unduly large slice of the business or individual income dollar, the capacity and incentive to invest may be all but eliminated.

The general level of business and economic activity is governed by a great many factors and forces. The businessman and the investor are key figures. But they do not deserve the exclusive credit for prosperity nor the blame for underemployment. They do their work within a complex political and economic climate. To get the most out of them, it is incumbent upon all citizens to:

(*a*) Discover the essential prerequisite conditions for the attainment of the businessman's and the investor's maximum potential contribution to economic well-being;

(*b*) Help clear away the roadblocks standing in the way of their performance.

This may require positive and definite action along the following lines:

1. More workable labor laws to promote industrial peace and industrial efficiency.
2. Less onerous regulation and control of business.
3. Development of a political and opinion climate more favorable to investment.
4. Elimination of subsidies and Government commercial- and industrial-type enterprises leading to unfair competition.
5. Reexamination of the practices and investment policies of trustees, trust funds, and insurance companies with a view to determining whether these are unduly restrictive.
6. Substantial expansion of investment trusts.
7. Widespread multiplication of risk capital institutions such as the American Research & Development Corp. in which Senator Ralph Flanders and others have taken such an effective interest.

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[2] See: Task Force Report on Revolving Funds and Business Enterprises of the Government, Hoover Commission, January 1949; and Government Competition: Problem and Perspective, Chamber of Commerce of the United States (Washington: 1954).

8. Setting up more community-type capital organizations which would specialize on a local basis in providing venture capital to new and growing businesses, especially small businesses.[3]
9. Teachers in our schools encouraging more students to become job-makers and imparting to them more knowledge and understanding of managerial know-how.

Most of these ideas are not new. They need thorough analysis and study, with such followup action as seems appropriate in each case. The shortage of venture capital is not due to any single cause. and the problem must be attacked on many fronts. We must be resourceful and innovative in our effort to raise more innovative capital. Imagination is, after all, the greatest "nation" in the world.

In this short report I cannot discuss all these suggestions. But there is no doubt that the current tax burden on business and on the sources of venture capital is such a serious impediment to new investment that, in addition to the above, action along the following lines is imperative:

1. Reduce Government expenditures.
2. Move toward lowering of the progressive personal income tax rates in order to stimulate equity financing.
3. Tax persons with highly fluctuating income on income averaged over a number of years.
4. Begin promptly to reduce the corporation income-tax rate.
5. Reduce the capital gains tax and make more adequate provision for the offsetting of losses, in order that the present penalties against the economic shifting of ownership of assets may be removed.

Epilog

Projections of growth widely accepted by students of the problem suggest during the 12 years between 1953 and 1965 the possibilities of these targets:

An increase in population of 20 percent or one-fifth;

A reduction of the average annual hours of work by nearly 10 percent;

An increase in output per man-hour of 40 percent in agriculture and 35 percent in private industry;

An increase in total national output of nearly 50 percent in constant prices; and

A rise in real disposable income per capita of nearly 30 percent.[4]

In recent times, both here and abroad, tax and other governmental policies have concentrated unduly on redistributing and socializing wealth and income. Most students of the problem of poverty and want are now recognizing that this is not in the best interests of a strong economy, our national security and the reduction of poverty. Grover W. Ensley, staff director of the Joint Committee on the Economic Report, wisely stated:

> There is no solution in redistributing the same size pie. That pie must be made bigger.

[3] See report on Community Industrial Financing Plans, Chamber of Commerce of the United States, Washington 6, D. C.

[4] See, for example, Potential Economic Growth of the United States During the Next Decade, committee staff, Joint Committee on the Economic Report, Washington, 1954, pp. 21–28.

Slichter, Boulding, and many other economists have been driven to this same conclusion.[5]

The National Bureau of Economic Research tells us that with the average family income of about $5,000 at present, if we maintain the last 80 years' rate of progress, in the next 80 years, our grandchildren or great-grandchildren will have average family incomes of about $25,000 of 1953 purchasing power. This is a level now attained only by about 1 percent of the Nation's families. Obviously, this would require fabulous quantities of new investment. If its benefits trickle, flow and spread all around to gain these heights, there should be no complaint.

That we can maintain prosperity and progress without new investment is doubtful. Prof. David M. Wright in his book Capitalism states:

> But investment is the basic problem. Measures to stabilize consumption (public works, unbalanced budgets, etc.) may indeed keep the slump from getting worse. But they are after all mere first aid; that is, if we are not just trying to smuggle socialism in by the back door. Until growth once more gets underway and with it new investment, there cannot be a spontaneous recovery of the private economy.

But, to repeat, progress and growth are not inevitable. They must be earned. High and uncertain taxes on investment and achievement can be among the chief factors which will hold us to lower scales of living than those we could achieve.

STIMULATION OF CONSUMPTION OR INVESTMENT THROUGH TAX POLICY

HERBERT STEIN,[1] Committee for Economic Development

This memorandum discusses question III–D of the outline of questions prepared by the Subcommittee on Tax Policy. It deals, therefore, with only 1 of 19 questions listed by the subcommittee, and there are, of course, many other questions relating to tax policy that are not included in the subcommittee's list. It should be clear, therefore, that this memorandum is confined to a limited aspect of the tax problem and must abstract from many considerations of principle and practice that would be important in rendering a balanced judgment on issues of tax policy.

As I interpret it, the question submitted to the panel has the following meaning:

1. A high rate of investment is a favorable condition, probably a necessary condition, for rapid economic growth.
2. The rate of investment is influenced by two factors:
   (*a*) The demand for consumption goods,
   (*b*) The return (after taxes) that would be earned on new investment at any given level of total demand.

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[5] See: The Welfare State and the State of Human Welfare, Chamber of Commerce of the United States, Washington 6, D. C.

[1] This memorandum expresses the views of the author only, and no inference as to the views of the Committee for Economic Development should be drawn from it. The committee has expressed its own views in a number of published statements. See, for example, Taxes, National Security and Economic Growth, January 1954, Committee for Economic Development, New York.

3. The structure and weight of the Federal tax system affect these two factors.

4. The more the Federal tax system cultivates one of these factors the less it can cultivate the other, i. e., the more the tax system enhances the demand for consumption goods the more it must repress the return on new investment at any given level of total demand, and vice versa.

5. Therefore it is necessary to ask whether, from the standpoint of economic growth, primary emphasis in the tax system should be given to expansion of consumer demand or to cultivation of the investment return factors.

In my opinion the problem raised is not a real one. It is not true that modifying the tax system in such a way as to increase the return on new investment at any given level of total demand requires that the tax system repress demand for consumption goods below the level at which it makes its maximum contribution to total investment. Conversely, taxation that restricts the return on new investment is not required in order to reduce or eliminate tax restraints on consumption that tend to limit investment. Therefore, if the objective is to promote investment and growth it is not necessary to choose between tax revision to expand consumer demand and tax revision to increase investment return. We can have both taxes affecting investment return so low that no reduction would stimulate more investment and taxes affecting consumption so low that no reduction would stimulate investment by increasing consumer demand. If promoting investment and growth were our only objective this would be the kind of tax system we ought to have.[2]

The following illustration will indicate the reasoning behind this position:

Suppose we start with the present tax system and a condition of "maximum" employment. It is our goal to promote an increase in the rate of investment. We are considering a reduction in some tax with a heavy impact on investment return—such as the corporate profits tax [3]—in order to achieve this goal. If we reduce the corporate profits tax, will we have to raise some other tax—say the first bracket of the individual income tax [3]—to a degree that, by reducing consumption, may offset or more than offset the investment-stimulating effect of the corporate tax cut?

If the only objective of policy is to promote investment and growth the answer is no. (Of course, this is not the only objective of policy, and the introduction of other objectives raises real problems, which will be discussed below. However, the question posed to the panel does not specify other objectives and it is desirable to clarify the question first on the assumption that growth is the only objective.) The reduction in the corporate tax will reduce the total Government revenues. But, there is nothing about the goal of promoting investment and growth that requires maintenance of the total revenues at any

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[2] I am accepting here the assumption implicit in the question posed to us that the only means to economic growth with which we are concerned is investment. Of course this assumption is incorrect but this probably does not seriously affect the answer to the specific question asked of us.

[3] The corporate profits tax and the first bracket rate of the individual income tax both have some initial effect on both investment and consumption. They are used here only to illustrate important differences in the degree to which the various taxes affect either investment or consumption.

given level. What does this goal require with respect to the total level of taxation? In my opinion the requirement is that taxes be high enough to prevent a rate of inflation that would interfere with growth. Just how much inflation can be tolerated without interference with growth is a difficult question. For present purposes it is probably sufficient to assume that the tolerable amount of inflation is zero, since there are good reasons for trying to avoid inflation anyway.

This leads to the conclusion that if we cut investment-repressive taxes, like the corporate profits tax, we have to raise other taxes only to the extent necessary to restrict consumption enough to avoid inflation. Now if we start with maximum employment, and the cut in corporate tax succeeds in bringing about an increase in investment expenditures, some increase in consumption taxes will be needed. Otherwise there will be an increase in total demand when the economy is already operating at full employment—which would be inflationary. But the consumption tax increase will not be one that restricts investment by restricting consumer demand; it will be one that restricts consumer demand under conditions where it would be inflationary and would not stimulate investment.

We do not have to choose between direct encouragement of investment and expansion of consumer demand where that expansion would be favorable to investment. No matter how far we reduce direct tax burdens on investment we can still have the maximum consumer demand that will contribute to the encouragement of investment—at least so far as consumer demand is affected by taxes.

My position may be summarized as follows:

1. The effects of the tax system upon investment depend upon:

   (*a*) its effects upon total demand (not just consumer demand);
   (*b*) its effects upon investment return.

2. Given its effects upon total demand, the tax system will be more favorable to investment the less it restricts investment return.

3. The effects of the tax system upon investment return and the effects upon total demand are independent. That is, any desired effect upon investment return can be combined with any desired effect upon total demand.

4. Therefore, we can have both the optimum or maximum effect upon investment return and the optimum or maximum effect upon total demand and do not have to choose between or balance these effects. Specifically, we can have a tax system that has no repressive effects upon investment return and that does not restrain total demand below any desired point.

It may be incumbent upon me to explain why I see no problem here when many people who have thought about the matter do see a problem. In my opinion, people who see a problem here are assuming three things:

1. That the budget is to be balanced, so that there is a given total amount of taxes to be raised, regardless of the character of the tax system (assuming total expenditures are given).

2. That different kinds of taxes have different effects upon total demand per dollar of revenue.

3. That the Government has no effective means outside the tax system for influencing total demand.

If these three propositions were true, then selection of the kinds of taxes we impose would be the only way in which the Government could influence total demand. The effect on total demand would be an important objective in the selection of the kinds of taxes to impose, and this objective might turn out to be in conflict with other objectives of the tax structure. The question posed to the panel revolves around one such conflict. The tax system that is best in terms of its direct effect on investment may not be best in terms of its effect on total demand. And we are asked how to resolve this conflict.

In my opinion the second proposition is correct, but the third is not. The first is a matter of policy—a policy which I believe is sound, in part because the third proposition is incorrect. There is an instrument outside the tax field that the Government can use to influence the level of total demand. That instrument is monetary policy. By permitting a faster or slower growth of the money supply the Government can expand or restrict total demand.

The availability of this third instrument allows us to determine both the structure of taxes and the total amount of taxes by considerations other than the desired level of total demand. Particularly, it allows us to choose the tax structure that imposes the least direct interference to investment without fear that such a tax structure may restrict investment indirectly by causing a deficiency of total demand.

Thus, there are 3 instruments and 3 guides to their use:

A. The total level of taxation should be high enough to balance the (cash) budget at high employment. Adherence to this rule is important as a means of achieving fiscal discipline—of assuring that Government counts the costs when it decides to make expenditures.

B. The kinds of taxes imposed should be determined by consideration of direct effects on investment, effects on efficiency, and fairness in distributing the burden of Government expenditure. There may be conflicts among these objectives, but no conflict with the objective of the "right" level of total demand, which is to be provided by monetary policy.

C. Monetary policy should be directed to the achievement of the level and rate of growth of total demand consistent with high employment, growth, and avoidance of inflation.

The interaction of these instruments may be illustrated in the following way:

Suppose we start with a balanced budget and high employment. We decide to reduce the corporate-profits tax $2 billion in order to stimulate investment and accelerate growth. The budget-balancing rule requires that we raise some other taxes by $2 billion. The cut in the corporate tax increases total demand by some amount, X. The increase in other taxes reduces total demand by some amount, Y. If X exceeds Y there is an increase in total demand which must be offset by monetary restriction. If Y exceeds X there is a reduction in total demand which must be offset by monetary expansion. The combination of policies will prevent any change in total demand, so that there will be no change in total demand to offset the initial investment-stimulating effect of the reduction in corporate taxes.

The panel is asked to consider the general question under three assumptions, which may be described as persistent adequacy, deficiency, or excess of total demand. I hope it is clear from what has been said

above that I believe tax policy should be the same under all three of these conditions and that it should be the responsibility of monetary policy to prevent or correct a persistent deficiency or excess of demands.[4]

We are also asked "In broad terms, what modification in the Federal tax system should be employed to promote the desired objective with respect to economic growth?" If maximum economic growth were the only objective of tax policy one might suggest that all present Federal taxes be abolished and that instead there be imposed a flat rate consumption expenditure tax at a rate high enough to balance the budget. But maximum economic growth is not the only objective of tax policy, and any such suggestion would obviously be unsuitable. In devising a tax system it is necessary to consider other objectives, such as fairness in the distribution of the tax burden and incentives to effort and enterprise. At some points these goals conflict, and it is necessary to strike some kind of balance. This cannot be done in any precise or "scientific" way, since our knowledge of the economic effects of taxes is rather uncertain and fairness in taxation is a highly subjective matter.

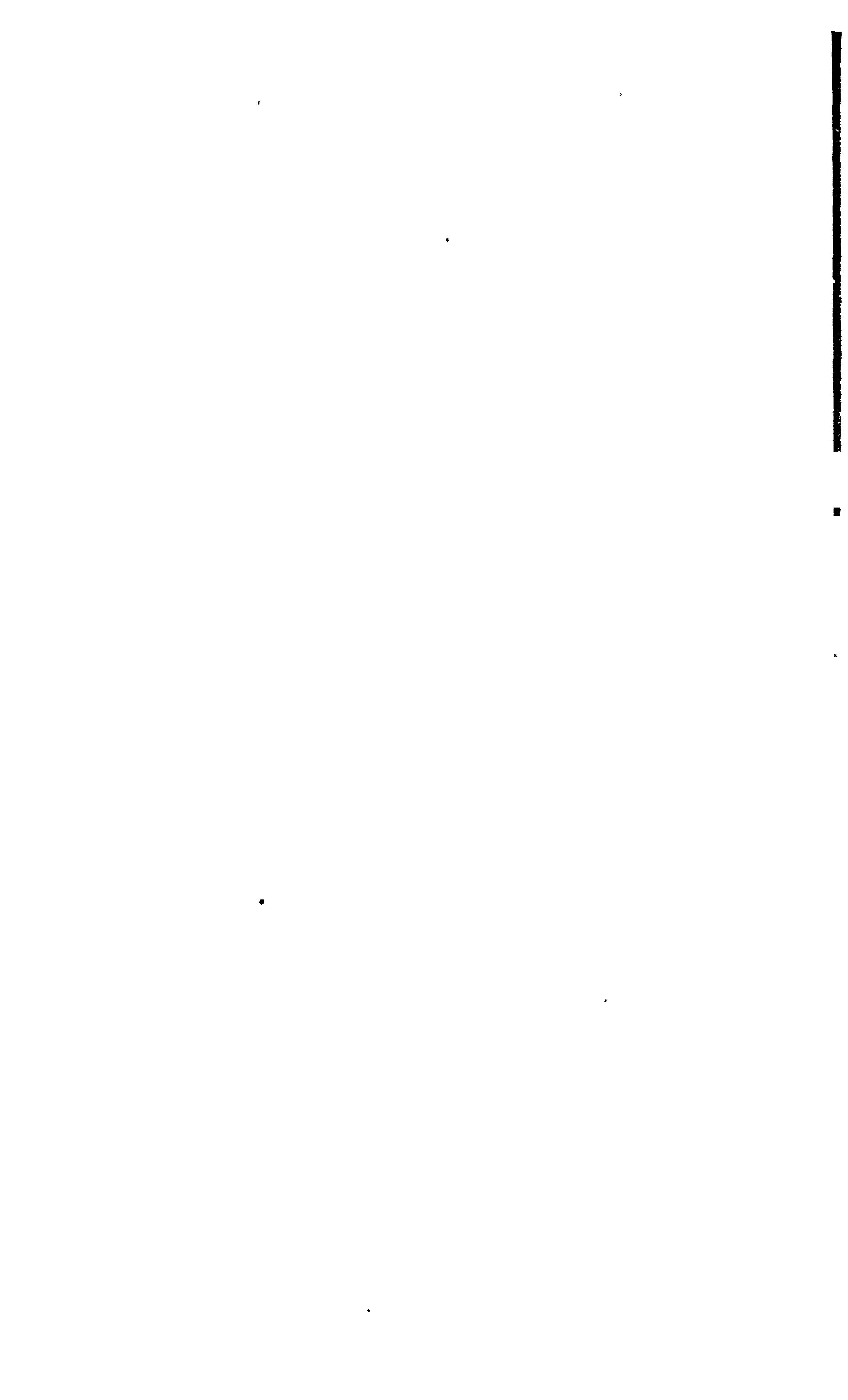
To recommend tax revisions that would best reconcile these different objectives would go beyond the specific scope of the question assigned to this panel. But since suggestions are invited I will indicate briefly what seem to me the most important directions for tax revision.

There are two main things we need:

(*a*) To reduce discriminations among different sources of income and different uses of income. Our objective should be to tax all income once in the hands of its recipient no matter where it comes from or what it is used for. The corporation profits tax, tax exemption for State and local securities, selective excise taxes, and many other parts of the tax system are in conflict with this principle.

(*b*) To reduce the restrictive effect of the present tax system upon investment. The removal of existing discriminations, suggested under (*a*) as a matter of equity, will also improve the system from the standpoint of investment. But, I believe that it would be desirable to go beyond this and reduce somewhat the income tax rates in the upper brackets. These rates are a danger to the supply and use of funds for taking the investment risks that must be taken if the economy is to grow rapidly. The desirability of avoiding this danger must be balanced against the fact that the community's notion of fairness includes the idea that the tax system should be progressive—an idea which I share. However, I do not believe that the community's idea of fairness requires as steep a schedule of income-tax rates as we now have, particularly if those rates are to be applied to all income from whatever source derived.

[4] Under certain cyclical conditions variations in the tax policy may be called for, but I understand the question not to relate to cyclical variations.



VI. ECONOMIC IMPACT OF EXPANSION AND CONTRACTION OF THE TAX BASE

THE EFFECTS OF SPECIAL PROVISIONS IN THE INCOME TAX ON TAXPAYER MORALE

WALTER J. BLUM, University of Chicago

I have been asked to comment upon how special provisions in the income tax—those granting preferential treatment to some persons—might affect the morale of taxpayers and their advisers.

I. DEFINITION OF PREFERENTIAL TAX TREATMENT

To discuss preferential or special provisions under our income tax, it is first necessary to define them. This is difficult in part, because taxpayers who benefit from special provisions commonly insist that these do not give them an advantage over the rest of the taxpaying public, but merely put them on a par with everyone else by recognizing that their situations are in fact somewhat different. Thus it can be made to appear that no provision in the law prefers any taxpayer and that all special legislation merely adjusts for special circumstances. To avoid this dead end the problem of determining what provisions result in preferential treatment must be separated from the problem of deciding whether such preferences are justified.

While theorists may argue about what constitutes preferential treatment, sophisticated taxpayers have not experienced a similar difficulty. Instead they have been guided by this single principle: It is more advantageous to accumulate wealth or enjoy personal consumption in ways calling for the payment of less total income tax than if the savings and consumption were financed only by money received in the form of ordinary income and if that money were spent on consumption or saved only in ways which did not give rise to deductions for tax purposes. There is no reason why we should depart from this realistic principle. Legislation is preferential to the extent it allows any taxpayer to accumulate wealth or enjoy personal consumption without paying the full tax. And the full tax is that which would be due if all of the taxpayer's economic enhancement were financed by cash received as ordinary income and if he did not qualify for any nonbusiness deductions or extraordinary exemptions or credits in the course of saving or spending his income.

The wholly nonpreferred taxpayer thus is the man who receives everything in fully taxable forms, who satisfies his personal consumption and accomplishes his savings in nondeductible ways, and who does not otherwise qualify for special exemptions or credits. To the extent that any taxpayer fares better than this yardstick he is being

preferred. In this sense many if not most taxpayers today enjoy some degree of preferential treatment under the law. But this does not impair the utility of the yardstick, for it nevertheless puts us in a position to know precisely how much and in what respects various taxpayers are being preferred. Such information is just what is needed before starting to discuss the consequences of special legislation.

II. Perspective

In my opinion the primary case for or against any preferential provision should turn on its impact on the fairness of the distribution of the income-tax burden. This aspect of special legislation is the subject of other papers. I mention it only to put my own presentation in proper perspective and to record my view that there should be a strong presumption that it is fairer to treat any receipt which is capable of financing a dollar of savings or consumption like every other dollar received, to treat every dollar spent on personal consumption like every other dollar so spent, and to treat every dollar saved like every other dollar saved. The dollar is a common denominator for measuring the relative incomes of taxpayers. When we differentiate taxwise between dollars on the basis of how they were received, or how they were spent on personal consumption, or how they were saved, we undermine the common unit of measure. As this happens it becomes increasingly difficult to form reasoned judgments as to whether the income-tax burden is being distributed fairly. We have yet to discover a substitute for the dollar as a common denominator in measuring ability to pay income taxes.

The case for many preferential provisions often is rested heavily on grounds of some asserted public policy, usually economic policy. The economic implications of various special provisions, as well as the economic consequences of all such provisions taken as a whole, are also matters which are explored in other papers. Here I again only seek perspective by noting my view that there should be a strong presumption against subsidizing a particular economic activity through the income-tax system. When one focuses attention on a particular economic activity it is only too easy to conclude that it should be encouraged. Of course there is a great deal to be said for encouraging the production of, say, oil; and of course a comfortable supply of oil is important for national defense. But in our society there is also a lot to be said for encouraging virtually every kind of legitimate investment and enterprise; and the production of many different commodities is important for national defense. The preferred treatment of one economic activity necessarily translates itself into a penalty on those not favored. For this reason, in legislating taxes it is especially important not to confine attention to any particular activity but to consider the whole of our economic system. And even if it be decided to subsidize a certain activity, we should be hesitant about administering the subsidy by way of a tax preference. Subsidies in this form vary directly in amount with the tax brackets of the recipients; they are invariably hidden in technicalities of the tax law; they do not show up in the budget; their cost frequently is difficult to calculate; and their accomplishments are even more difficult to assess. Partly for these very reasons they are likely to become fixtures which are not easily removed.

But while the most significant aspects of preferential tax provisions are thus outside the scope of my presentation, the consequences with which I shall deal are not unimportant. Anything which has a bearing on the morale of taxpayers and their advisers deserves attention because it may have an impact on the health and strength of our income-tax system.

III. Special Provisions Complicate the Income Tax

Probably the most nearly universal quality of preferential provisions is that they complicate the job of determining the proper amount of tax to be paid. To create a preference the law must draw a distinction between that which is and that which is not to be accorded the special benefit. Thereafter this distinction becomes relevant in computing the tax liability of anyone who possibly might qualify for the preference. If a taxpayer wants to take advantage of every preference to which he is entitled—and it is right that he should do so, regardless of how many dollars are involved—attention will have to be paid to the applicability of each special provision for which he conceivably might qualify.

Thus, preferential provisions place a burden on the community as a whole. Those taxpayers who attempt to make out their own returns will obviously have to devote more time and effort to this task. Each added distinction, moreover, will afford additional occasions for error, and it therefore is to be expected that the total volume of mistakes will increase. At the same time the increased complexity of the tax is likely to cause larger numbers of taxpayers to seek expert assistance, either from Government officials or from private practitioners. It has been argued that wider use of private tax experts is desirable because errors would thereby be avoided and the workload of the Revenue Service would correspondingly be reduced. No doubt numerous errors would be eliminated, but it would not be surprising to find that many who now hold themselves out as tax experts actually add to the burden of the Revenue Service in the course of trying to show their patrons how useful they are in minimizing tax assessments. In some circles a tax expert is little more than one who thinks he knows how to cut the corners. But even if all tax experts were more mindful of the revenues, it seems clear that on balance the net effect of additional complexity in the law can only be to increase the total cost of administration to the individual taxpayers or the Government, or both.

Preferential provisions may also cause some taxpayers to become hostile—a potentially dangerous attitude in a system which depends to a high degree on voluntary cooperation by the public. Such resentment can develop in a number of ways. A taxpayer simply might react against having to turn to a professional in making out a return, or he might rebel when he discovers that at some past time he did not obtain the benefit of a special provision because its complexities resulted in his failure to understand its application, or he might become upset in finding that a preferential rule just barely misses fitting his case, even though his situation seems to him to be indistinguishable from others covered by it. This occurrence is made more likely when, as is often the case, the theory behind the preferential provision is not obvious or where the line which it draws is largely arbitrary, or the

resentment may come about in a more indirect fashion. Special provisions which are widely publicized and usually associated with wealthier taxpayers (such as those concerning percentage depletion and capital gains) might lead people to underestimate greatly the amount of taxes generally paid by those with high incomes. Discontent flowing from this kind of misunderstanding can be particularly serious. Since it goes to the fairness or unfairness of the distribution of the whole income-tax burden, it might take hold deeply and be contagious.

The complexities of the law, aided perhaps at times by accompanying feelings of hostility, may encourage some taxpayers to relax their consciences in assessing themselves. Probably in most instances such a result is due merely to the usual give-yourself-the-benefit-of-the-doubt attitude. But in some cases it seems to have more disturbing roots. We have heard about taxpayers who knowingly winked at the law because they thought that a special relief provision should in all justice have been written more broadly to cover their circumstances. We have known of taxpayers who deliberately erred and excused themselves on the ground that their friends were in a position lawfully to take advantage of some special provision which did not quite reach their case. And there has been talk of taxpayers who willfully erred because they figured that a preferential provision would be too complicated for the Government to police effectively.

This is not to say that the preferential features now in the law have engendered wholesale resentment or cheating by taxpayers. It is likely that many of those who are now discontented or are inclined to cheat would be that way in the absence of special provisions. It is possible, moreover, that taxpayers as a whole would be more hostile and more lax in conscience if we were to adhere tenaciously to a tax law without preferences of any kind. It is even conceivable that taxpayers on the average would be more cooperative in a system which intentionally went out of its way to accord at least some kind of preferential treatment to everybody, so that each person could feel that the legislators were not unmindful of his particular circumstances. The plausibility of this is increased where, as in the case of our income tax, the whole set of rules is so complex that very few persons are aware of or understand the benefits bestowed upon others. In the face of these untested possibilities, one cannot be certain how the average taxpayer will react to a maze of preferential provisions in the law. But at the very least, a strong caution is in order. Preferences do burden the system. And while they might please their beneficiaries, they might well have a seriously adverse effect upon the attitude of other taxpayers.

IV. Special Provisions Increase Tax-Motivated Conduct

Other considerations enter the picture when we center attention on the sophisticated taxpayer who is personally knowledgable taxwise or who regularly receives professional counsel in tax matters. The most glaring is that preferential provisions usually result in time and talent being devoted by the principals and their advisers to planning designed to maximize the tax benefits. There probably is no way of reasonably estimating the quantity of energy which has been spent this year in manufacturing capital gains, splitting income, deferring income, and so forth, but surely the total must be tremendous. To

the effort given over to such planning must be added that devoted to learning the ropes and to transmitting the know-how to others in the field. In these days there might be more than well-meant humor in the warning that the golden opportunity of this decade could be lost to us because our top talent was consecrating itself to the invention of new and better capital gains.

Tax planning, which eventually rests on preferential provisions, not only consumes time and skill but it can also have the effect of channeling transactions into molds which are wasteful or otherwise undesirable. This might be true from two distinct points of view. The individual taxpayer himself might not have set up the transaction as he did in the absence of the tax benefit. Often a tax-conscious person is willing to arrange business transactions, or investments, or family estate plans in a relatively inefficient manner because the tax advantages thereby gained seem to make the inferior plans worthwhile. In effect the preferential rules subsidize particular forms or practices. From the view of society as a whole, the resulting arrangements might be less desirable than alternatives which would have prevailed if the tax inducements had not been present. And the very fact that tax considerations tend to freeze transactions into rigid patterns may be a loss to a society which develops and moves forward through experimentation. Unfortunately it is only future generations who will be in a position to gage the extent of such a loss.

In inviting tax planning, preferential provisions also multiply the volume of litigation and of controversy at the administrative level, and thus are a further drain on the talent resources of our society. Virtually all statutes of course require interpretation and application, and the doubtful points must be resolved by administrators or courts or subsequent legislatures. But a tax statute is especially likely to be fruitful in this respect since dollars turn on every substantive distinction it draws. There will always be some persons (and no criticism of them is intended) who will seek to probe for the limits of a tax rule in their favor; to a large degree, tax planning for these taxpayers consists in arranging their affairs so as to come as close as possible to these limits without crossing over them. Such efforts continually put the statutory language into issue and thus call for administrative or judicial determinations. When a preferential rule is added to the statute, it usually provides another area within which this process can go on anew. While the capacity of a special provision to produce controversy varies with its nature, those now in the law certainly have left, and are still leaving, a monumental trail of controversy in their wake.

The evolution of our present income-tax statute is powerful testimony that there is no inherent limitation on the development of preferential provisions. On the contrary, it seems patent that one special enactment breeds pressures for others, especially among sophisticated taxpayers and their counselors. At any time in recent years it would have been easy to locate hundreds of preferential proposals which were with varying degrees of intensity being readied for presentation to Congress. In most instances the proposal in some respect copied a preferential provision already in the law; and usually the chief argument advanced in its behalf was that some other taxpayers already were enjoying a comparable benefit. This is a contention which any

legislator will find hard to ignore or resist since our generally accepted major premise of tax justice is that equals should be treated equally. But the very fact that the argument frequently is persuasive serves to underscore why preferential provisions have a propensity to multiply. No matter how compelling the case for special relief may be in one situation, there will almost always be other taxpayers who can demonstrate that their situation is comparable if not identical. Congress then has two avenues for treating equals equally: it can revoke the preference which it has already granted or it can give a comparable preference to those in comparable situations. No great research is needed to show which of these ways is likely to be chosen. We all know that there is a reluctance to withdraw a preference once granted, that a sudden revocation might disturb plans made in reliance upon it, and that the unraveling process might itself cause new complications and discriminations. A legislator's freedom of action is thus hedged about by the largess or sympathy or mistakes of his predecessors in office. But nevertheless there can only be one of two results if the original preferential treatment is retained in the law. Either the pleas of taxpayers with comparable cases will have to be turned down, or comparable preferences will have to be written into the statute.

It is generally agreed that simplification of the income tax is a goal to which we should aim. Simplification may well mean different things to different persons. It should be obvious, however, that a compounding of preferential provisions must in the long run serve to increase the complexity of the tax. Conversely, real simplification can be achieved only through the elimination of preferences now in the law.

V. Effects of Special Provisions on Tax Advisers

Some mention has already been made of the impact of preferential provisions upon professional tax advisers—that is, lawyers and accountants. It is clear that as the law grows in complexity, more taxpayers consult them and they work under heightened pressure to arrange for their clients the maximum tax advantages available. Moreover, as special legislation expands in volume, the professional adviser tends increasingly to become a lobbyist on behalf of his clients. These happenings have not been without consequences for the professions involved.

It has repeatedly been observed in recent years that the general lawyer or accountant is often no longer in a position to supply adequate advise on tax matters. Gradually a more or less well defined group of tax men has been emerging to cope with the complexities of our tax system. It may be questioned whether this development is of itself desirable or whether it is inevitable in a society which is almost everywhere putting a premium on specialization. Whatever be one's opinions on these issues, the fact is that the creation of the tax specialist itself represents another major cost of the tax system for our society. Furthermore, this development has affected taxpayers as a whole because for many years the usual lag in the production of competent specialists existed. There is abundant evidence that many taxpayers received inadequate tax advice at a time when general practitioners were not in a position to master the complexities

accompanying the special provisions, and when specialists were either not available or their role was not recognized. In effect a whole range of new discriminations could be said to have come into existence between taxpayers who did and those who did not or could not obtain competent advice.

The development of a group of tax specialists has paralleled and perhaps has affected the role of the professions in tax legislation. To what seems to be an increasing extent, members of the tax bar have become special pleaders for preferential legislation on behalf of their clients. In and of itself such activity calls for no reproach. Through the years in many situations lawyers have traditionally served their clients in presenting views to the legislature, and this is entirely proper in the tax field even though in the end it may turn out that tax lawyers are incidentally the prime beneficiaries of an increase in preferential tax rules. Lately, however, leaders of the tax bar themselves have begun to express uneasiness that many of their fellow specialists have moved so far in the direction of special pleading that they are in danger of losing all capacity to judge proposed legislation objectively from the point of view of our tax system as a whole. Such an occurrence would indeed be a significant loss. A high degree of skill is required to write our tax laws and regulations in a sound manner, and the available supply of talent is definitely limited. If any large share of it were indifferent or actively hostile to the public interest, or if, as some have cynically predicted, the organized tax bar became an organized taxpayers' lobby, it is certain that our tax system would suffer.

While there is no way of demonstrating decisively that the attitude of taxmen toward legislation has been affected by the high incidence of preferential enactments, it appears most likely that the two things are related. Surely the successes of special pleading in the past have encouraged further efforts along the same line. Certainly the ease or strategems with which various preferences were secured has caused not a few taxmen to become cynical about notions of justice in taxation. The very fact that Congress has frequently been willing to overturn Supreme Court interpretations of the statute favorable to the Government has itself augmented this attitude. It is indeed a sad commentary on our system to have leading taxmen confidently boast that, "If we can't win in court, we can always win in Congress."

In brief, the pyramiding of preferential provisions in our tax law is slowly but surely likely to make inroads on the public morality of professional taxmen. Of course, it will not directly influence them to countenance loose practices or wink at frauds on the revenues. It is very likely, however, to weaken their will to serve the public interest and to undermine their convictions about the justice of our system. What this might eventually lead to is anyone's guess. But it is safe to predict that the cynicism of tax advisers is almost certain to be communicated to their clients and to infect them as well.

VI. Special Provisions and the Administration of the Tax Law

Preferential provisions might also have an effect on taxpayer morale through their impact on the administration of the tax law. It has already been noted that the complexities introduced by the accumulation of special provisions in the law greatly burdens the administra-

tion of the income tax. Taxpayers on the average are more likely to request assistance from revenue officials; controversy and litigation are almost certain to expand; and there is virtually bound to be an increase in errors committed by taxpayers. Moreover, the revenue officials will be in need of more extensive training so as to be able to advise taxpayers and properly administer the provisions. As professional tax counselors become more specialized, their counterparts in Government service are likely to feel pressure for comparable specialization. And, as the number of distinctions drawn by the law increases, the lag in learning is apt to be experienced inside of Government service as well as by taxmen on the outside.

All of these items have one thing in common: They tend to divert the drive of revenue officials away from the central task of checking up on the accuracy of returns and taxpayer compliance with the law. Unless the size and quality of the administrative staff is kept abreast of the additional workload generated by special provisions, a vicious cycle can be set into operation. As enforcement proficiency declines, more and more taxpayers get by with inproprieties in their returns. This in turn encourages them to repeat or enlarge their questionable practices and, as word gets around, tempts other to follow suit. The result is likely to be an even heavier handicap for the administrators, coupled with a shrinking chance that the improprieties of taxpayers will be detected. And so the administrative process is in danger of running downhill steadily, and increasing great efforts will be required to convince the taxpaying public that the Revenue Service had stepped up its enforcement activities to close the breach.

That this unpleasant picture of taxpayer response to ineffective administration is not more fancy is shown by some reactions to new preferential provisions introduced by the 1954 code. To many taxmen, for example, it is a familiar story that not a few taxpayers last year helped themselves to an undeserved retirement-income credit because they reasoned that it would be years before the Revenue Service would be in a position effectively to police the provision. Others for the same reason knowingly enlarged the dividend credit to which they were entitled by showing a relatively larger portion of their dividends as having been received in the months that counted for the credit. Whether the total of such indiscretions is large or small is beyond the immediate point. The fact is that in the thoughts of some taxpayers the efficiency of administration was downgraded because of the new complications in the law, and these views have been and are being spread to others.

VII. Broad Versus Narrow Special Provisions

So far all preferential provisions have been lumped together in commenting upon their consequences. However, it sometimes is argued that, wholly apart from their merit on grounds of equity or economic effects, special provisions which are fairly general in their application are less obnoxious than those whose applicability is restricted to only a few taxpayers. The thought here is simply that in our tradition the rules of taxation ideally are to be general rules, and a more general preference seems to be closer to the ideal than a less general one.

Certainly a special dispensation for which only one or a handful of taxpayers can qualify is most undesirable. Our sense of fairness

is apt to be irritated by what virtually amounts to the incorporation of a private bill in public law. The more private the bill the more likely it is to offend against our ideal of government by rule of law. But fairness (and economic considerations) to one side, special legislation of limited applicability probably has fewer undesirable consequences than special relief of a broader nature. The private bill variety of preference hardly can be said to complicate the tax system to any appreciable extent inasmuch as so few taxpayers need be concerned with it. In all probability, the more limited the scope of the preference, the less likely it is that any sizable number of taxpayers will know about it at all. Moreover, because of its minuscule reach, neither private tax advisers nor Government administrative officials need give much thought to the private bill type of preference. Similarly it is not likely that such legislation will stimulate much tax planning or maneuvering to come within its terms. For the same reason a narrow preference usually does not have much potential to produce controversy or litigation. And by and large it is probable that the tightly circumscribed character of the private bill variety of preference does not lend itself readily to spawning new preferential provisions by suggesting analogous situations which seem to merit comparable treatment. In all these respects it is easier to live with special legislation of restricted applicability.

Thus, for example, take the special provision which suspends the usual percentage limitation on the deduction of charitable contributions where the donor's contributions and income taxes in 9 out of 11 years have exceeded 90 percent of his taxable income in each of those years. Everyone would agree that this special rule is relatively tame and not burdensome. Apart from the inescapable conclusion that it is hard if not impossible to justify on grounds of equity or policy, and passing over the fact that it clutters up the statute, this preference is not particularly disturbing and we can be sure that few taxpayers will seek the distinction of qualifying under it. The undesirable aspects of special legislation which have been noted make themselves felt as we move away from such private bills to provisions of more general application. It perhaps may not be too much of an overstatement to suggest that these undesirable qualities tend to vary proportionately with the potential application of the preferential rules. Private bills may be most unjust on principle but it is the preferences with the widest application, such as the rules for capital gains, which have most dramatically exhibited those weaknesses of special rules with which we have here been concerned.

VIII. Conclusion

These, then, are some of the secondary consequences affecting the morale of taxpayers which might stem from the adoption of preferential provisions. That they could have a bearing on the health and strength of our income tax is patently clear. It is also plain that, despite the large number of special provisions which have found their way into the law, these consequences have not yet appeared in alarming proportions. This is high testimony to the ability of our income-tax system to absorb considerable punishment before it reaches the danger point. If we could be sure that we have seen the end of the growth of special legislation, the secondary consequences perhaps

could be regarded as unimportant and attention could then be confined to the merits of the special provisions now in the law. But one of the secondary consequences, as we have seen, is the propensity of preferential provisions to produce progenies. Should preferential legislation continue to mushroom in the future as it has in the past, the secondary consequences could seriously impair the workings of our income-tax system. From our vantage point of today, it would be highly imprudent to overlook them.

PRESSURE GROUPS AND THE INCREASING EROSION OF THE REVENUE LAWS

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I. INTRODUCTION

The democratic process—almost by definition—assumes that legislation is arrived at through compromise between pressures and counterpressures. Tax laws are no exception. But one need not repudiate the democratic process to deplore certain abuses which have been creeping into it. Pressure groups appear to be active and effective in the constant erosion of our tax system. The law is being riddled with special provisions while we preserve the fiction of uniformity and equity. I believe there is a basis for alarm over this trend.

To those who may think my concern naive—that is, trying to take political questions out of politics—I would point out that theirs is the philosophy of the French Chamber of Deputies. It is not merely realistic, but cynical. Most of us, I think, bemoan the fiscal plight of France. There in March of 1955 a tradesmen's lobby demonstrated its power by threatening to overthrow the Government unless it revoked penalties for tax delinquencies and for resisting inspection of their books. Yet if we can be critical of France, may we sit idly by and watch the erosion proceed in more subtle ways?

It is highly appropriate that pressure groups on all sides—whether business or labor—be represented on such questions as rates, exemptions, and the choice between higher excise, individual income, or corporate income taxes. As Dr. T. S. Adams [1] said 30 years ago, modern taxation or tax-making is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. The concern here is not with the basic structure of the act, but with the patchwork which obscures it. The efforts of pressure groups may take the form of a subsection, or euphemistically called technical changes—each of them difficult to detect and becoming apparent only after careful study. However innocuous they may be individually, collectively they point out an accelerating tendency away from uniformity and toward preferential treatment. The Internal Revenue Code of 1954 has not altered this trend.

One economist [2] has argued that when tax revenue exceeds 25 percent of national income, the danger point has been reached. Many

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[1] Adams, Ideals and Idealism in Taxation, 18 American Economic Review, p. 1 (1928).
[2] Clark, The Danger Point in Taxes, Harper's, December 1950, p. 67.

disagree. But regardless of our stand on that question, there is another limit on taxable capacity which is basically psychological and has been too long taken for granted despite its importance. Our fiscal system cannot survive unless the majority of the citizenry retain confidence in the equity and uniformity of our tax system. Preferential treatment breeds disrespect for the revenue laws, and without respect there will be no effort made to abide by them.

My task here is to take two revenue acts, of 1951 and 1954, and through them demonstrate the current trend toward special legislation. Much of this material has already appeared in the Harvard Law and Harvard Business Reviews, and has been reprinted in the Congressional Record.[3]

II. Relief for Individuals and Special Groups

Special relief provisions for individuals and private groups contained in the old law have been reenacted and are firmly embedded in the 1954 Code. Probably the finest demonstration of legislative tenacity, and of human incapacity to weed out laws once on the books, is the section (1240) popularly known as the Mayer provision, in honor of the alleged principal beneficiary under it.[4] The provision bears the deceptively general title of "Taxability to Employee of Termination Payments." As a general rule of taxation, except in the case of qualified pension plans, any lump-sum distribution upon retirement is taxable to the employee and bunched in 1 year as ordinary income.[5] Yet to resolve this predicament in the case of one movie executive, the bill provided for capital-gains treatment, but only where the taxpayer (1) had been employed for more than 20 years, (2) had held his rights to future profits for 12 years, and (3) had the right to receive a percentage of profits for life or for a period of at least 5 years after the termination of his employment. How many persons could such a restricted provision cover? Perhaps some kind of relief such as an averaging system is needed for bunched income generally, or for retiring employees, but is there any sound basis for the relief of one executive through capital-gains treatment? It is especially noteworthy that counsel did not even trouble to present this amendment, and another involving personal holding companies, to the House Ways and Means Committee, but took all the matters which he sponsored directly to the Senate Finance Committee. Apparently pressure upon Members of one House sufficed to insure enactment of both measures.[6]

In 1954 the question arose as to how this provision should be treated in the new code. Presumably because of its narrow scope, it was omitted in the House bill. However, in the hearings before the Sen-

[3] 68 Harvard Law Review 745 (March 1955); 33 Harvard Business Review, p. 103 (September-October 1935); 101 Congressional Record, p. 86 (May 24, 1955, pp. A3612-A3620)

[4] Internal Revenue Code of 1939, sec. 117 (p), added by 65 Stat. 504 (1951). See Miller, Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code, 64 Yale Law Journal, pp. 1, 13 (1954). Sections of the 1954 Code are hereinafter referred to simply by section number; sections of the 1939 Code, 53 Stat. 1, as they read immediately before repeal, are referred to by "old" section number.

[5] *E. T. Sproull*, 12 T. C. 244 (1951), aff'd per curiam, 194 F. 2d 541 (6th Cir. 1952); cf. *Elliott C. Morse*, 17 T. C. 1244 (1952), aff'd 202 F. 2d 69 (2d Cir. 1953). But cf. *Commissioner v. Oates*, 207 F. 2d 711 (7th Cir. 1953), 67 Harvard Law Review 1268 (1954); see Eisenstein, A Case of Deferred Compensation, 4 Tax Law Review, p. 391 (1949).

[6] See Hearings Before the Senate Committee on Finance on H. R. 4473, 82d Cong., 2d sess., pt. 3, at p. 1478 (1951).

ate committee the proponent pointed out that "no explanation of the omission is contained in the Ways and Means Committee report, and it is believed that the omission was inadvertent." He urged not only that the bill should incorporate the existing provision but also that the provision should be extended to cover a few other borderline cases. The plea was effective to achieve the reacceptance of the original provision by the Senate,[7] though it did not go any further.

A new case of congressional generosity in the 1954 Code seems tailored to the needs of certain commission merchants in the South. Whether by custom or rules of the trade, a few of them are required to do business as partnerships, although for tax purposes their preference would be in favor of operating in the corporate form. Their problem was considered by the Treasury and received serious attention in connection with the administration's stated policy of favoring small business. In his budget message of 1954, the President said that small firms should be able to operate under whatever form of organization is desirable without being influenced by tax considerations and then recommended "that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations."

Provisions implementing this recommendation did not appear in the 1954 House bill (H. R. 8300), but were incorporated in the later Senate version. Section 1351 of the latter provided that corporations could elect to have the tax status of partnerships under specified conditions, and section 1361 gave an option to partnerships where capital was a material income-producing factor to be taxed as corporations. The latter was described in the Senate report as "complementary to the similar option granted certain corporations."[8]

The first and more important section, section 1351, was eliminated in conference, but—though few were affected—the momentum behind section 1361 was enough to effect its retention, thus putting the cart before the horse. In other words, two provisions linked together by the President and Senate were separated, and only the minor one—benefiting a handful—was ultimately enacted. This is not a sensible solution. At this point it may be asked why these partners should not be permitted to be taxed as if incorporated when they are not allowed to operate in the corporate form. But if this is the case, should they be singled out or should the same relief be available to all the professions as well? They, too, are required to practice as partners. The facts are that the statute is carefully drafted to exclude lawyers, doctors, and all types of partnerships in which capital is not a material income-producing factor.

The 1954 code has not only incorporated the special relief provisions contained in preceding acts, but has also added new ones. A major example of largess in 1954 was in favor of inventors and persons financing them. Under the preceding law the controversy whether the sale of a patent should receive capital-gains treatment involved two questions: Was the originator an amateur or a professional, and

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[7] S. Rept. 1622, 83d Cong., 2d sess., pp. 115, 444 (1954) (hereinafter cited as S. Rept. 1622). "Your committee agrees with the objective of removing this provision prospectively but took that action in such a way as not to affect individuals who prior to 1954 entered into employment contracts relying on the application of this provision." Id. at 115.

[8] S. Rept. 1622, at p. 119.

did he receive for his patent installment payments or royalties taxable as ordinary income? The new code has not only omitted these conditions, but extended preferred treatment to anyone not a close relative or employee of the inventor who purchased an interest in the invention before it was reduced to actual practice. It should be noted, however, that the wishes of the patent lobby have not been fully satisfied. In the 1953 hearings the president of the National Patent Council urged that patents receive percentage depletion on the ground that -

> The depletion allowance is based on the fact that the supply of oil or minerals in a given area will eventually be exhausted. However, not one penny is given to an inventor for depletion, although a patent can last only 17 years.[9]

The benefits conferred upon inventors and their financial angels should be contrasted with the treatment of artists, authors, and composers under the current tax law. While many groups within our society (including a single movie executive) have become beneficiaries of amendments converting income into capital gains, the Revenue Act of 1950 administered the *coup de grace* to literary, musical, or artistic compositions by expressly excluding them from favorable treatment.[10] Why should the disposition of books and symphonies not enjoy capital gains, while the sale of patents, livestock, and coal and timber royalties do? Is it because America tends to favor material success at the expense of developing the arts? Surely it cannot be that our critics abroad speak the truth. Most of us believe that this is not a conscious policy of discrimination against nonmaterial values. In general, the reason why professional men and artists are not receiving favorable treatment is probably a pragmatic one. They are individualists, too scattered to represent an effective political force, and without a lobby dedicated solely to the cause of obtaining special tax advantages. For example, while 3 representatives of 2 separate patent organizations appeared before the Senate committee on the 1954 act,[11] only 1 representative of the Mystery Writers of America, Inc., was present.[12] Upon the conclusion of her testimony, the chairman asked, "Why shouldn't we give these people some relief?" and received the reply that "We looked into this, and it is just a question of how far we want to go in extending capital-gains treatment."[13]

Although the foregoing illustrate, without exhausting, the special relief provisions enacted in 1954, brief reference should be made to the amendment of old estate-tax provisions. The 1954 code excludes life-insurance proceeds from the estate, whether decedent paid some or all of the premiums, so long as he retained no elements of ownership. Even before the new section was 6 months old, it was said that the administration might seek its modification. Some officials have discovered that the life-insurance industry has been strenuously selling the new provision, telling clients that only through insurance policies can they completely escape tax liability.[14]

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[9] Hearings before the House Committee on Ways and Means on H. R. 8300, 83d Cong., 1st sess., pt. 2, at p. 1191 (1954).

[10] Sec. 210 (a) (1), 64 Stat. 933 (1950).

[11] See hearings before the Senate Committee on Finance on H. R. 8300, 83d Cong., 2d sess., pt. 3, at pp. 1662 1666, 1684 (1954).

[12] Id. at p. 1610.

[13] Id. at p. 1612.

[14] Wall Street Journal, November 17, 1954, p. 1, col. 5.

Full comprehension of the pressure for preferential treatment cannot be conveyed without consideration of 1955 and forthcoming legislation. Even before the President had signed the 1954 act, another tax bill had been referred to the Senate Committee on Finance, and was reported favorably. Congress adjourned before it passed.[15] The amendments included by the Senate committee provided relief to one railroad (retroactive to 1941), certain trusts for military personnel who died in action from 1948 through 1950, farmers selling livestock on account of drought, and other random beneficiaries.[16] Some of these were reintroduced and one has already become law. Public Law 310, approved August 9, 1955, involves a refund of taxes on trust income accumulated for servicemen and is so narrow that it must be pinpointing one situation. Other new special relief measures are pending for the second session of this Congress in 1956. See, for example, H. R. 7064, extending the period for stock option exercise for 6 months, rather than the present 3 months, after the termination of employment.[17]

Before analyzing further instances of congressional response to outside pressures, we should arrive at some preliminary generalizations from the preceding examples of relief to individual taxpayers and private groups. In each instance the character of the relief afforded is so technical as to make a simple explanation impossible. Being obscure or incomprehensible to the layman, it is not recognized as an outright favor to one individual or highly selective group. Moreover, the relief is not palpably unwarranted. The case involving the retiring movie magnate demonstrates one of the basic weaknesses in the tax system, namely, the taxing of bunched income where no averaging method is available. But this inequity affects a multitude of taxpayers: artists, writers, athletes, and all persons retiring under similar circumstances. The movie executive here is probably not injured as much as the actors who work for the same company. By the same token, the inventor has received favored treatment without any congressional notice of others engaged in creative work. Perhaps all these cases warranted relief, but is it not true that the tax laws work hardship in an infinite number of transactions? Can relief be scattered sporadically among a few individuals—whose only common characteristic is access to Congress—without making a mockery of the revenue laws? For every person who successfully argues that he is discriminated against there are thousands of others, inarticulate or ineffective, who are suffering the same fate in silence.

III. Relief for Special Industries

The code has not only scattered largess among specific individuals and private groups who requested relief but has also shown some evidence of responding to pressures from several industry groups. Of these, the oil industry has been the most frequently commented upon, principally by reason of the 27½ percent deduction allowed against

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[15] H. R. 6440, 83d Cong., 2d sess., passed the House on July 29, 1954, and was reported with substantial amendments by Senator Millikin, chairman of the Senate Finance Committee, on August 2, 1954. S. Rept. No. 2038, 83d Cong., 2d sess. (1954).

[16] H. R. 6440, 83d Cong., 2d sess., sec. 3 (1954).

[17] See also, among others, H. R. 6595, authorizing refunds of estate taxes upon certain transfers conditioned on survivorship made by persons who died after November 11, 1935, and before January 30, 1940.

gross income for depletion. No attempt will be made here to repeat the criticisms leveled at the favored status which the oil group enjoys.[18] Only a handful of Senators venture to oppose it. In fact, one Senator urged his colleague to withdraw a controversial amendment by saying, "I am simply trying to keep [him] * * * from committing suicide." [19] The industry now regards percentage depletion as a sacrosanct, almost constitutional, prerogative, but still not enough.

Several other extractive industries appear to have profited recently from effective lobbying: Coal in 1951 [20] and in the same year, sand, gravel, and stone. With respect to coal, the percentage depletion deduction was increased from 5 to 10 percent on the ground, stated in the committee report of 1951, that the coal-mining industry was peculiarly in need of more favorable tax treatment because of the inroads which alternative sources of energy, particularly oil and gas, had made on the potential markets for coal. It is interesting to note the inconsistent theories upon which the percentage depletion deduction is granted. On the one hand, the intention is to stimulate development and wildcatting by awarding such a tax advantage to the oil industry. On the other, it is to furnish relief to an industry which has suffered by reason of the increasing use of oil and gas. If percentage depletion has any function in our tax structure, should it be used to encourage development of one group and "bail out" another at the same time?

Another group which has been satisfied, after years of clamor over "discrimination," may be referred to loosely as the "sand and gravel lobby." In 1951 almost every known building material received a 5-percent allowance for depletion. When Senator Douglas moved unsuccessfully to strike out clam and oyster shells on the ground that he did not regard them as necessary to the national defense, Senator Connally said in debate, "The Senator from Illinois is greatly concerned about clam shells. He does not have many in his district." [21] In 1954, allowances for granite, marble, slate, and other stone, when used as dimension or ornamental stone, were raised from 5 to 15 percent.[22] In order to draw some line, however remote, Congress in the new code expressly stated that percentage depletion does not apply to soil and water, or minerals from sea water, air, or similar inexhaustible sources.

One of the most troublesome issues in 1954 arose over limestone. The general policy of the statute appears to be that minerals used for road material, concrete, or similar purposes shall receive only a 5-percent allowance. However, two Senators on the Senate floor pointed out that this would give higher grade limestone unfair treatment when used or sold competitively with items such as rock asphalt, which receives 15 percent even though used on roads.[23] The statute therefore was amended specially to provide 15-percent depletion where a mineral is sold "on bid in direct competition with a bona fide bid to sell a mineral" bearing the higher rate.[24] Thus the gates have

[18] E. g., Baker and Griswold, Percentage Depletion—A Correspondence, 64 Harvard Law Review p. 361 (1951); Blum, How To Get All (But All) the Tax Advantages of Dabbling in Oil, 31 Taxes, p. 343 (1953).
[19] 100 Congressional Record, p. 8864 (daily edition June 30, 1954) (Senator Neely).
[20] Revenue Act of 1951, sec. 319 (a), 65 Stat. 497.
[21] 97 Congressional Record, pp. 12335–12336 (1951)
[22] Sec. 613 (b) (6). See S. Rept. No. 1622, at pp. 78–79, 331–332.
[23] 100 Congressional Record, p. 9043 (daily edition, July 1, 1954) (both Senators were from Texas).
[24] Sec. 613 (b) (6).

been opened to permit even roadbuilding materials to receive further tax relief.

The next step can be best visualized through the testimony of the chairman of the taxation committee of the National Sand and Gravel Association before the Senate Finance Committee in 1954. He pointed out that the House bill at the time proposed a 15-percent allowance for limestone for whatever purpose used, and expressed the hope that "the wisdom and justification of the proposal will be recognized by your committee."[25] He further testified that the same considerations which led to this decision by the House apply with equal force and logic to the sand and gravel producers, who are in competition with producers of crushed limestone all over the United States.

The foregoing illustrations of congressional responses to pressure from industry groups point toward the basis upon which tax relief has been granted. As already noted, the extractive industries have been the principal beneficiaries. How have they succeeded so admirably, when in fact the coal industry's plea rests upon its depressed condition, while the oil industry bases its claim upon the importance of stimulating exploration and developing reserves? The formula in most cases appears to be the discrimination argument, the demand for tax equity. As one author has indicated, tax equity is achieved when the same load is placed on different persons who are in similar economic positions.[26] With respect to percentage depletion the coal industry sought to be placed in the same favorable position as the oil group, and the sand and gravel spokesmen felt they were being discriminated against if they did not receive treatment similar to that already available to the oil, coal, sulfur, and mining industries. And now that timber and coal royalties are afforded capital gains treatment, the lever of discrimination can again be used most effectively by the iron-ore and oil men to claim similar advantages for royalties and "in-oil payments."

IV. Relief Among Economic Groups

Investor

Moving from the privileged tax treatment accorded to specific individuals and industries, let us now attempt a brief survey of some of the important economic groups in our society and how they are faring in the race for special benefits. Today the large investor probably constitutes the most important beneficiary of preferential treatment. A Harvard Business School study has reached the opinion that much of the income received by upper-bracket individuals appears to avoid the full impact of the income tax.[27] One chart indicates that in 1946 there was little or no progression in effective tax rates beyond the $50,000 income level, and the maximum average tax rate was less than 50 percent, despite the fact that theoretical effective rates ranged as high as 85.5 percent.

The difference in effective tax rates on individuals with large incomes can be attributed in major part to capital gains. There is undoubtedly a segment among the investor group whose whole atten-

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[25] Hearings before the Senate Committee on Finance on H. R. 8300, 83d Cong., 2d sess., pt. 3, at p. 1267 (1954).

[26] Blough, The Federal Taxing Process, p. 48 (1952).

[27] Butters, Thompson, and Bollinger, Effects of Taxation—Investments by Individuals, pp. 65, 84 (1953). Much of the material in the subsection is based upon this excellent book.

tion is directed toward transactions which ultimately might yield return of a capital nature. Some of the available media are marketable common stocks, new ventures, real estate, oil properties, and closely held concerns. Since the war there has been considerable activity in the purchase and sale of appreciated property, sometimes following the acquisition of the stock and the liquidation of a family or close corporation. Another opportunity available to those in control of operating companies is to insure the retention of corporate earnings and continuous expansion until the owner can realize upon the correspondingly enhanced value of stock or assets at capital gains rates.[28] Furthermore, the area of capital gains has been growing to include timber royalties and, most recently, coal royalties.

As already described by Randolph Paul,[29] another, quite different, way of reducing the effective rate of taxation is through the purchase of tax-exempt securities and of insurance. A further grant available to the large investor, namely, percentage depletion, has already been discussed. Investment in oil royalties from proven fields offers one means of utilizing this advantage. Oil-drilling syndicates financed by persons of wealth have now become commonplace. They frequently invest a portion of their funds with the expectation of writing off intangible drilling costs immediately as an expense against high income and taking the additional 27½-percent deduction in the event that drilling is successful.

Perhaps the most obvious benefit to the investor group is the new dividend credit provision of the 1954 act.[30] Besides the argument of alleged double taxation, probably the major reason given for the relief is that the tax burden on distributed corporate earnings "has contributed to the impairment of investment incentives." The Senate committee report pointed out that capital which would otherwise be invested in stocks is driven into channels involving less risk, restricting the ability of companies to raise equity capital and forcing them to rely too heavily on borrowed money. Thus in part the credit for dividends can be described as an inducement to counteract the existing tax exemption of insurance and municipal bonds.

Corporate executives

Another group which has been substantially favored by the income-tax laws is the executives of established corporations. For some time this group has shared the advantages of pension and profit-sharing plans available to employees of such companies generally.[31] In order to qualify, such plans must be drawn in such a way as not to discriminate in favor of employees who are officers, shareholders, or supervisors. At the same time the group covered can be severely limited, and there is no objection to providing ultimately for substantial remuneration to top employees after retirement. The basic difference between executives and other employees is that the former benefit in a larger dollar amount. The new code has taken an additional step favorable to employees having sizable estates by excluding from the

[28] Butters, Lintner, and Cary, Effects of Taxation—Corporate Mergers, p. 94 (1951).
[29] See section of his paper entitled "Leakages in the Rate Structure."
[30] Secs. 34, 116.
[31] In general, the advantage to executives, i. e., employees, is that sums contributed by the corporation, while immediately deductible by the corporation, are not taxable to the recipient until their ultimate receipt.

estate tax any annuity or other payment receivable by a widow or other beneficiary under a qualified plan.[32]

One benefit available to corporate executives does not arise from a special provision in the code, but rather from a judicial definition of when income becomes taxable. Deferred compensation plans are common today, pursuant to which executives receive some of their increased compensation in the form of payments after retirement in return for acting as consultants.[33] The trend in the direction of favoring corporate executives is perhaps demonstrated most clearly by the stock option provisions, broadened in several respects under the 1954 code.[34] Having the alleged objective of providing an incentive for executives to obtain a stake in the enterprise, this provision nevertheless favors officers who are recipients of options, if they sell the shares after a limited time. Under these circumstances they are permitted to realize the profit upon their "stake" at capital-gains rates. The corporation law cases[35] demonstrate that such options are basically for services rendered and therefore compensation, which in the case of other classes in our society is treated as ordinary income, not as capital gain.[36] An interesting facet of the stock-option law is that it rarely provides relief for employees of small businesses because of the 10-percent stock-ownership limitation and the difficulty of ascertaining the value of the stock at the option date. This result is directly in conflict with the incentive rationale underlying the stock-option law, for the efforts of the management of a small concern seem more likely to be reflected in its success and the value of its shares than the efforts of employees of public corporations, where the price rise may represent stock-market trends or extrinsic conditions such as the Korean war.

Though not related to special legislation, a further avenue for privileged treatment of company executives and owners is through perquisites of office, which are becoming increasingly accepted among corporations today. The allocation of automobiles to executives for personal use, an executive lunchroom with meals at cost, club memberships, entertainment and expense accounts are probably the least objectionable of many benefits which today are available to many company officers.[37] Most of them are actually income to the person, but are difficult for the Internal Revenue Service to detect. In fact, any strict application of the principle of taxing all of them would undoubtedly be regarded as an attack on a customary method of doing business in this country.

Owners of family businesses

The owners of family businesses today are probably in a position even more favorable taxwise than that of corporate executives. Here the owners are in a favorable position to build up the company by accumulating profits which may be realized at capital-gains rates

[32] Sec. 2039 (c).

[33] Deferred-compensation plans are discussed in Washington & Rothschild, Compensating the Corporate Executive, pp. 168-185 (1951).

[34] Revenue Act of 1950, secs. 218 (a), (b), 64 Stat. 942, added sec. 130A to the 1939 code; retained as sec. 421 of the new code.

[35] *Kerbs v. California Eastern Airways, Inc.* 90 A. 2d. pp. 652, 656-657 (Del., 1952); *Gottlieb v. Heyden Chemical Corp.* 90 A. 2d., pp. 660, 664 (Del., 1952).

[36] For a demonstration of the potential profits ($21 million for the corporate officers participating in 26 stock-option plans), see Stryker, Do Stock Options Pay?, Fortune, December 1954, p. 118; see also Miller, Capital Gains Taxation of the Fruits of Personal Effort; Before and Under the 1954 Code, 64 Yale Law Journal, p. 1 (1954).

[37] For lurid expositions of the growing use of expense accounts, see Havemann, Expense Account Aristocracy, Life, March 9, 1953, p. 140; F. Allen, The Big Change, pp. 215-218 (1952).

through ultimate sale or liquidation. The cost involved is payment of the corporate tax and an ultimate capital-gains tax upon earnings which, if distributed as dividends, would have been taxable to the owners as income. Moreover, one of the most important tax advantages to the owners of family businesses today, whether in the corporate or partnership form, is the facility to charge off substantial amounts of personal expenditures as business expenses. And it should be noted that the proprietors of closely held concerns have an extraordinary opportunity to benefit through a profit-sharing and pension plan in their capacity as employees of their own companies. In these respects they can have many of the advantages available to the executives of public corporations, and yet do not lose any possible opportunities to realize on their profits through ultimate sale or liquidation at favorable rates.

The owner of a family business, like the large investor, can spread the total earned income of the business over the family group to obtain tax advantages. This may be done in the corporate field by the distribution of shares to members of the family or to trusts for their benefit. Largely because such a benefit was available to persons operating in the corporate form, the same kind of relief was made available to family partnerships. Thus in the case of both corporate and partnership firms where capital plays some part, owners are able to spread among their family groups income derived in large measure from their own efforts.

Organized labor

The tax benefits derived by organized labor under the Internal Revenue Code are not yet on a par with those of the investor, corporate executives, or business owners. The capital-gains provision, for example, is of less advantage to the average worker. Also, no opportunity is afforded for taking generous deductions, by reason of the withholding process. As a consequence, it is not surprising to find that organized labor has opposed as loopholes many of the provisions which Congress has enacted favoring other economic groups: percentage depletion, capital gains, and the like.[38]

At the same time labor can scarcely be described as unrealistic. Tax considerations have played a part in the current shifting of bargaining from wages alone to payments in the event of retirement, layoff, accident, or sickness. Perhaps ultimately labor will resort to the same arguments that have been relied upon by business owners and executives. Already the tax position of organized employees in established firms is much more favorable than that of workers as a whole. The former may be said to receive preferential tax treatment through pension and profit-sharing plans, under which contributions are exempted from tax in the hands of the trust and until actually received by the employee. The 1954 code further provides that total distributions paid to the employee within 1 year on account of his death or other separation from service shall be considered capital gain. The code has carried over, and in some cases broadened, previously enacted exclusions from income in the case of contributions by employers to health plans, compensation for injury and sickness,

[38] See, e. g., the testimony of the director of the department of education and research of the CIO, in the hearings on the Revenue Act of 1951 before the Senate Finance Committee, 82d Cong., 1st sess., pt. 2, at p. 932 (1951).

wages continued in such event, and $5,000 of insurance paid by reason of the employee's death.

A movement seems to be growing to bargain for broader fringe benefits, which might be treated as falling under a comprehensive definition of income. These benefits take innumerable forms, such as free meals, medical service, summer vacations, purchase discounts, and insurance. They have grown from $8.8 billion in 1952 to $9.6 billion in 1953.[39] Yet there is some doubt whether it is administratively feasible to tax them. Perhaps by reason of taxes our society is moving back to the status of a barter economy. As Professor Ratchford has said, "we are going through a development which is just the opposite of that which marked the end of the feudal period when wage payments were being commuted into money. Now many wages are being commuted into tax-free services. Perhaps the time will come when the individual unfortunate enough to receive all of his wages in money will have an impossible tax burden."[40]

Farmers

It is perhaps never fully appreciated that one class of persons profiting extensively from the present tax laws is the farmer. In general the benefits he receives do not flow from special legislation. Part of the farmer's tax advantage seems to stem from three facts: Farmer's lodging (like that of all homeowners) is not treated as income; none of the fuel or food, if the farm is self-supporting, is included in income; and there is much careless reporting, perhaps even deliberate omission.[41] As a practical matter, is there any real way of enabling the Government to realize upon any one of these sources of income? Much of the benefit farmers receive can be attributed to the impossibility of administering a tax law which could include, or even discover, all items that might in theory be treated as income in the farmer's hands. At the same time it cannot be said that farmers as a class are resting on their existing favorable tax status. The Revenue Code now provides that income derived from disposition of livestock should have the benefits of capital-gains treatment.[42] At one point in the history of the bill turkeys, but not chickens, were included.[43] Both were finally eliminated. But now that favorable treatment has been accorded to quadrupeds, the question may arise whether similar advantages should not be accorded to poultry, and ultimately to crops.

Professional people

One element in our society which may be regarded as orphaned under the Internal Revenue Code is the professional class. Although

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[39] New York Times, October 17, 1954, sec. 3, p. 1, col. 5.

[40] Ratchford, Practical Limitations to the Net Income Tax—General, 7 Journal of Finance, pp. 203, 211 (1952). "During 1949 these [fringe benefit] programs became the primary issue on the collective bargaining agenda of many unions * * *. This intensified drive * * * resulted in the extension of these plans to more than 7½ million workers by mid-1950." Id., at pp. 210-211.

[41] "For 1945 * * * the startling result is that 'only 36 percent of farm income was reported on tax returns * * * as against 87 percent of nonfarm entrepreneurial income'." Heller, Practical Limitations on the Federal Net Income Tax: Limitations of the Federal Individual Income Tax, 7 Journal of Finance, pp. 185, 198 (1952).

[42] Sec. 324. 65 Stat. 501.

[43] H. R. 4423, 82d Cong., 1st sess., sec. 1175 (1951). In the course of the Senate debate Senator George said, "I certainly cannot take the chicken amendment to conference. Turkeys were included somehow, I do not know how." 97 Congressional Record, pp. 12336-12338 (1951).

lawyers and doctors are said to enjoy their peak earnings during the 20-year span from the age of 40 to 60,[44] there is no opportunity to average that income throughout their working lives. It is true that lawyers, writers, and other professional men have the opportunity to spread an extraordinary amount received in any one year over a longer period if the services rendered cover more than 3 years, but the privilege is a limited one.[45] There is little tax relief and no pension plan available to professional people, though bills are now pending which may afford them the opportunity to deduct a portion of their income provided it is irrevocably set aside until their retirement.[46] The status of actors, athletes, and artists is even worse. The span of their earning power frequently is a period of less than 10 years. They are probably the worst victims of the principle that income must be computed upon an annual basis and taxed in the year of receipt. Although authors, artists, and musicians share the privilege of spreading the income received from work involving prolonged effort, they too may fairly claim to be victims of discrimination. Why should not the disposition of books and symphonies enjoy the capital-gains treatment that the sale of patents, livestock, and interests in coal and timber now receives?

V. Relief to the Blind and the Aged

Quite apart from the provisions favoring economic groups, special relief is expanding to benefit the blind and the aged, two relatively new and separate classes of recipients. The Biblical objects of pity were "the maimed and the halt, and the blind,"[47] but thus far, and for reasons which appear to be wholly divorced from logic, only blind persons have been accorded special treatment.[48] An additional exemption of $600 is available to them. It seems perilous to raise the issue, for this hole in the revenue dike has remained small. Yet, over the last decade, with developments in medical statistics it has become apparent that many more people are totally disabled—indeed bedridden—from causes other than blindness. Mental illness is one example.[49] Still the pressure in favor of the blind appears to have been the only politically effective one. The issue before Congress, then, is whether to widen the breach or close it; as things stand, the situation seems incongruous at best.

Professor Paul Strayer[50] has already discussed relief for the aged before the American Economic Association, and pointed out that the provision of extra exemptions for taxpayers over 65 is continued, and that an additional tax allowance for retirement income has been added by the 1954 act.[51] Thus, generally, older people will not pay

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[44] Postponement of Income Tax on Income Set Aside for Retirement, hearings before the House Committee on Ways and Means on H. R. 4371, 4373, 3456, 82d Cong., 2d sess., pp. 13, 14, 18 (1952); Silverson, Earned Income and Ability To Pay, 3 Tax Law Review, p. 299 (1948).

[45] See sec. 1301.

[46] See, e. g., the Jenkins-Keogh bill, H. R. 10, 83d Cong., 1st sess. (1953); see generally note, 66 Harvard Law Review, p. 1105 (1953).

[47] Luke 14: 21.

[48] Sec. 151 (d).

[49] According to the Statistical Abstract of the United States (Department of Commerce, 1954), p. 89, patients in hospitals for mental disease in 1951 were 584,455. This may be compared with 320,000, the total number of blind persons as of 1954, reported by the American Federation for the Blind, New York.

[50] XLV, the American Economic Review, p. 430 (May 1955).

[51] Sec. 37.

any income tax if their retirement income does not exceed $4,000. The advantages of age are further extended by complete exemption of social-security payments, and other special provisions for certain types of retirement income and also for some annuities. Mr. Strayer finds it difficult to justify this trend when contrasting the position of the older group and those starting out in life. The latter group has little stock to draw upon and cannot wisely expand what little capital they may have. The desire of those who are forced to retire to live more nearly as they had been able before their reduction in earning power explains the appeal to the aged. Yet—as he points out—all of us wish to live better or have larger incomes than we do, and probably the young could "out yearn" the aged any day. In this connection perhaps special emphasis should be laid upon the aging of the population—which means that erosion of the revenue will broaden in the coming years.

VI. Conclusions

Perhaps the general conclusion can now be ventured that the tax laws represent a patchwork of special legislation awarded on a random basis. It may be too late for thoroughgoing reform, but there may yet be time for occasional improvements. At this point, therefore, let us attempt to restate some of the dangers arising out of these deepening inequities in the code. The United States has operated under a system of self-assessment of taxes, which of necessity assumes strict adherence by the great majority of people. As indicated at the outset, if the average taxpayer finds our tax laws more and more checkered with special legislation, the danger is that disrespect will spread and make enforcement impossible. Whatever may be the economic limit upon taxes, there is a practical and psychological limit which is probably short of it.

Part of the problem today is the general acceptance of a philosophy of taxation which attempts to justify a system of disuniformity. Randolph Paul has already referred to George O. May's analogy between the revenue process and a football game: "You have to let someone get through the line and score a touchdown occasionally or you won't have a game." [52] This homely argument of a distinguished accountant in favor of capital gains is another way of saying that with rates as high as they are, holes in the code must be available so that someone can make money. But should these holes be drilled for the benefit of those who can exert the most pressure? And if many such escapes are provided, doesn't tax collection then become a process of "dipping deep with a sieve," to use a phrase of Henry Simons? It may be said in rebuttal that virtually every provision in the code is preferential to some more than others—which no doubt is true. Yet within broad classifications there can still be some restraint upon special provisions and some effort to cling to uniformity. Otherwise the law, already hopelessly complicated, will soon approach the ridiculous.[53]

Without such restraint, it is difficult to see where the accelerating pattern of preferential treatment can stop. The likelihood of continuing special legislation is demonstrated by the number of pressure

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[52] Tax Institute, Capital Gains Taxation, p. 22 (1946).

[53] See Blum & Johnson, 1913–2013, A Hundred Years of Income Taxation, 33 Taxes, p. 41 (1955).

groups which appear in every hearing on revenue measures before Congress. The four volumes of testimony preceding the latest general revision, from June to August 1953, demonstrate the current zeal of hundreds of interested groups and their representatives to be heard.

Many of the special provisions owe their existence to the discrimination argument. Perhaps the principal point made before Congress is that, since one group in our society has received a benefit, the complainant deserves like treatment. The more preferential the legislation written into the code, the greater the opportunity for others to claim they are being discriminated against. The difficulty lies in finding, first, some logical basis for drawing a line, and second, some political groups supporting the policy of drawing it. There are very few organizations before Congress opposing further extension of capital-gains treatment. Perhaps we are gradually approaching the taxpayer's millenium, when all citizens have available the benefits of converting ordinary income into capital gains.[54] As one writer has indicated, the preferred political way of reducing inequities is to extend an existing privilege to new groups, instead of withdrawing it from the present holders.[55]

A final danger, already self-evident, is the increasing complexity of the tax laws. The 1954 code has added to the confusion. Only counsel spending the majority of his time in minute examination of the tax laws is competent to assure his client that he has taken full advantage of the existing benefits under it and avoided the pitfalls.

> Every word added to the code for the benefit of some particular taxpayer may well prove a trap and a very costly one for some other unsuspecting taxpayers.[56]

It is ironic to recall the statement which appeared in the minority report on the Revenue Act of 1943:

> We should develop as soon as possible a long-range, integrated, well-balanced, equitable, and simplified scheme of taxation, and we of the Republican minority propose to do all in our power to bring about such a plan.[57]

The recitation of dangers arising out of preferential legislation poses the final question: What correctives are available in a political society? Frequently one hears the suggestion that the pressures exerted and special favors sought are all due to current tax rates, and there would not have to be relief provisions if the rate structure were not so high. As a rough generalization this is partially true, though there would still be persons seeking percentage depletion and other deductions and even lower capital-gains rates. At any rate, it is undeniable that the intensity of the efforts to obtain special treatment would slacken if rates were lower, and if we could be sure that some reduction would satisfy existing pressure groups, it is certainly worth serious consideration on the part of Congress. But so long as international tension exists and the budget remains unbalanced, one obviously cannot expect revenue receipts to be reduced substantially. Politically, as well as economically, high taxes and some progression in rates appear to be a part of the facts of life.

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[54] As described in Blum, The Decline and Fall of Capital Gains: 1921–1957, 28 Taxes, p. 838 (1950); See also Johnson, The Last Taxpayer, 30 Taxes, p. 181 (1952).

[55] Heller, Practical Limitations on the Federal Net Income Tax: Limitations of the Federal Individual Income Tax, 7 Journal of Finance, pp. 185, 195 (1952).

[56] Miller, Ethical Problems in Lobbying for Legislation, 8 Tax Law Review, pp. 19, 22 (1952).

[57] H. Rept. No. 871, 78th Cong., 1st sess., pt. 2, at p. 7 (1943).

There is no set formula for arresting this pattern of preferential legislation. Obviously, Congress is not going to eliminate all the special provisions which have been wedged into the code. But my chief alarm focuses not so much upon the existing law but upon the accelerating trend. The particularity and complexity of the 1954 code offers an even better medium for the intrusion of additional relief provisions. If there was a philosophy of taxation in the 1939 code, it has been lost in the 1954 revision. With this concern in mind, I venture to make several suggestions which can do little more than abate the fever and not cure it.

First of all, I would favor the application of an averaging provision to a broader group of transactions. At the outset it might be relatively simple, like section 1301 of the 1954 act, which has for some years been applicable to persons in law, writing, and other professions. There are averaging proposals before Congress now which should also be considered. In connection with averaging generally, there are no doubt inequities in the law which warrant some remedial treatment. Among the foremost is the taxing of bunched income representing years of effort or capital accretion. But whenever pressure groups urge their case to receive capital-gains treatment, these questions should be asked: (1) Is there any logical basis for relief at all; and if so, is the need for relief more urgent than the need on the part of other taxpayers' groups; and (2) if relief is to be granted, is the transaction such as to warrant averaging rather than conferring capital gains as an overgenerous form of relief?

Second, although elimination of every existing special provision is too much to expect, Congress should commence a rollback and exorcise at least a few inexcusable sections as a symbol of its effort to hold the line, if nothing more. Section 1240 involving the Mayer provision, section 1351 favoring southern commission merchants, and section 1235 benefiting inventors are but several examples.

Third, as a general rule, regardless of which party is in power, the views of the Treasury should receive more consideration from Congress on questions of uniformity and fairness in tax bills. Much of the special legislation which appears in the revenue acts represents congressional action taken against the advice of the Treasury. It is in a stronger position than is Congress to represent the public interest because each Senator and Representative is subject to pressure from constituents and special groups. In this connection, some of us were disappointed with the fact that the Treasury seemed to abdicate its position last year, and did not offer its separate recommendations with respect to the proposed Internal Revenue Code of 1954.

Fourth, more information should be available to Congress itself, in the hope that it might act with greater watchfulness. To reach individual Congressmen more effectively there might be separate technical staffs for the House Ways and Means and the Senate Finance Committees, as well as the Joint Committee staff. For some years the latter has been directed by its able chief of staff, who, being the agent of both the Senate and the House, cannot always take a position strongly opposing provisions personally sponsored by leading Members of either. In view of the fact that Senators and Representatives have differing objections to legislation before them, it is possible that each committee's staff might screen bills proposed in the other House

and keep members advised of any evidences of special favor. Thus a system might ultimately become established for checkmating undesirable measures introduced by legislators overwhelmed by pressure from a constituent or an organized group in their districts.

A fifth suggestion stems from the fact that in congressional hearings there is practically no one, except perhaps the Treasury, available to represent the public. Perhaps the reason is that all of the pressure group proposals are of such character that no one of them would have a large adverse effect on the tax bill of any individual. Hence counterpressure groups seldom develop. A second reason why the public is not more frequently represented is the difficulty of forming pressure groups around general interests. The concentration of business organizations on appeals brought to Congress and the emphasis placed on specific and often very technical provisions make it difficult even for the members of the tax committees to secure a balanced view of what is in the general interest, what the public wants or, indeed, what the public would want if it were informed as to the facts. In order to obtain such a balanced view, therefore, it is suggested that several leading tax experts throughout the country be invited and retained to make a presentation before the Ways and Means or Finance Committee. Because they may be restrained by loyalty to private clients, these lawyers could indicate the provisions in the bill on which they could not render an unbiased opinion. At the same time some of the craftsmen of the tax bar might, as a public service, be willing to call Congress' attention to particular provisions in which special legislation is creeping into a pending tax bill. Many of them have served willingly as advisers upon the American Law Institute project to revise the tax laws.

Elsewhere I have urged that the blame cannot be left solely upon Congress' shoulders without some twinges of conscience. It is too easy to cry "politics" without recognizing the forces determining political decisions. I have attempted to stress the responsibility of bar associations for the ever-widening circle of preferential legislation. Yet neither Congress nor the legal profession is acting on its own without pressure in turn from constituents or clients. Businessmen and business organizations, likewise, must ask themselves what is their role in stemming the tide.

Since they must seek reelection, it may be too much to expect Representatives to ignore the pressures exerted upon them. But lest our system of taxation break down, a presumption should exist in the mind of every Congressman against enacting tax legislation for the benefit of one individual or company or even of special groups. In each case the question should be raised whether the proposed bill will generate as much inequity as it is supposed to remedy. The decision before Congress on revenue bills differs radically from that on subsidies in general. In many instances the parties involved have first attempted to secure relief through the Internal Revenue Service or the courts, and failed. Under any circumstances, Congress should try to resolve tax issues in almost a judicial manner, determining whether relief is justified in view of the hardships inevitably imposed by a uniform revenue statute. Let me repeat, for every one who obtains relief on the ground that he has been the victim of discrimination, there are thousands of others who are suffering the same fate in silence.

THE ECONOMIC COST OF ADMINISTERING SPECIAL TAX PROVISIONS

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As used in this summary discussion, the term "Economic Cost" means the impact of all efforts expended by public and private entities in furtherance of taxpayer compliance with the Federal tax laws, but does not include the efforts involved in "compliance" as such. The term "Administering" means all efforts public and private in the tax laws' interpretation, communication, and enforcement. The term "Special Tax Provisions" means any and all provisions of tax law which are designed to afford significant preferential treatment within each of the *normal* basic taxpayer categories.

ENTITIES BURDENED WITH "ADMINISTERING" THE FEDERAL TAX LAWS

The initial burden of administering the Federal tax laws is distributed among each of the following: (*a*) The Internal Revenue Service; (*b*) certain classes of private citizens and organizations, such as employers, excise-tax collectors, and information return filers who are charged by law with certain administrative duties, and tax advisers whose services are available professionally; (*c*) all agencies of the executive branch of Government other than the Internal Revenue Service; (*d*) State and local governments; and, (*e*) the judicial branch of the Federal Government.

(*a*) *The Internal Revenue Service*

The major components of the Internal Revenue Service's part in administering the tax laws are (1) interpretation of the tax laws for the public through the preparation and issuance of regulations, special rules, and tax return forms and instructions; (2) collection of the revenue through the receipt and accounting for all payments and the forcible collection of taxes due but not timely paid; (3) the audit of tax returns as required by section 6201 (a);[1] (4) the conduct of special investigations involving apparent fraud; (5) regulatory and inspection duties in respect to alcohol and tobacco taxes; (6) the hearing of taxpayers' appeals involving protested assessments; (7) legal services incident to interpretation, trials, and enforcement; (8) internal inspection duties; (9) statistical services as required by section 6108 and related analyses of operations; and, (10) executive direction. For the fiscal year 1954 there was expended for these functions $241,103,000 involving some 50,000 man-years of effort, and $27,866,000 in other than personal services.[2]

(*b*) *Certain classes of private citizens and organizations*

The major components of this group's part in administering the tax laws are (1) advising with and assisting their employees and others in arriving at an understanding of the tax laws as applied to them; (2) obtaining income tax withholding exemption certificates as required by section 3402 (f); (3) collecting on behalf of the Government the employment taxes as required by subtitle C of the 1954 code; (4) collecting on behalf of the Government all excise taxes which by

[1] All section references are to the Internal Revenue Code of 1954.

[2] Annual Report of the Commissioner of Internal Revenue for the Fiscal Year Ended June 30, 1954, pp. 32–33.

law are separately identified as part of the price paid by the consumer such as retailers' excise taxes, and excise taxes on facilities and services, as distinct from those taxes imposed by law upon the seller, such as the manufacturers' excise taxes, irrespective of the "shifting" involved;[3] and, (5) the preparation and filing of information returns on wages, dividends, rents, etc., to aid in the administration of the laws.

The total initial cost of providing these services as a necessary adjunct in administering the laws is not known. It is, however, reasonable to assume that it is not less, and probably much greater, than the aggregate of the $269 million expended by the Internal Revenue Service. This assumption is based on estimates derived from the known volume of reports involved.[4]

(c) Agencies of the executive branch other than the Internal Revenue Service

The major components of this group's part in administering the laws are identical with those for group (*b*) above, with the omission of the excise-tax requirements. The assistance-rendered factor is probably more costly to the Defense Department than in the case of all the other executive agencies combined because of the tax problems peculiar to members of the armed services. In addition to those listed under group (*b*) above, other factors are involved in this category such as (1) legal and enforcement work of the Department of Justice, and (2) the entire cost of the Tax Court of the United States (which for this purpose is being included with the executive branch of the Government). The initial cost of this group is not known but the amount cannot exceed a small fraction of that expended by the Internal Revenue Service.

(d) State and local governments

The major components of this group's function are (1) advising with and assisting their employees in arriving at an understanding of the tax laws as applied to them; (2) obtaining income-tax withholding exemption certificates as required by section 3402 (f); and (3) collecting on behalf of the Government the employment taxes as required by subtitle C of the 1954 code. No precise information is available as to cost but here, too, the amount is negligible in relation to that expended by the Revenue Service.

(e) The judicial branch of the Government

The major cost here is that represented by the proportion of total time devoted to tax cases. This is included as a part of the cost of "administering" the tax laws as administration includes enforcement and there cannot be enforcement without court action in some cases. The total cost of the Federal judiciary is in the neighborhood of $30

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[3] Collection of taxes from someone else in behalf of the Government is here classified as "administering" the taxes, while the payment of taxes such as manufacturers' excise tax is "compliance," with which we are not concerned in this paper.

[4] Quarterly listing of approximately 45 million employee names on schedule A of form 941; annual preparation in triplicate of 125 million forms W-2; annual preparation in duplicate of 35 million forms 1099; the payroll accounting work incident to the tax deduction for each payroll period during the years of some 50 million employees; the current maintenance of a file of approximately 65 million exemption certificates on form W-4; the rendering of advice to several million employees and others during the tax-filing period; and the accounting for, the collection of, and the filing of reports on form 720 relating to excise taxes separately stated, numbering approximately 3 million.

million. The proportion applicable to tax cases can hardly exceed one-tenth of this amount.

DISTRIBUTION OF THE COST IN ADMINISTERING THE FEDERAL TAX LAWS

The initial, as distinguished from the ultimate, cost falls heaviest upon certain classes of private citizens and organizations; secondly, upon the Internal Revenue Service; thirdly, upon agencies of the executive branch of the Government, other than the Internal Revenue Service; fourthly, upon State and local governments; and, lastly, upon the judiciary. The distribution of the final burden, however, is highly diffused as indicated below:

(*a*) Certain classes of private citizens and organizations: All private citizens and organizations who are charged by law with a part in "administering" the tax laws and who close their tax year with a taxable income can shift a portion of their initial expense in an amount equal to their tax rate by means of taking such cost as a deduction for ordinary and necessary expenses. Those who have a part in "administering" the tax laws who have no taxable income cannot shift the burden in this manner which, undoubtedly, results in many hardship cases. The certain classes of private citizens and organizations mostly concerned with administration of the laws are the 600,000 nonexempt corporations, of which about two-thirds show a taxable income, and one-third a deficit; exempt organizations, numbering 126,000, practically all of which show no taxable income; sole proprietorships numbering about 6.8 million, of which 1 million show a loss; and partnerships numbering close to 1 million, of which around 10 percent show a loss.[5] Obviously the major part of the task is handled by the taxable entities as they have the larger number of employees, and substantial relief is provided through the tax deductions for their expenses. Thus this portion of the cost is passed on to the general economy through an aggregate reduction in tax receipts. In the case of the remainder of the cost for the taxable entities, and the total cost for the nontaxable entities, such portion of the cost must be borne by the owners, except where some portion of such cost is passed on by the owners to the public through added prices.

In the case of the private tax advisers whose services are available professionally, the cost of such advice is generally deductible by the client as an expense for the preparation of tax returns. Thus, the cost of this administrative element is borne partly by the taxpayer seeking advice and partly passed on to the general economy through an aggregate reduction in tax receipts.

(*b*) The last four groups—namely, the Internal Revenue Service; agencies of the executive branch, other than the Internal Revenue Service; State and local governments; and the judiciary derive the funds to cover their expenses from general governmental appropriations, and, therefore, it must be assumed that the ultimate burden of this cost is distributed in the same manner as all other governmental expenditures from the general fund, namely, in accordance with the distribution provided by the tax system itself.

[5] U. S. Treasury Department, Statistics of Income for 1952.

Thus a summary conclusion might be stated as follows: The dollar cost of administering the tax laws is borne partly by the owners of business, partly by the consumers of the goods and services of such business, partly by taxpayers who require the advice of private counsel, and the remainder is distributed among the taxpayers in direct proportion to the taxes each pays. The probability is strong that something more than half of the overall total is being borne by the owners of business and taxpayers seeking private counsel, a relatively small proportion by the consumers of the goods and services of the owners, with the taxpayers in general (including the two foregoing groups) bearing the remainder in proportion to the taxes paid by each.

The economic cost, as distinguished from the dollar cost, if measured by productive output of an equivalent number of man-years in physical production, as contrasted with service production (of a type spent in "administering" the tax laws) would, of course, be distributed differently, namely, according to the distribution pattern of physical goods which the same number of man-years of effort would produce.

There are no fixed standards as to the extent and quality of "tax administration." Tax laws on which little effort is expended in "administering" them tend to shift a greater effort to the "compliance" aspect, and vice versa. As for example, savings in tax administration by cutting down on information pamphlets, educational efforts, taxpayer assistance programs, and the like reduce the cost of "administering" a tax law, but make the effort of "compliance" greater, as well as lessen the quality of compliance. Thus any measure of "administrative costs" must take into account the quality and extent of administrative effort.

In general there is a fairly reasonable relationship being maintained between the two efforts of "administering" and "compliance" with, of course, "compliance" by its nature being forced to assume the larger share of the cost. Notable exceptions to this reasonable relationship in which too little effort is expended in "administration," relate to (1) certain of the excise taxes at the retail level; (2) employees' exemption certificates on file with their employers; (3) wages not subject to withholding; (4) business and investment income in the lower income classes; and (5) more prompt and thorough scrutiny of all returns involving ingenious tax minimization schemes. This is not a criticism as the administrator's choice is limited by available funds and he must establish the necessary priorities, and certainly there are many phases of administration with a higher priority than can be claimed for some of the items cited.

Special Tax Provisions

Against the above outlined general background the economic cost of administering special tax provisions will be examined. As indicated at the outset, the special tax provisions, for the purpose of this paper, means any and all provisions of law which are designed to afford significant preferential treatment within each of the normal basic taxpayer categories. Thus, this runs the whole gamut of taxpayer differentiation affected by type of entity, size of income, time and nature of receipts and expenses, geographical location, age, state of health, and family status.

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Over the past several years each of these normally basic categories have undergone many refinements by way of differentiation. By way of illustration, under type of entity, we find that an "individual" may now be distinguished by such characteristics as outside salesmen, self-employed for social-security purposes, farmers for declaration and other purposes; "partnerships" may be distinguished as between those electing to be taxed as partnerships or as corporations; "corporations" as between collapsible and various other types; and "estates and trusts" as between simple and complex. The size of income is now distinguished between those who can and who cannot "split" their income. The time of receipts and expenses now involves many new considerations for averaging income; the nature of receipts are affected by such things as postponement in the case of sale of personal residences, exclusion in the case of sick pay, capital gains versus ordinary income and dividend income; the nature of expenses are affected by added categories of depreciation. Geographical location is used to distinguish between income earned abroad and that earned within the United States; and, Western Hemisphere corporations. Age of taxpayer now becomes an important factor in personal exemptions and the retired income credit. State of health accounts for many new distinctions in respect to the medical deduction. And family status has developed many fine distinctions such as surviving spouse, head of household, care of dependent children, dependents in college, and a host of others.

These special provisions are fairly normal projections of prior laws stemming from the natural tendency to provide more and more by way of equity as between categories of taxpayers, and will in all probability continue by way of further refinements over time. Whether or not the direction of the course in which the laws are moving is wise is not within the scope of this paper. Consideration here will be limited to the economic cost of administering the special provisions.

Dependents

Among the special provisions, the one most common to the largest number of individual taxpayers is that providing for dependents. The refinements that have been made in this area by the 1954 code for purposes of distinguishing between taxpayer categories may be summarized as follows:

The general definition of a dependent has been broadened by the 1954 code to embrace (*a*) unrelated persons having as their principal place of abode the home of the taxpayer and are members of the taxpayer's household; (*b*) cousins of the taxpayer who receive institutional care because of physical or mental disability provided they are recognized as a member of the taxpayer's household; (*c*) persons who normally would not qualify because of failure to receive more than one-half of his or her support provided multiple-support agreements are entered into by those eligible to claim the dependency relationship; (*d*) persons under 19 years of age earning $600 or more provided they are a son, stepson, daughter, or stepdaughter of the taxpayer; (*e*) persons in (*d*) above if 19 or over provided they are students of the type defined by law.

From the overall categories of eligible dependents, a taxpayer who claims the status as head of household must have out of this list as a

member of his household either a son, stepson, daughter, stepdaughter, or a descendant of one of these. The same is true for one who claims the status of a surviving spouse.

For one who claims the child care deduction the dependent definition places a 12-year-age limitation on the son, stepson, daughter, stepdaughter group unless physically or mentally incapable of caring for himself. But a descendant of any of these is excluded for this purpose. For the medical expense deduction the basic exemption rules apply as to who is and who is not a dependent.

In computing the amount contributed toward the support of a dependent to determine whether or not more than half was contributed by the taxpayer a new exclusion item has been added by the 1954 code, namely scholarships.

Sick pay exclusion

Perhaps the item next most common to the largest number of people is the new sick pay exclusion and the more liberal rules for medical expenses.

Both of these items have many finely devised distinctions for purposes of preferential treatment. These are followed in frequency of application by the new rules relating to (*a*) dividend credit; (*b*) annuity exclusion and the retirement income credit; (*c*) interest on installment contracts; (*d*) life insurance contracts; and (*e*) sale of personal residences.

These, of course, are but a few but will serve to indicate the nature of the problems involved in administering special provisions.

Problems of administering the special provisions

Under date of February 14, 1955, in testimony before the Subcommittee of the Committee on Appropriations of the House, Commissioner Andrews stated in part as follows: "We are having a tremendous demand for taxpayer assistance. In volume, I am told that it is 100 percent above what it was last year. Why I know the increased demand is tremendous is because I see it in the lines which have congregated in our buildings, and we are giving them assistance."

Every additional provision requires added information on the tax return form and instructions, yet this is not enough; for example, the official instructions relating to the multiple-support agreements carry the statement "Consult your Internal Revenue Service office for information regarding the filing of these declarations." Also, the instructions regarding the exclusion ratios for annuities contain this statement, "The multiples are set out in actuarial tables which will be furnished by your Internal Revenue Service office upon request."

The overcrowding of information and instructions on tax returns is also indicated by the instructions regarding sick pay exclusions which resort to the statement, "Attach a statement showing your computation," rather than providing a formal schedule to guide the taxpayer in this computation. The same type of instructions appear under the "reimbursed expenses" line, which reads, "Attach a detailed statement in explanation."

In addition to the taxpayers' need to consult the Revenue Service, the employers get their share of requests for help in connection with such items as "cost of annuities," and the tax status of "fringe benefits." Brokerage houses and dividend-paying corporations also assist in the administration through helping their customers and stockholders sort

out the information needed for capital-gain purposes and the dividend credit.

The Commissioner has the duty to require reasonable documentation of each item on the return, yet how does one go about documenting an exemption claim for a child under 19 years of age with $700 of summer earnings, which involves such vague accounting factors as board, lodging, clothing, cost of education, medical and dental care which are seldom allocated accountingwise among the members of the family group? Or, how does one document the "convenience of employer" rule? Or the numerous expenses incident to occasional travel away from home, medical expenses, the dividend credit, and numerous other income and deduction items that are so hedged about with finely drawn distinctions as to be wholly impracticable of complete communication to the taxpayer through the regular medium of the tax return forms?

The result, of course, is one of approximation of the correct tax and the extent of its deviation from complete accuracy is far from being known.

Yet lines must be drawn somewhere to carve out those segments for preferential treatment. Some of those lines are as follows: (1) A son and a stepson are dependents. A son's descendants are dependents but the descendants of the stepson are on the other side of the line. (2) A child 19 or over who attends day school for 5 months is a dependent, but one who attends for 4 months is not. One who attends day school is a dependent while a night school disqualifies him as a dependent. (3) A person may qualify as a head of household on the basis of his son's son living with him but not on the basis of his stepson's son. (4) The child-care deduction is allowable if paid to the taxpayer's cousin but not to her niece. One by one the rules are fairly simple but in aggregate become complex due to sheer numbers.

Thus, the Commissioner is confronted with the problem of "how to tell the story" to the taxpayer in brief and intelligent form without burdening him with information not essential to his particular tax status. This accounts for the many kinds of tax forms, such as the form 1040-A for wage earners, the long and short form 1040, with other divisions as between farmers, other businesses and professions, and salaried workers. This always involves the risk of not telling every taxpayer all he should know to protect his interest as well as the interest of the Government. For example, the taxpayer who is content with the short return, form 1040-A, should know something more about the things he is giving up taxwise than can be shown on the instructions accompanying that type of form.

And finally, there is the problem of fast-changing relationships in respect to the taxpayer's family status, nature of his income and deductions, and in the tax law itself, which pose new problems for the administrator and the taxpayer each year from the standpoint of keeping up to date with respect to the application of the special provisions.

As may be expected, these problems invariably result in imperfect compliance and imperfect compliance in turn raises the cost of administering the law. For example, note the following exchange of questions and answers appearing on pages 477 and 478 of the hearings

before the Subcommittee of the Committee on Appropriations of the House under date of February 16, 1955:

Mr. CANFIELD. Mr. Commissioner, you told us yesterday that as a result of improved selection methods you have discovered that 68 out of every 100 returns calling for refunds that you examined contained errors. What is the usual type of error found?

Mr. DELK. Mainly the errors are excessive claims for deductions in the nature of medical expenses or for dependents, claims for exemptions, and such things as that.

Mr. CANFIELD. In other words they go to the substance and not merely to mathematical calculation?

Mr. DELK. No, sir; the mathematics are not questioned in that group * * *.

Mr. ANDREWS. I would like to say, Mr. Chairman, and Mr. Canfield, that we regard this activity as not only of great importance, but of tremendous significance. It is my considered opinion that if we do not do a thorough job in this particular area that our whole revenue system would fall into almost disrepute.

Mr. CANFIELD. You indicate that the average amount of tax error per return was up from $95 in 1953 to $115 in 1954.

The returns of the type under discussion were the so-called prepayment refund cases of which there are some 30 to 33 million annually out of the 56 million returns filed. The errors referred to by Mr. Delk go directly to those special provisions which are common to the largest number of taxpayers.

Areas of problem concentration

In looking over the distribution of individual income-tax returns as reflected by the Statistics of Income for 1952, the latest available official tabulation, we find that the returns with adjusted gross income of under $2,500 account for (1) 38 percent of all returns filed; (2) 28 percent of all exemptions claimed; (3) 32 percent of all returns reporting tax withheld from salaries; (4) 43 percent of all returns claiming refunds on account of excessive tax withheld from salaries (of those in this class, 75 percent claimed a refund); (5) 50 percent of all returns reporting annuities; (6) 19 percent of all returns claiming a medical deduction; (7) 26 percent of all returns reporting income or loss from sole proprietorships; (8) 20 percent of all returns reporting income or loss from partnerships; and, (9) only 5.2 percent of the total tax liability.

In making this comparison, it should be pointed out that there is nothing particularly significant about the $2,500 adjusted gross income level as the same general type of relationship as between workload and tax would be seen from the $2,000 to $3,000 dividing line. The $2,500 class was selected solely as a matter of convenience in drawing off the approximate lower third of the income scale.

The points to be observed from this comparison are as follows: (1) 28 percent of all the problems relating to interpretation, understanding, and application of the many fine distinctions relating to exemptions are localized in an area in which the tax liability is proportionately too small and the volume is too great to warrant the spending of any substantial sum by way of "administration" on the part of the Internal Revenue Service; (2) the same is true of the medical deduction, the annuity inclusions and exclusions, the numerous income and expense items of the sole proprietorships and partnerships, or the verification of the credits for tax withheld and the amounts refunded; (3) the fact that the Internal Revenue Service has a low "administrative" cost in this area is due largely to its efforts being necessarily limited

to clerical processing operations of receiving, recording, and filing the papers involved and certain types of office checking for internal consistency, with only negligible external checking of independent sources, such as would be involved in an effective audit program; (4) the fact that the Internal Revenue Service can get by with little expenditure in this area does not mean that the "employers" can do the same, as they must spend at least as much and sometimes more in connection with exemptions certificates, payroll deductions, tax reporting, etc., for the under $2,500 wage earner than for the higher-income employees; (5) the necessary failure over time on the part of the Internal Revenue Service to properly police the returns in the lower-income group tends to add to the "administrative" burden of the employer as such group becomes more indifferent to the record keeping requirements and, therefore, will require more assistance and guidance from their employers.

Some points to be borne in mind regarding this area of problem concentration are the following:

(1) The Revenue Service is able to make an effective audit of only about 3 percent of the 56 million individual income tax returns,[6] which audit is necessarily heavily weighted with the returns above the $2,500 class, thus limiting its administrative expense below the $2,500 class to clerical processing actions.

(2) The employers have to bear the major portion of the cost of "administering" the special exemption provisions by assisting their employees in the preparation of exemption certificates and tax returns.

(3) The cost to the employers in handling the exemption problems for the under $2,500 class is equally, or more expensive, than for the higher-income classes.

(4) The special provisions, in addition to exemptions, such as medical deductions, sick-pay exclusion, retirement-income credit, the dividend credit, and the annuity exclusions are relatively more important taxwise to the lower income classes than to the higher income classes but receive practically no verification by way of effective audit.

(5) The under-$2,500 class comprises better than a one-third of the employers' administrative cost and more than one-third of the Revenue Service's nonaudit costs, but accounts for only 5.2 percent of the total individual income tax.

(6) Of the returns of under $2,500 reporting tax withheld from salaries and wages, 75 percent result in withholding tax refunds in whole or part, with close to one-half of the 23 million being wholly nontaxable because the reported exemptions exceed the reported income.

(7) The total nonaudit cost to the Revenue Service attributable to these 23 million returns is in the neighborhood of $40 million, which if applied to the effective audit of returns above the $2,500 level would result in added taxes under the present revenue law of close to $800 million.[7] This, plus the tax value of the expense deduction by employers for their part in "administering" the exemption provisions related to these employees would exceed the total tax due under the 1954 Code on all returns of under $2,500.

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[6] Computed from data shown on p. 12 of the Annual Report of the Commissioner of Internal Revenue, 1954.

[7] Treasury-Post Office Appropriation Hearings, House committee, 1955, pp. 552–558.

(8) Despite the foregoing, one-third of all taxpayers at the lower end of the income scale are subjected by law to precisely the same intricate rules contained in all the special provisions as are the two-thirds in the higher brackets. The reason, of course, is the ever desirable objective of "equity."

The problems created by the special provisions for the upper bracket two-thirds of the taxpayers are much less from an administrative standpoint because of the higher "compliance" average potential of this group. In other words, the compliance burden is assumed to a higher degree by the taxpayers themselves which in turn lightens the load of "administering" the law. (It should be recalled that this paper is not concerned with measuring the compliance cost.)

While it is true, as previously indicated, that substantial additional sums can be obtained through more effective audits in the upper two-thirds of the income scale, the "underreporting," which is synonymous with imperfect voluntary compliance, stems more from errors in substantive reporting rather than failure to understand the "special provisions" of the type under discussion.

Catalog of factors determinative of economic cost

(1) The need to prescribe a variety of types of individual income tax returns to fit particular groups of taxpayers rather than one type for all taxpayers results in much inaccurate distribution and wastage of blank forms because of taxpayer classification changes from year to year.

(2) The impossibility of providing adequate instructions results in much loss of taxpayer's time from work in seeking assistance either of the Revenue Service, his employer, or a tax practitioner.

(3) The high degree of inaccurate reporting (as indicated by Commissioner Andrews) in certain areas results in added expense in money and time to the Revenue Service and the taxpayer.

(4) The resources of the employer devoted to maintaining the necessary records and counseling with his employees in respect to tax provisions are diverted from his main productive effort.

(5) The resources of the Revenue Service devoted to assisting the taxpayers to an understanding of the special provisions could more profitably be applied to a more substantive enforcement of the laws.

(6) A long continued policy of "weak" administration, as indicated by the audit of only a small fraction of the returns encourages weak compliance with increasing tax losses. (Voluntary compliance has been described as a valuable national asset subject to depreciation unless kept in adequate repair through strong "administration.")

(7) Special provisions tend to cancel each other as they approach the lower brackets (such as any one of a group may be all that is necessary to render a return nontaxable without the need of the others) but accurate reporting requires the taxpayer to make a complete report, thus adding to his work and that of the Revenue Service with no difference in tax effect. (For 1952 there were 10.5 million nontaxable returns filed, which number will materially increase under the added special provisions of the 1954 Code.)

(8) The technicalities of the special provisions has added greatly to the printed matter privately published and sold throughout the country, which adds to the Nation's cost of tax administration.

(9) States which attempt to pattern their income-tax laws after the Federal law are hard-pressed to keep apace with the special provisions and further confusion and cost results either whether they lag or whether they keep apace.

Conclusions

Quantitative answers as to the economic cost of administering the special provisions are not possible to obtain with precision, but the evidence appears to justify the following generalizations:

1. The cost of reasonably complete administration of the special provisions for all returns would be prohibitive under our concept of good government.
2. The cost of the highly incomplete administration of today in respect to returns to which the special provisions apply is proportionately much higher in relation to the tax on such returns than on returns of other types; and in many cases greater than the tax.
3. Diversion of funds for the administration (although only partial) of the special provisions costs the Government much by way of revenue through failure to make appropriate tax audits; and, the employers much by way of added production.
4. The administrative cost of administering the special provisions, although relatively small in relation to the job to be done, is sufficiently large to dilute the administrator's fire upon the main job and adds an element of inefficiency in overall tax collection with a resulting leakage which should be charged against the cost of administering the special provisions.

SPECIAL TAX PROVISIONS AND THE ECONOMY

HAROLD GROVES, University of Wisconsin

Introduction

My assignment as I understand it is to consider the economic effects of the various provisions of the tax system other than rates, credits, the selection of one tax as against another, and the overall level of the tax burden.

Before I take up some of the more important of these provisions one by one, I shall seek a bit of orientation by listing some of the principal ways in which taxation can affect the economy. In so doing I can also probably suggest my own general point of view.

Let me first say a word, however, about the relation of equity considerations to the economic ones. Leaving aside the controversial matter of progression, tax equity is another phrase for impartiality of treatment (or, at any rate, of consideration) for taxpayers. It implies the evenhanded application of the tax laws. Our tradition requires that the rules of taxation shall be general rules. It is true that there may be exceptions—indeed, it is often said that taxation is the classic example of a case where the exceptions are more important than the general rule. But the exceptions themselves must be general to a degree and moreover they must carry a positive burden of proof. A tax exception is first cousin to a subsidy and even more suspect because it is less conspicuous and aboveboard. One of the principal grounds on which exceptions may be defended is that they serve an economic end—facilitating either the growth of the national

income or the stability of its flow. However, exceptions may also be the product of pressure politics successfully opposing the public interest. Our problem is to distinguish the sheep from the goats in some of our special tax institutions.

List of economic effects

Now for a brief catalog of the economic effects (actual or possible) of taxes:

1. First, and not our immediate concern, we may note the effect of tax increases and cuts which, along with expenditure manipulation, determine the ebb and flow of money to and from the Government. The level of taxation, of course, is a factor in budgetary policy and budgetary policy is a factor in controlling inflation and deflation.

2. Second, there is the effect of taxes on the availability of capital. This is a function of the degree of taxes and of their progressivity and to some extent of what the Government does with the money. For many years it was generally agreed that the availability of capital was the limiting factor in economic progress. This was the prop that held the line for years against the upsurge of progressive taxation. Stanley Jevons, a British economist of the 19th century, expressed the general trepidation when he said: "Let it ever be remembered that the vast machine of British industry depends for all its movements upon a profuse supply of capital * * *." But now we hear divided counsel upon this matter. Our advertisers are praised for their service in extending the bounds of consumption. We give away huge sums abroad and note with satisfaction that this helps to clear the shelves of our enormous output of goods. There are those who still hold to the classical view that whatever is saved will be invested if taxes do not interfere with incentive. I do not pretend to the degree of sophistication that would support an estimate of what would constitute optimum saving in our time and place. I say only that I doubt that much if any business expansion justifiable on other grounds has been held up for want of capital during the last 15 years. However, the availability of equity capital for small and growing firms is another matter and one that may well cause us some concern.

3. Third, there is the perennial question about the effect of taxation on incentives—the incentive to work, to save, and to risk. It seems true beyond doubt that taxes can dry up their source, or as it is frequently said, they can kill the goose that lays the golden egg. They differ in many respects from fines—yet can be used with much the same effect.

But when this is said it must be added that most of what we hear about taxes and incentives is in the Fourth of July speeches of those who have a special interest to serve. The general character of most taxes is itself a protection because rewards like many other things are a relative phenomenon. The virility of the American economy in the face of heavy taxation has surprised all of us more or less. We do look abroad and shake our heads about the alleged moribund character of the British and Scandinavian economies where heavier personal taxes have prevailed longer than here; but as far as I can learn even these economies seem to have recovered reasonably well from the shock of the war—at least compared with the French, where incentive-preserving indirect taxes have featured the national tax system.

What empirical evidence we have—the well-known Harvard studies—does not indicate that the effect of our taxes in this country

has substantially undermined the work habits or changed the investment patterns of our people. John Stuart Mill advised economists many years ago that the delicate mechanism of the price system would not permit much meddling without unfortunate consequences, but he thought the ultimate rewards of the system might be altered very substantially without serious repercussions.

4. Taxes and the expenditures which accompany them can have a powerful effect on our most important resource—human beings. I find here the principal justification of progression at least at the bottom of the scale. On the expenditures side a financial program that improves the environment and extends the opportunities of youth may be a top-yielding investment; and on the taxation side a program which encroaches upon the private means also requisite to a suitable environment for youth may squander our most important (future) factor of production, along with potentialities for national defense and citizenship. I put the special emphasis upon youth because of the acute emergency in education and because they in some special sense are properly regarded as the wards of the state. They cannot be said to share the sins (economic or other) of their parents, and they represent the greatest capacity to respond to a public investment in people. I know well enough that not all the factors in a suitable environment for youth are economic; but many of them are, and it behooves the state in its tax policy not to encroach upon them. Here you may recall the advice of a famous economist, A. C. Pigou, who observed that the marginal net product of resources wisely invested in persons is likely to exceed that of resources wisely invested in material capital.

5. Taxes and tax devices may have economic effects because they alter the flow of revenue over time. As to Federal taxes, the features that augment the flow in boom times and retard it in bad economic weather are generally applauded. They are said to increase the "built-in flexibility" of the system. One of the characteristics of the tax system associated with built-in flexibility is its progressiveness, and anything that decreases the latter also reduces the former. This is because progression doubles up the influence of a change in the tax base; the effective rate goes up and down with the tax base. Of course, built-in flexibility is advantageous only if we are willing to tolerate deficits during bad times; and it is no more effective (except that it is faster, is automatic, and probably more equitable) than a change in the rate schedule. In any event, in recent years much attention has been bestowed on this matter of timing—loss carryovers and deprecation provisions and LIFO accounting have especially been subjected to the test of their effect on built-in flexibility. Our confidence that there will be no recurrence of 1930 nightmares rests considerably on the flexibility that is built into our tax system.

6. There is the economic effect of uneven taxes upon the allocation of economic resources. The uneven incidence may arise either in the selection of taxes or the exceptions that are made to their general application. It may also arise from uneven administration from otherwise neutral laws. The clearest case of the former occurs in excise taxation; a tax on liquor, for instance, is supported in part on the ground that it would be desirable to discourage the consumption of liquor and reduce the size of the liquor business. Examples outside of excise taxation are also easy to cite; heavy reliance on property

taxation for local financing is said to adversely affect our outlays for shelter; a prejudicial incidence of various taxes on railroads is said to threaten the maintenance of our transportation system. And so on. Within the income-tax field special allowances for depletion are said to encourage the employment of capital in the discovery and exploitation of natural resources. Personally, I generally lean to the view that unneutralities in the tax system should be minimized and confined to cases that can shoulder a heavy burden of proof.

No doubt among the most defensible unneutralities in the tax system would be those that encouraged small and new business at the expense of firms that are large and mature and established. Or one might applaud features that discouraged growth by intercorporate investment and merger. At least periodically the American people manifest some recurrence of concern about these matters. But taxation has not proved itself too ready or precise an instrument to serve these ends. It is true that the graduated feature of our corporate income tax and our partial levy on intercorporate dividends may make for reduced concentration. Our treatment of undistributed profits, in my opinion, has worked in the opposite direction. I shall have more to say about some of these matters later.

Loopholes and high-top income rates

The term "loophole" is well established in tax parlance but no one so far as I know has taken the trouble to define it with precision. Some say that it designates any exception in the tax laws which the particular critic using the term does not like. Thus, while many Americans refer to the favors granted capital gains as a loophole, the British seem to accept much larger favors as a part of the natural order. Anyway, fair critics must recognize that some exceptions in the tax laws are justified and amply qualified to carry their burden of proof.

Nevertheless I am one of those critics who takes a dim view of the growing list of so-called loopholes in the tax laws. As to equity I agree with Walter Heller who has observed that "growing erosion and corrosion of the income-tax base is increasingly raising questions as to how far we can extend our reliance on this form of taxation." As to economics I suspect that there are many loopholes that follow their natural course of distorting the economic mechanism without beneficial compensating gains. They were not passed with serious intent to achieve an economic objective; they were passed under duress from pressure groups or with design to reduce the impact of a severe schedule of rates for the higher brackets. I said on an earlier occasion before this committee that "the impression is widely shared that the Congress deliberately throws a high-rate scale to the public as a demagogic bone and then as deliberately allows escapes from taxes that make these rates specious." The result is unfortunate both in terms of enforcement of what remains of the law and in terms of the public respect for the Congress. We can't afford too much cynicism in attitudes toward the income tax.

Now I am not here to enter a plea against the top-income tax rates but I much prefer lower rates to a combination of high ones and the fine print that makes them partially ineffective. If it be true as alleged that the high rates serve principally as an incentive to devise new loopholes, secure their enactment and adjust one's affairs to their avail-

ability, then these rates, I submit, should be reduced. There are two ways to give relief to any group of taxpayers; one is to reduce rates and the other is to provide avoidance devices. The final result wouldn't differ in terms of equity if everyone could put himself in position to enjoy the loopholes in nice proportion to his income and the established scale of rates. Such is not the case, however, and this means that avoidance devices introduced to temper a tough rate scale end by opening the door wide to capricious incidence of the tax system.

The first and least controversial principle of tax equity is that two persons whose relevant circumstances are the same should pay the same tax. As to economics, all will agree, I think, that it is better for the businessman to spend his time contriving to increase his income than to spend it contriving to do better taxwise with the income he already has. The unwanted beneficiary of the present combination of circumstances is the lawyers. Theirs is a necessary and noble profession but we could well dispense with that part of it which lives well off of some of the nice distinctions in the tax laws.

Now to survey the special features of the tax system with special regard to economic effects, we may start with the most troublesome of all—capital gains taxation.

Capital gains taxation

So far as considerations of equity go, I am convinced that there is a high preponderance of logic to support parity treatment of this form of income. Equity can hardly support a distinction between a man who makes a million dollars buying and selling stocks and one who does so buying and selling potatoes. It hardly suffices to say that one is a producer, the other a speculator. So what? Or that in the case of the stocks there may be as many losses as gains. Relative taxation is not a matter of revenue.

To be sure there are or may be aggregation problems in the case of the stocks—perhaps the realization in 1 year of income that has been accumulating over a 10-year period. This calls eloquently for a new feature of the system that would in effect apply the marginal rates of tax that would have prevailed if the gains had accumulated annually. This cannot be done perfectly but it could be achieved with fair approximation; it represents the minimum extension of our ad hoc provisions for averaging income over time that is clearly required for equity and for the mitigation of special privileges associated with capital gains taxation.

The capital gains tax tends to add progressiveness to the income-tax system and special favors to reduce it; this is because capital gains are heavily concentrated in the high brackets. The economic effects associated with progressivity such as built-in flexibility are consequently reinforced by including capital gains in the base.

Yet the real case for the concessions to capital gains is the economic one and in this case the effect of taxation on incentives. We do have some evidence from the Harvard incentive studies that investors lend support to young and growing firms because of the tax advantage that goes with capital gains. However, there is no evidence that this requires complete exemption of capital gains or even as large a tax advantage as that now allowed.

The standard criticisms of capital gains taxation on the score of economic effects do not appear to me to be convincing. One holds

that the tax creates an artificial shortage of good stocks because people tend to hold them lest they pay the penalty of the tax. But the pressure which limits the transfer of stocks would appear to be about as effective in curtailing demand as in checking supply. Those people who enter the selling side of the market today will be back tomorrow on the buying side. I give more weight to a second argument, namely, that the tax interferes with the liquidity of investments and prevents exchanges that otherwise would and probably should occur. But I find the argument especially valid against another feature of capital gains taxation—and a loophole in most any man's book—the feature which wipes out acquired increments on the death of the taxpayer.

The capital gains tax and the progressive feature of our income tax may serve in another and salutary way as a check upon the excesses of the stock market. When investment-seeking funds tend to exceed the opportunities for new real investment, the investor has two recourses—one is to hoard his money in idle bank accounts, and the other is to invest in existing stocks. (We have precluded the third possibility—that is to create new assets and stocks—by assumption.) If he takes the second of these alternatives he will help bid up the price of stocks. This avoids unemployment of money all right and it avoids inflation in the commodity markets, but it provides no employment for idle workers and it does artificially inflate the stock market. This may be one of the causes of the boom market of recent months.

Treatment of dividends

Concerning the treatment of dividends under the Revenue Act of 1954, I think I should first repeat what I said on this subject before this committee on an earlier occasion:

> A word may be added about the controversial so-called preferential treatment of dividends. I accept the view that there is an inequity in the double taxation of profits but I think the so-called dividend received credit, recently enacted, stepped off on the wrong foot. It is so vulnerable to objection in terms of equity that it better be recalled. A change is not likely to rest easily in prospects of a stable future unless it is done right in the first place.
>
> The credit as enacted violates the fundamental principle of income taxation, namely, that all the income of the personal taxpayer should be used in measuring the base of the personal tax. If the corporate tax is to be regarded as a personal levy collected at the source then the tax itself should be included in the individual's tax base. This is the rule that we now follow in the case of wages and salaries. Moreover, the dividend received credit disregards the fact that corporate taxes, particularly those of public utilities, are sometimes shifted forward to consumers.
>
> There is no solution to the problem as long as American business refuses to accept the proper one—a differential rate on undistributed as compared with distributed profits.

The above statement concerns mainly the equity aspect of the problem. As to the economic aspect, strong support can be offered for a differential tax accomplished by a partial dividend paid credit (partial deductibility of dividends at the corporate level).

The present bias of the tax system runs strongly in favor of reinvested earnings as compared with dividends. There is surely much to be said for this on economic grounds; it provides a cheap and ready source of equity capital and it allocates investment where past outlay has justified itself. But I am strongly convinced that it also makes for concentration of industry. It says in effect to the board of directors: "If you can find a plausible outlet for corporate earnings, we will add a third or a half to the amount at your disposal compared to

what your directors and others would have to invest privately were dividends declared." If this isn't an open invitation to intercorporate stockholding, megalomanic growth, and forced consolidation, what is it?

It is often argued that while there is no shortage of available capital in this country, there is a shortage of equity capital obtained by outside equity financing. The shortage if it exists is of particular significance to small and new business. What is needed I think is a more equal treatment of distributed and undistributed profits and some special concessions that will make it possible for the little companies to reinvest on especially favorable terms. Some years ago a committee of the National Tax Association outlined some ways and means by which this objective could be accomplished.

Depreciation and Depletion

I am disposed to take a favorable view of the new dispensation allowed in the income-tax law of 1954 with regard to depreciation. The old law erred I think both as to rigidity and niggardliness in depreciation allowances. This is to extend no endorsement to the continuation of the 5-year amortization program associated with defense equipment. This latter is an emergency program justified in large part on the score that production of armaments was a discontinuous process. The emergency has passed and the assumptions on which special allowances were granted are no longer valid.

The new dispensation, it will be recalled, makes several alternative patterns of depreciation accounting available to the businessman. The main innovation is that businesses are now allowed to deduct, roughly, two-thirds of the value of assets during the first half of their expected life. By all odds the strongest support for this innovation is that assets do in fact lose value according to the allowed pattern of deduction. Evidence from used-equipment markets supports this view; it is fragmentary and does not tell exactly the same story for all assets; but taking account of the fact that business has a backlog of depreciation due to inflation and that there is good reason to err on the generous rather than the niggardly side of these allowances, the concessions granted by the 1954 law appear to have been fully justified.

Logically these new concessions should have been granted to all assets and not merely confined to new ones. The distinction made in this regard brings with it discrimination and unfair competition. This may not be serious and certainly will not long continue in the case of short-lived equipment but this conclusion will not hold for long-lived assets like factory buildings. It seems quite doubtful that the law should have applied to this type of capital in the first place. An example of what I am talking about is the extra stimulation given to some firms to forsake established plants in the Northeast and erect new factories in the South. Territorial relocation of industry was occurring fast enough (at least) to serve the national interest without an assist from the Federal tax laws.

There are several reasons why Federal allowances for depreciation should at least seek to approximate the actual losses of taxpayers. Underdepreciation results in fictitious income and thus distorts the basis for relative assessments among taxpayers. Modernization of plant and equipment are in the interest of a dynamic economy. Generous depreciation allowances represent funds earmarked for replace-

ment; they are not available for dividends and they should provide an effective stimulus for new investment. They may compensate for the notorious difficulties of the small firm which lacks ready access to external funds.

In the case of any item of equipment, rapid depreciation involves only a postponement of taxes and not a forgiveness. Any postponement of taxes does constitute a net gain for the taxpayer and a permanent loss to the Treasury in the sense that barring foreclosure of the economy or the demise of the taxpayer we never catch up with the postponement. If we were to allow corporations a year's delay in meeting their annual tax bill, taxpayers would gain and the Government would lose similarly. It is true that a growing firm will usually acquire more funds from its depreciation account than are required for replacement. But I can find in none of this any justification for denying taxpayers deductions corresponding with their actual losses.

When we depart from realistic depreciation and enter the realm of incentive depreciation (accelerated beyond any plausible evidence of fact) we are confronted by the inequities and possible distortions associated with tax subsidies. Even so, incentive depreciation might be justified to encourage investment during depression, especially if the policy were advertised as reversible. For the present at least we may content ourself with the sufficient problem of catching up with the underdepreciation that attended previous policy.

If we have been moving in the right direction with regard to depreciation allowances we have been moving from bad to worse, it seems, in the special privileges granted in the name of depletion. This is not a matter of timing but of allowing recovery of capital many times over (as much as 13 times in some cases, I am told).

This is a plain case of tax subsidies and it comes under my general rule that if we are to have subsidies it is generally better to grant them openly than by means of tax privileges. If the discovery and exploitation of natural resources is so risky a business and one so clothed with a public interest that it needs a subsidy, which I doubt, it would be better to grant one openly.

As a matter of fact I have yet to see any plausible evidence that our large oil companies which are the principal beneficiaries of depletion tax bounties incur any specially heavy risks. Their stocks are regarded as a sound buy for conservative investors. To be sure they lose considerably on particular ventures, but they are protected from overall loss by the size of their operations and the law of large numbers. As to the desirability of adequate capital and morale in the discovery and exploitation of our natural resources there is no doubt that both are needed and so they are in many other American industries.

The conclusion is inescapable, I think, that here is a clear case of dictation to the Congress by pressure groups and the result undermines respect both for the Congress and for the entire tax system.

Loss carryovers and carrybacks

In the absence of a general averaging provision in our income-tax laws, we have provided since the war for the carryover and carryback of business losses. Presently we allow a 2-year carryback and a 5-year carryforward. I shall assume that the well known economic and

equity arguments in favor of generous treatment of losses are convincing; this leaves only the much mooted question of whether the greater privilege extended to carry forwards is justified.

I am inclined to accept our present arrangement as a fair compromise. On strictly fiscal policy grounds the carryback seems more strategic than the carry forward. The latter reduces taxes during the prosperity phase of the business cycle when high taxes may be needed as a brake upon an upward spiral. The carryback on the other hand is more likely to produce refunds during a depression when they could be useful to sustain dividends and stock values and confidence. But there is some question of how much refunding the public and Congress will tolerate when times are bad and the budget seriously unbalanced. And, of course, carrybacks are of no value to new enterprises. Psychologically we seem to accept more readily the idea of offsetting a future liability with a past loss than allowing present losses to create a present liability for the Government.

LIFO inventory accounting

Concessions to the taxpayer in inventory accounting are made not to facilitate a steady economy but to avoid what is regarded as an overstatement of current profits. To explain LIFO briefly, its purpose is to minimize speculative profits that accrue to inventory during a year while such inventory is being processed or moved. The device allows the producer to short circuit his assembly line so to speak and to regard the cost of a unit currently disposed as equivalent to that of one currently added. This accounting technique was originally feasible and allowed for tax purposes only in the case of firms producing homogeneous units, but with the aid of a price index it is now available to department stores and others. Profits avoided during the upswing of prices are presumably recaptured by the tax system when prices fall.

The authorization to use LIFO for income-tax purposes is criticized on the score that it favors large concerns that are in the best position to take advantage of its complicated procedure. It is also argued that it postpones taxes during the upswing of the business cycle (rising prices), thus tending to aggravate the swing. These contentions are rebutted on the ground that alterations in relative taxes are a matter of timing only and that accounting practices which avoid fictitious profits during upswings prevent undue optimism at the stock exchange.

In recent years my own position on LIFO has moved in the direction of skepticism and I am particularly doubtful about proposed amendments which would seek to extend its use.

Because of the highly complicated accounting techniques involved there appears to be no prospects that the use of LIFO will be universalized. At present its use is concentrated in manufacturing and department and specialty stores; it covers only some 10 percent of business taxpayers. The privilege probably creates fairly serious inequities among taxpayers—those that have and those that have not adopted LIFO and among those who have adopted it at one or another price level. Taxes are reduced for LIFO companies on the upswing and increased on the downswing of prices. This irons out inequities only on the assumption that in economics what goes up must come down. In the present state of public opinion and world affairs such

compensatory action may not materialize. Moreover the LIFO companies gamble less on the effectiveness of losses as tax offsets. Probably we cannot unscramble the eggs in allowing LIFO but we can circumscribe the privilege within its present boundaries.

Gifts

The phenomenon of gifts is a puzzler both for the income tax and the death tax. In the income tax we have, for instance, the distinction made between university scholarships and assistantships. The former presumably involves money paid as an award without obligation to produce; the latter involves payments for services rendered. Undoubtedly there is a distinction, but it seems highly anomalous that the more favored scholars should escape the income tax while the belabored assistants have to pay.

The difficulty of dealing with interfamily gifts was one of the grounds on which the celebrated institution known as splitting was inaugurated. And it is the basis for the current rules regarding family partnerships. Currently the income tax recognizes the possibility for an infant son to be in business with his generous father, the former contributing only capital which originated with the latter and which is still subject to the latter's control. This is defended on the score that any other gift of property from father to son would result in income that would be attributed for tax purposes to the son. At the risk of being labeled un American, I suggest that income accruing to minor children, at least on capital contributed by a parent, should be aggregated with that of the parent. Splitting of all sorts is suspect economically because it weakens the progressivity of the tax.

But gifts are much more of a problem for the estates tax than for the income tax. Parenthetically we may say that the case for a strong estate tax on economic grounds is very impressive. Here is a tax which the critics agree is much less threatening to incentives than the income tax, and while the bite it takes out of savings per dollar of revenue is probably greater, many are less concerned about capital supply than about adequacy of motivation. But for every hour of attention given to the income tax the Congress probably invests less than a minute in the death tax. In short, it is my opinion that the estate-tax field suffers very heavily from neglect.

Gifts are a problem in the estates-tax area because those made before death are aggregated separately and this creates an invitation to split the base in the face of a progressive tax. Indeed, with the new marital deduction in the picture, the base can quite easily be split into quarters: One-half is given to the next generation and one-half of this is presumed to come from each parent; one-quarter is bequeathed to the spouse at death and is later taxed when the spouse dies; the other quarter is bequeathed directly to the next generation. It goes without saying that all of this division makes the application of progressive rates both weak and capricious.

Gifts inter vivos have been open to taxpayers' inhibitions; these donations may place youth in dominion over wealth before it is ready. But recent law makes it possible to give away life insurance like any other property; premiums have been and will continue to be paid by the parent. This makes gifts before death more attractive: they need now involve no problem at all of dominion over either property or income.

The remedy for much of these shenanigans is to aggregate gifts made before death with those made by bequest providing a completely cumulative base with 1 set of exemptions and 1 set of rates. This provision has been in effect in France since 1942. It would still leave the splitting associated with the marital deduction. Good ground can be found for postponing the tax on the surviving spouse until the latter's death and then aggregating gifts and bequests made by both spouses to their children.

This reform would by no means exhaust the leakage in death taxation but it would make a good start. It would also be a first step toward making the death tax respectable.

Tax-exempt securities

Tax exempt securities are maintained largely because of a vested interest of municipalities; they can muster a very effective lobby; and their interest is more tangible and direct than that of the great masses of taxpayers who are logically arrayed on the other side. The situation is not unlike that which prevails in percentage depletion.

The case against tax exempt securities in terms of economic effects is well known. The exemption coaxes upper bracket income into the relatively riskless security market which is the natural hunting ground for widows and orphans. Many have noted the perversity of a system that lauds the risk taker and then creates a tax haven for the safest of investments.

It has been argued for tax exemption that it helps keep down the regressive general property tax which is the most available source of revenue with which to meet debt service at the local level. It is also argued that it promotes State and local public works needed for national defense and to absorb investment funds. Particularly when our need for school and highway construction is critically high, any protest against tax-exempt securities is likely to fall on deaf ears.

But again we have a case where if subsidies are needed they had better be direct. Public works that are financed out of taxes are hardly of less interest to the Nation than those that are financed by borrowing. Direct aid for construction or for certain kinds of construction makes more sense than indirect support for borrowing, particularly when the latter clutters up the tax system. Better still we might have a construction aid geared to fluctuations in an index of employment or production.

The debate concerning public power would be much simpler and clearer if we had never got our Federal system entangled in this jungle. The fact that tax-exempt securities are very largely a unique American institution answers those who seem to think that this exception in our tax laws was ordained by nature.

Fringe benefits

This is a large and growing subject to which I shall have to do far less than justice. It is serving as a convenient means of tax avoidance at all levels of income.

The most conspicuous of all fringe benefits are the stock options granted to business executives. This involves also the modern alchemy of transforming ordinary income into capital gains. The options are to purchase stock at favorable prices and usually exercisable over a considerable period. Stock thus acquired when subsequently sold at a profit results in capital gain rather than an addition to the employee's

salary. The code provides complicated boundary lines within which this wide-open invitation to tax avoidance may be exercised with impunity. For instance, the option price may not be less than 85 percent of the market price at the time the option was granted; the employee may not own more than 10 percent of the stock of the company; and the sale must be at least 2 years after the option was granted and 6 months after it was exercised. However, outside these restrictions, the courts have generally allowed capital-gains treatment where the company's purpose in granting the option was to encourage a proprietary interest.

A public purpose in stock-option privileges may be claimed on the score that they develop a stake for managerial employees in the success of their employers. Stripped of all rationalization, however, they serve principally as a reminder that our will to impose rates exceeds our will to apply them. This is surely another case of that erosion and corrosion of the income tax which has alarmed the friends of this form of taxation everywhere.

Interesting issue in the area of fringe-benefit taxation is posed by the proposal to allow professional people to postpone tax on a limited amount of savings set aside for retirement. It is suggested that this would give them parity of treatment with business executives who qualify under tax-exempt pension schemes. Perhaps this is the best available illustration of how one special privilege in the tax laws breeds another.

It seems that the proposal is none too persuasive even as one to equalize privileges. The business executive has no control of his pension allowances nor are they fully realized or vested. Moreover the fortunes of business executives are bound to corporations which are now seeking relief on the ground that they are over- and double-taxed. Finally, any scheme of the kind proposed would be rank discrimination unless it brought in its fold employees that are not covered by pension funds. Of course these employees do have the benefit of social security. The professional groups might also have had it, had they not vetoed the idea.

If the present laws do perpetrate a discrimination we might better proceed to place some income limitation on tax-privileged executive pensions. Wholesale exemption of savings from the income tax would constitute erosion of a much-eroded institution and would compromise beyond recognition the theoretical basis of the tax. The economic effects of such mutation would be far-reaching. Among them would be those associated with a weakening of the progressive feature of the tax; and an aggravation of the problem of finding investment outlets for our abundant savings might also be expected.

EROSION OF THE TAX BASE AND RATE STRUCTURE

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INTRODUCTION

The idea is firmly planted in the ambivalent American mind that the United States has a progressive income-tax system. Some Americans, a good many of them Americans paying income tax at a flat or unprogressive rate, take virtuous pride in the fact that we have a sys-

tem of this kind; they regard our system as a victory for the democratic control of taxation. They assume, of course, sometimes for Keynesian reasons, that a progressive system helps the economy in several ways. Other Americans object, often with loud voice, to the high degree of progressivity they are able to detect in our Federal tax system. To a certain incalculable extent some of these Americans, especially if they are taxpayers—or hope to become taxpayers—paying tax at progressive rates, deplore, at least at the subconscious level, the contribution the Federal tax system exacts, or may some day exact, from their pocketbooks. But the story has a different emphasis when it is told. Progressivity is semantically popular in low-income quarters, and objectors usually find it prudent to dress their objections in fancy verbal clothes. They do so sometimes by asserting that the excessive progressivity of the American system impairs incentives to work, produces a shortage of venture capital, and inhibits the healthy growth of the economy. Objections in this vein sound better than plain objections to the payment of taxes.

These two violently opposed schools of thought make one common assumption. It is that the American income-tax system is highly progressive. My testimony will question that premise. It will concentrate upon the single factual issue of the extent of progressivity in our Federal income-tax system.[1] To state my findings of fact in advance of my proof, my conclusions will be that the pride of one school of thought and the fears of the other school are largely unfounded. My first conclusion will be that for most taxpayers we have a far less progressive income-tax system than is popularly supposed and that the system is not as progressive as it pretends to be.[2] My second conclusion will be that the progression remaining in that system after considerable erosion over the course of time works a number of gross discriminations, particularly against a large and respectable part of the American population which earns the principal part of its taxable income.

The Rate Structure of the Income Tax

We may look first to the pretenses of the individual income tax. The tax begins at 20 percent of taxable income and rates rise fairly rapidly in the principal schedule[3] to 91 percent on the excess of taxable income over $200,000 in the case of individuals other than heads of households, $300,000 in the case of heads of households, and $400,000 in the case of the combined income of a married couple. On paper these rates certainly indicate a progressive system. If our tax system actually imposed any such rates upon individual incomes, there might be a prima facie case for the hypothesis, often stated as dogma, that our income-tax system has impaired incentives to work and wiped out the capacity of upper bracket taxpayers to provide investment funds for the growth of the economy. It would be strange if a system carrying these rates did not have some effects of this kind.

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[1] Our various State income taxes are progressive only to a very mild degree.

[2] Recent years have witnessed a shift away from taxes upon consumption to taxes upon individual and corporate profits. This may have made the whole tax system more progressive than it formerly was. This paper is directed primarily to the income tax itself, the supposedly most progressive element in the system, and not to the whole system.

[3] Internal Revenue Code of 1954, sec. 1.

But, as we shall see, the bark of our individual income tax is much worse than its bite. Perhaps this is one reason why the American taxpaying public continues to work as indefatigably as it used to work in the good old days nostalgia sometimes brings to fond memory. The same fact may help to explain why convincing evidence remains mysteriously lacking[4] that there is any dangerous shortage of investment funds to provide for a healthy development of the American economy.[5]

We may, perhaps appropriately, start our analysis at the bottom of the income scale. The income-tax rates start at 20 percent of taxable income.[6] The 20-percent rate applies to the first $2,000 of taxable income, or $4,000 of taxable income of a married couple filing joint returns. In 1953, the last year for which estimates are available, 63 million out of 77 million taxpayers[7] paid tax at this first bracket rate. For these taxpayers the exemptions were the only important factor of progressivity. They are probably the all-important factor of progressivity for a good many additional taxpayers in the lower and middle range of the income scale.[8]

Now we may move to statistics which cover the whole income range. An estimated total of $117 billion of taxable income was reported for 1953. This total of taxable income paid $32 billion of individual income taxes. Therefore the average effective rate of tax applying to the total reported tax base was about 27 percent.[9] This average effective rate exceeded the first bracket rate of 22.2 percent by only 4.8 percentage points. Thus, only about 18 percent of the total yield of the individual income tax came from the impact of this average excess effective rate over the first bracket rate.

The present structure shows marginal rates moving up to 87 percent upon taxable incomes of $100,000 and 91 percent upon incomes in excess of $200,000. The income tax upon a taxable income of $100,000 received by an unmarried individual other than the head of a household is supposed to be $67,320. An individual having the same status receiving $200,000 is supposed to be liable to an income tax of $156,820. The apparent effective rate applicable to unmarried individuals is, therefore, about 67 percent upon incomes of $100,000 and 78 percent upon incomes of $200,000.

These are high rates of tax. On paper they certainly look severe enough. But in fact the statutory schedule does not tell the whole story. It is a column of theoretical rates at the beginning of the code. At other places the same code sets up a number of alternative separate lower tax rates.[10] If we use the concept of income called adjusted

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[4] See Butters, Thompson, and Bollinger, Effects of Taxation: Investments by Individuals, pp. 28, 48, 50 (1953); Saunders, Effects of Taxation on Executives, p. 12 (1951); Heller, Limits to Taxable Capacity With Respect to Income Taxation, 1952 Tax Institute Symposium.

[5] It could be argued that we are past the time when investment depends upon contributions from the untaxed funds of the high bracket incomes, and that this source of investment capital is less important than it used to be because much potential investment is now available in pension trust funds and other pools of capital owned in part by the low incomes.

[6] Internal Revenue Code of 1954, sec. 1.

[7] Counting married couples filing joint returns as 2 taxpayers, each with half the combined taxable income.

[8] Musgrave, Conference on Taxation, CIO Committee on Economic Policy, p. 32 (1953); Paul, Taxation in the United States, p. 761 (1954).

[9] Pechman, Yield of the Individual Income Tax During a Recession, 7 National Tax Journal, pp. 1, 9 (1954).

[10] Some of these later rates apply to individuals or very limited groups. See Surrey, Conference on Taxation, CIO Committee on Economic Policy, p. 42 (1953); Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, 68 Harvard Law Review, p. 745 (1955).

gross income, which includes half of net capital gains, the actual effective rates of income tax for 1952 for taxpayers with incomes above $100,000 was 53.4 percent. This was so even though marginal rates reached the stratospheric level of 92 percent in that year and the maximum effective rate then reached the high level of 88 percent.[11]

What I have said does not mean that the Federal Government in 1952 received as much as 53 percent of every dollar of the income of high-bracket individual taxpayers. This percentage for 1952, well below the theoretical effective rates made applicable by the code to high incomes, is a percentage only of the total adjusted gross income, including half of long-term capital gains. If we defined income as including the other half of net capital gains, the percentage for 1951 would go down from 53.1 percent to about 45 percent. It would go still lower if we counted as taxable exempt State and local bond interest and the value of personal consumption expenditures not included in adjusted gross income, and if we made allowance for the effect of percentage depletion deductions in excess of cost.[12] Other provisions of the code enabling the legal minimization of the tax liability the statute pretends at its beginning to impose would bring the actual effective rate to a still lower level.

Leakages in the Rate Structure

Most of you are familiar with the reasons why most American taxpayers do not pay income tax at the rates appearing in the schedules at the beginning of the Internal Revenue Code. For the sake of the record I should like, however, to list the principal of these reasons.[13]

(1) Although I think that the Congress has constitutional power to tax[14] interest upon bonds issued by State and local governments, the code explicitly exempts this type of income.[15] Many attempts to stop this costly leak in revenue have proved unsuccessful.[16] Curiously enough, Congress grants this exemption not so much to help the bond-

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[11] Statistics of Income for 1952, pt. 1 (preliminary report, table 1, p. 9) This percentage was 53.1 percent for 1951. Statistics of Income for 1951, pt. 1, tables 1a and 11, pp. 26, 75 See also Butters, Thompson, and Bollinger, Effects of Taxation: Investments by Individuals, pp. 86-87 (1953); Surrey, Conference on Taxation, CIO Committee on Economic Policy, p. 42 (1953). For the year 1946 the percentage reached only 50 percent; for the year 1948 it reached 57 percent.

[12] On the other hand, the percentages used do not take cognizance of additional taxes arising from the audit of returns.

[13] There are some offsets to the above list which tend to diminish the disparity between theoretical and actual tax rates. For example, capital losses are not completely deductible. Individuals with fluctuating incomes my pay over a period of years greater taxes than would be called for by the theoretical rates. And from the standpoint of wealth accumulation we must remember that most States, and some cities, impose income taxes. This, however, would not seem to be an important factor since these taxes are deductible in computing income subject to the Federal tax. Generally speaking, it may be assumed that these offsets have an almost negligible impact compared with the considerations which tend to bring the impact of the income tax below what would be expected from the theoretical rates contained in the statute.

[14] See *Helvering* v. *Gerhardt* (304 U. S. 405 (1938)); *Allen* v. *Regents of the University System of Georgia* (304 U. S. (1938)); see also Opinion of Assistant Attorney General Samuel Clark, Apr. 14, 1942, reported in hearings before the Ways and Means Committee, Revenue Revision of 1942, p. 3106.

[15] Internal Revenue Code of 1954, sec. 103 (a) (1).

[16] In 1935 President Roosevelt, following the lead of Presidents Harding and Coolidge, and all Secretaries of the Treasury since 1919, including Secretary Mellon, suggested that a constitutional amendment be submitted to the States permitting a Federal income tax on income from this source. Congress did not act upon this proposal, nor again upon a proposal made in 1938 that Congress assume constitutionality and adopt legislation ending these exemptions for the future. Again in 1942, a war year, another attempt to eliminate this statutory exemption was unsuccessful.

holder receiving the interest as to help the debtor State or municipality issuing the bond which, it is claimed, would have to pay a higher interest rate if the exemption were not available. This exemption costs the Federal Government something like $300 million of revenue a year.

(2) The statute exempts interest upon savings invested by individuals through life-insurance companies.[17] The tax inducement in life insurance has to do with the savings component of insurance premiums. Interest earned and accumulated on the reserves of life-insurance policies is not taxable to the policyholder or in any substantial degree to the insurance company. The proceeds of a policy paid to beneficiaries upon the death of the insured are completely exempt for income taxation.[18] Where a policy matures or is surrendered for its cash value, only the excess of the amount realized over the entire amount of premiums paid is taxable. Since the premiums paid include the cost of the insurance in a pure sense (including agents' fees and operating costs of the insurance company), as well as the savings contribution of the policyholder, there will often be no income tax upon the surrender of a policy, even where the policy has substantial savings features. In other words, the insurance component of the premiums frequently will be large enough to offset the interest accumulation under the savings component. Therefore, insurance offers investors a means of obtaining tax-exempt income, if they are willing to make a package purchase of insurance and savings, and are able to pass the necessary physical examination to qualify for life insurance.

(3) In the case of almost all minerals[19] the statute permits a deduction of percentage depletion beyond the cost of the property being depleted; it also permits a full deduction for certain expenses of exploration and development.[20] In the case of other property used in business the deduction for depreciation is limited to the cost of the property. The combination of percentage depletion and the intangible development expense deduction are costly to the revenue. They cost at least $500 million which would otherwise come from corporate taxpayers; no one knows how much subsidy they extend to individual taxpayers.[21] It may be one of the vices of this subsidy that it does not appear on the expenditure side of the budget.[22]

(4) The statute permits a deduction of a number of personal consumption expenditures, such as real-estate and other taxes,[23] interest payments upon mortgages upon owner-occupied homes, and interest upon consumer debt.[24] These deductions have the effect of excluding

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[17] Butters, Thompson and Bollinger, Effects of Taxation: Investments by Individuals, p. 310 (1953).

[18] Internal Revenue Code of 1954, sec. 2042.

[19] The deduction extends to clam and oyster shells, which may not be classifiable as minerals. Internal Revenue Code of 1954, sec. 613 (b) (5).

[20] Internal Revenue Code of 1954, sec. 615, 616.

[21] See Fortune directory of the 500 largest United States industrial corporations, supplement to Fortune issue July 1955, which shows that the 10 largest American industrial companies, excluding oil companies, in 1954 paid 48 percent of their net income in taxes, whereas the 10 largest oil and gas companies paid only 28 percent. The 10 largest oil and gas companies kept in 1954 a total of $597 million which they would have paid in taxes but for the percentage depletion and intangible development expense deduction.

[22] Heller, Limits to Taxable Capacity With Respect to Income Taxation, 1952 Tax Institute Symposium.

[23] Internal Revenue Code of 1954, sec. 164.

[24] Internal Revenue Code of 1954, sec. 163.

these items of expenditure from taxable income,[25] and create a tax discrimination in favor of borrowers and homeowners.

(5) The splitting of family income [26] by the use of multiple trusts, gifts inter vivos, and family partnerships, enables a substantial reduction of family tax liability.[27]

(6) Many taxpayers employ other legal means to minimize the tax liability which would arise from the apparent rates listed in the statute. Some of the most popular techniques are deferred compensation arrangements,[28] pension trusts,[29] and various types of fringe benefits.

(7) The impact of the theoretical tax rates imposed by the statute is frequently diluted by the accumulation of profits in closely held corporations.[30] While these accumulated corporate profits do not in a technical sense represent income of the individual stockholders until they are distributed, they do constitute an addition to the wealth of the stockholders. Moreover, they may become the income of the individual stockholders in years of low rates or loss years, or they may eventually be taxed as capital gains of the individual stockholders upon sale of their stock or upon final liquidation and some partial liquidation. They may never be taxed if the stock is not sold by the shareholder. Thus, in one way or another the stockholders often escape the impact of the theoretical rates appearing at the beginning of the statute.

(8) Capital gains receive preferential treatment in the form of an exclusion of 50 percent of net capital gains and an optional rate of 25 percent, a rate only a little higher than the lowest surtax rate. In addition, many potential capital gains altogether escape taxation where owners refrain from selling appreciated assets until their death.[31] These preferences probably are the major reason for the disparity between theoretical and actual rates of income taxation in the high-income brackets. It may be added that each tax bill coming from Congress contains provisions establishing new tax-sheltered havens arising from the classification as capital gain of items of receipts formerly taxable as ordinary income.[32] The most recent beneficiaries of this legislative generosity are sales of timber,[33] stock options,[34] coal royalties,[35] sales of breeding livestock,[36] sales of unharvested crops with the farm,[37] and sales of patents.[38]

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[25] Deductible Contributions, Butters, Thompson, and Bollinger, Effects of Taxation: Investments by Individuals, p. 81 (1953).

[26] I favor, as does Professor Surrey, the income splitting principle introduced into the code by the 1948 act as the only practical solution of the problem of discrimination created by the community property system of some Western and Southern States. Indeed, in 1947 we both testified before the Senate Finance Committee on behalf of this change in the statute. There is probably too much differential under existing rate schedules in favor of married persons. But this error can be corrected by substituting new rate schedules.

[27] Gerhard Colm has said that "The high rates are largely ineffective" for this reason. Colm, Conference on Taxation, CIO Committee on Economic Policy, p. 3 (1953).

[28] Internal Revenue Code of 1954, secs. 401–404.

[29] Internal Revenue Code of 1954, secs. 401–404.

[30] Hall, Taxation of Corporate Surplus Accumulations, a study prepared for the Joint Committee on the Economic Report, p. 185, 82d Cong., 2d sess., Washington, 1952. See also Smith Effects of Taxation. Corporate Financial Policy, p. 184 (1952).

[31] Internal Revenue Code of 1954, sec. 1014.

[32] I leave to another witness, Prof. William L. Cary, the story of how these and other provisions have been added to the tax code. See Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, 68 Harvard Law Review, p. 745 (1955).

[33] Internal Revenue Code of 1954, sec. 1231 (b) (2).

[34] Internal Revenue Code of 1954, sec. 421.

[35] Internal Revenue Code of 1954, sec. 1231 (b) (2).

[36] Internal Revenue Code of 1954, sec. 1231 (b) (3).

[37] Internal Revenue Code of 1954, sec. 1231 (b) (4).

[38] Internal Revenue Code of 1954, sec. 1235. Capital gain treatment may now be available on sales of oil and gas rights and sales of sulfur royalties. *P. G. Lake, Inc. v. Commissioner* (24 T. C. No. 114); *W. F. Weed v. Commissioner* (24 T. C. No. 116).

(9) One more contribution to the difference between the theoretical and the actual impact of income taxation comes from evasion of the tax. Some of this evasion is unintentional; some is deliberate. Even though the statute does not so permit, in actual practice a good many higher bracket individuals, especially the owners of family businesses, are able to charge off substantial amounts of personal consumption expenditures as business expenses. The failure to withhold income taxes from interest and dividends[39] loses about $400 million annually in revenue. Some further evasion is made possible by inadequate administration.[40]

Some basic data support the conclusion that income is underreported in tax returns. Striking discrepancies[41] appear between Department of Commerce estimates of income[42] and the amounts of income reported on income-tax returns for 1944, 1945, and 1946. On the average only 86 percent of consumer money income, after excluding military income, social security benefits, and unemployment compensation pensions and annuities, were reported for tax purpose. The average ran high, with only 36 percent of farm income reporting for 1945 only because the reporting of civilian wages and salaries reach 95 percent.[43]

THE EFFECT OF LEAKAGES IN THE RATE STRUCTURE

The obvious effect of this softness in the graduated rate structure of the Internal Revenue Code is a substantial loss of revenue. This loss of revenue is important. Of course, the restoration of the tax base and the renovation of the rate structure would also accomplish objectives beyond an increase of revenue. For one thing, it would make the income tax a more efficient agent for the redistribution or equalization of income and wealth, if that is an important value.[44] Also, the distortions and violations of equity now in the statute set a limitation upon the potential additional revenues that could be derived from rate increases if a national emergency should demand tax increases.[45] On the other hand, if the incidence of the income tax in the upper brackets were as severe as the rate schedules make it appear to be, work incentives might truly suffer and venture capital might be as scarce as many opponents of high taxes claim that it now is.[46] As things now are, these opponents are able to make their arguments sound more convincing than they would sound if they did not receive

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[39] Attempts to persuade Congress to provide for the withholding of tax on dividends, interest, and royalties have so far proved unsuccessful. Paul, Taxation in the United States, pp. 557, 584, 606, 616, 625 (1954).

[40] See The Internal Revenue Service, Its Reorganization and Administration, study printed by Joint Committee on Internal Revenue Taxation (1955). Almost one-half of all business returns (including farm returns) contain some errors the majority of which favor the taxpayer. A recent sample study made by the Internal Revenue Service indicates that the tax resulting from errors in returns totaled $1.5 billion in 1948; of this amount $1.4 billion should be attributed to errors in the taxpayer's favor.

[41] Selma F. Goldsmith, Appraisal of Basic Data Available for Constructing Income Size Distributions, pt. VI in vol. 13 of Studies, Conference on Research in Income and Wealth (National Bureau of Economic Research, pp. 301–304 (1951)).

[42] As adjusted for comparability with tax returns.

[43] The coverage of combined farm and nonfarm entrepreneurial income ranged from 66 to 71 percent. With respect to other income sources, the range for the 3 years was 65 to 68 percent of the "interest, dividends, and fiduciary income" as a group, and 45 percent of rent, excluding roomer-boarder income. Heller, Conference on Taxation, CIO Committee on Economic Policy, pp. 21, 24 (1953).

[44] Strayer, Individual Income Tax and Income Distribution, 14 American Economic Review, p. 430 (1955).

[45] Heller, Practical Limitations on the Federal Net Income Tax, 7 Journal of Finance, p. 185 (1952).

[46] Paul, Taxation in the United States, p. 501 (1954).

plausibility from a delusively high apparent, but unreal, rate structure.

From the standpoint of tax policy the inequity and discrimination resulting from the failure of the income tax to live up to its progressive pretensions has other unfortunate results. As it stands, the income tax is not treating alike taxpayers who are in an economic sense similarly situated. The tax has an uneven impact and is more and more failing to do equity in the sense of similar treatment of persons with equal incomes. The vice of the present rate structure is not only that it is more apparent than real. It is also that it is no more than apparent for some taxpayers and real in a very grim sense for others in the same economic position. It does not distribute its burdens fairly among taxpayers from the standpoint of ability to pay. It permits escape from taxation by many taxpayers with substantial ability to pay and at the same time places a disproportionate burden upon others with the same taxpaying capacity. Since "uniform taxation upon those equally able to bear their fair shares of the burdens of government is the objective of every just government,"[77] this aspect of a growing failure of income taxation to do justice among taxpayers should be a matter of intense concern to all of us.

On the other hand, the income tax statute comes closer to living up to its pretensions with respect to low income taxpayers.[78] Except in certain areas the effective rate of tax upon these taxpayers is what the statute at its beginning says it is. In contrast, the effective rates for most taxpayers with high incomes fall far below the pretensions of the statute. The rate schedules in the statute therefore misrepresent the comparative situation as between high- and low bracket taxpayers. In actual fact the average ratio of apparent to actual tax rates is considerably higher for low incomes than for middle and upper bracket incomes.[79] Moreover, the effective rates for some high bracket taxpayers are as represented in the rate schedules contained in the statute. This means that for many others in this category the effective rates are considerably less than 53 percent of adjusted gross income, or 45 percent of adjusted gross income plus the other half of capital gains. Thus, discrimination does violence to equity not only as between taxpayers with high incomes and taxpayers with low incomes, but also among taxpayers with high incomes.

This condition of income-tax affairs follows inevitably from the causes of discrimination I have listed. The important causes of disparity between apparent and actual effective tax rates operate primarily in favor of the high incomes. The ownership of State and municipal securities is largely among high-bracket taxpayers.[80] High-income taxpayers receive the greatest benefit from investment of savings in life insurance.[81] It is a fair assumption, I think, that

[77] Black, J., concurring in *Helvering* v. *Gerhardt* (304 U. S. 405, 427 (1938)). See also Blough, The Federal Taxing Process, p. 382 (1952); Blough, Basic Tax Issues, included in The History and Philosophy of Taxation, p. 21 (1955).

[78] In some respects the statute fails to live up to its pretentions in the case of, and among, low income taxpayers. Fringe benefits are on the increase in a dramatic way. The over-65 exemption, sec. 151 (c), and the retirement-income credit, sec. 37, help small taxpayers. In addition, many small business owners, marginal farmers, casual workers, and domestics are able to escape much of the nominal impact of the tax, and not a few low-income taxpayers enjoy the benefit of deductions for personal-consumption expenditures.

[79] See Heller, Practical Limitations on the Federal Net Income Tax, 7 Journal of Finance, pp. 185, 199 (1952).

[80] Butters, Thompson, and Bolinger, Effects of Taxation: Investments by Individuals, p. 284 (1953).

[81] Id. at p. 316.

the benefit of percentage depletion goes mostly to the upper brackets, and that these brackets secure a large part of the benefit arising from the deduction of personal consumption expenditures, such as real-estate and other taxes and interest payments upon mortgages upon owner occupied homes. It is the higher incomes which resort more generally to tax avoidance devices such as multiple trusts, gifts inter vivos, and family partnership, deferred compensation and pension trust arrangements.[52] Few small taxpayers avoid tax liability by accumulating profits in family owned corporations. Since stock ownership is concentrated to a considerable degree in the top wealth groups,[53] capital gains are also concentrated to a remarkable degree in the upper levels of income.[54] And, finally, last but far from least, taxpayers whose income consists largely of wages and salaries have only a limited opportunity[55] to minimize the impact of the high theoretical tax rates the statute pretends to impose upon all taxpayers. While high salaried executives may to some extent resort to such expedients as deferred compensation[56] and stock option arrangements,[57] and pension and profit sharing trusts, many high bracket taxpayers are helpless to escape, as do other high bracket taxpayers, from the impact of the severe rates contained in the statute. These rates are for them actual rates, as they are also for wage earners who likewise have only limited pathways of escape through fringe benefits, group life insurance and welfare funds, pension plans, health and welfare funds, and food and lodging and other benefits in kind.[58] Most of these limited methods of escape are available only to organized labor.[59]

DANGERS INHERENT IN THE PRESENT RATE STRUCTURE

There are real dangers for the income tax in these variations in the rate structure and erosions of the potential tax base. Paul Strayer has said[60] that

> current practices are so bad as to seriously weaken the income tax as a means of income distribution and to threaten its future as the largest single source of revenue.

Professor Strayer also visualizes the unpleasant alternative of a greater dependence upon indirect taxation.[61] Walter Heller has suggested that—

> growing erosion and corrosion of the income tax base is increasingly raising questions of how far we can extend our reliance upon this form of taxation.[62]

William Cary has attributed "the increasing complexity of the tax laws" to the present policy of growing preferential treatment to segment after segment of our taxpaying public, and has suggested with

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[52] Id. at pp. 368, 361.
[53] Id. at pp. 373, 22.
[54] Surrey and Warren, Federal Income Taxation Cases and Materials, p. 990 (1954 edition).
[55] The opportunity afforded by fringe benefit arrangements. See note 49.
[56] Eisenstein, A. Case of Deferred Compensation, 4 Tax Law Review, p. 391 (1949).
[57] 1954 Code, sec. 421.
[58] Guttentag, Leonard, and Rodenwald, Federal Income Taxation and Fringe Benefits Special Proposal, 6 National Tax Journal, p. 250 (1953).
[59] Strayer, Individual Income Tax and Income Distribution, 14 American Economic Review, p. 430 (1955).
[60] Strayer, Individual Income Tax and Income Distribution, vol. 14, American Economic Review, p. 430 (1955).
[61] Strayer, Individual Income Tax and Income Distribution, vol. 14, American Economic Review, p. 430 (1955).
[62] Heller, Conference on Taxation, CIO committee on economic policy, pp. 21, 23 (1953).

alarm the collapse of the income-tax system.[63] On one point a good many serious critics are in complete agreement. We have "a system of taxation by confession."[64] We cannot hope for the continued success of a system that depends so completely upon the good will of taxpayers and voluntary cooperation of the taxpaying public unless the system is kept fair and uniform in its application. As Professor Cary has said:

> If the average taxpayer finds our tax laws more and more checkered with special legislation, the danger is that disrespect will spread and make enforcement impossible whatever may be the economic limit upon taxes, there is a practical and psychological limit which is probably short of it.[65]

Various explanations have been given for the "disuniformity" that now pervades our income-tax system. A somewhat cynical explanation has come from L. H. Seltzer, an eminent economist. Seltzer has attributed to many Congressmen and other persons a feeling about the tax system comparable to the feelings of spectators at an athletic contest.

> Few persons like to see a baseball game in which there are no runs, no hits, and no errors; or a football game in which no one makes a touchdown.

So he concludes that Congressmen do not want—

> an airtight system. They want to preserve the opportunity for a man to make a financial home run, a touchdown, a killing.[67]

In Seltzer's opinion the preferential treatment of capital gains and other permitted avoidance techniques have the virtue in the legislative mind of offering just such an opportunity.

Stanley Surrey puts forward the hypothesis that Congress does not believe in high surtax rates in the upper brackets or the principle of progression, but bows to the political necessity of putting nominally high rates in the statute and then deliberately makes them ineffective. Harold Groves suggests that Congress—

> throws a high-rate schedule to the public as a demagogic bone and then as deliberately allows escapes from taxes that make these rates specious.[68]

Surrey does not condemn Congress for its choice of lower effective rates. In terms of total tax burden the choice may be wise, he admits, from the standpoint of incentives for effort and investment. It may be a necessary escape valve. But it does, equitywise, distort the impact of the tax among high-bracket taxpayers and as between many high- and most low-bracket taxpayers.[69]

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[63] Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, vol. 68, Harvard Law Review, pp. 745, 775, 780 (1955).

[64] Justice Jackson, concurring in *United States* v. *Kahringer* (345 U. S. 22, 36 (1953)), said: "That a people so numerous, scattered, and individualistic annually assesses itself with a tax liability, often in highly burdensome amounts, is a reassuring sign of the stability and vitality of our system of self-government. What surprised me in once trying to help administer these laws was not to discover examples of recalcitrance, fraud, or self-serving mistakes in reporting, but to discover that such derelictions were so few."

[65] Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, vol. 68, Harvard Law Review, pp. 745, 773 (1955).

[66] See also Tax Institute, Capital Gains Taxation, p. 22 (1946).

[67] Seltzer, Capital Gains and the Income Tax, vol. 40, American Economic Review, pp. 371, 378 (1950).

[68] Groves, hearings before the Joint Committee on the Economic Report, 84th Cong., 1st sess., p. 394.

[69] Surrey, Conference on Taxation, CIO committee on economic policy, pp. 42, 48 (1953).

Suggested Remedies

Several remedies have been suggested for this disease of "disuniformity" in the income tax. Heller would like to see a tightening up of enforcement and a restoration of some of the lost base.[70] Strayer and Heller, and Cary all suggest a reduction in top-bracket rates coupled with a wholesale revision to prevent tax avoidance.[71] Heller would also like to reverse the split-income provision applicable to husbands and wives, and take the Spartan path of "making the original 8 community-property States (and their 4 or 5 imitators) give up their favored position"; for him "the 8-State tail wagged the 40-State dog" when this provision was enacted. With this remedy I would disagree, and I think Surrey would also, though I think that we would both agree upon the wisdom of reducing the present differential in favor of married persons.

There is general agreement that something strenuous needs to be done. The income tax is now a wasting asset of the Nation. Each special favor granted by Congress to place an unfavored group on an equal basis with some previously favored group leads to new necessities; some similarly placed taxpayer very naturally claims that he deserves like treatment.[72] This process of erosion and patchwork amendment must stop somewhere; otherwise the statute, even now almost hopelessly complicated, will "approach the ridiculous,"[73] and taxpayers will have to spend more and more of their time and energy on the job of keeping their tax liability at a minimum. Somewhere a line must be drawn if the statute and regulations are not to become a shambles, and if we are to stop short of a tax law which imposes its nominally severe rates upon only a few politically powerless high-bracket taxpayers and its actual lenient rates upon other high-bracket taxpayers, with a consequent discrimination against most low-bracket taxpayers who are unable to take advantage of the alternative lower rates available to most high-income taxpayers.

Perhaps some pattern of rescue will develop from an analysis of underlying causes of our present difficulties. One important cause, it seems to me, has been undue emphasis upon the stimulation of investment and freedom from taxation for incentive reasons.[74] Industry after industry, segment after segment of our population, have convinced Congress that economic disaster was imminent if relief should be withheld.[75] The assumption of much legislation has been that investment was desperately in need of stimulation. Pressure comes from an almost neurotic fear that American business is a house of cards which a slight gust of wind can blow away, and that high taxes

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[70] Heller, Conference on Taxation, CIO committee on economic policy, pp. 21, 25 (1953). Surrey disagrees. Surrey, Conference on Taxation, CIO committee on economic policy, at p. 44.

[71] DeWind, The Battle of March 15, Esquire, March 1953, p. 78; Colm, Conference on Taxation, CIO committee on economic policy, p. 5 (1953); Strayer, Individual Income Tax and Income Distribution, vol. 14, American Economic Review, pp. 430, 440 (1955); Heller, Conference on Taxation, CIO committee on economic policy, pp. 21, 26 (1953); Heller, testimony before Joint Committee on the Economic Report, 84th Cong., 1st sess., p. 399.

[72] See Heller, Practical Limitations on the Federal Net Income Tax, 7 Journal of Finance, pp. 185, 195 (1952); see also Johnson, The Last Taxpayer, 30 Taxes, p. 181 (1952).

[73] Blum & Johnson, 1913–2013, A Hundred Years of Income Taxation, 33 Taxes, p. 41 (1955). See also Hand, Thomas Walter Swan, in the Spirit of Liberty, p. 213 (1952).

[74] See Heller, Appraisal of the Administration's Tax Policy, vol. 8, National Tax Journal, pp. 12, 18 (1955). See DeWind, The Battle of March 15, Esquire, March 1953, p. 78.

[75] Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, vol. 68, Harvard Law Review, p. 745 (1955).

will destroy the American economy. If it proves anything, history proves otherwise. Certainly history fails to support arguments that high taxes have a ruinous effect upon the economy. I do not like high taxes myself, but I am obliged, nevertheless, to admit that work and investment incentives have remarkably survived the high taxes of the last 20 years, and that venture capital is not lacking today after a long period of high taxation.[76] Many available statistics properly suggested to Prof. Alvin Hansen that we have an Alice in Wonderland economy in which the more we spend for defense, and the higher our taxes go, the more we have left for investment and consumption.[77] The historical record of the last 30 years shows:

(1) In the prosperous year 1955 taxes are virtually at World War II levels. Indeed, the combined corporate normal and surtaxes are even now at a level 12 points higher than the level they reached during World War II.

(2) After a period of low taxation in the twenties the national income fell from a high of $80 billion in 1929 to a low of $40 billion in 1932. Unemployment rose to a high of 13 million.

(3) In the subsequent period of increasing taxes the American economy moved forward to the prosperity we are now enjoying. After adjustment for price changes the per capita income of the average American after taxes increased 42 percent between 1929 and 1952; farm income increased about 50 percent. Unemployment is hardly a problem in 1955.

In the lesser period between 1940 and 1952, side by side with heavy military spending and high taxes, the United States increased its output by 70 percent, doubled its manufacturing capacity, and invested gross almost $40 billion a year in 1951 prices. In the same period current consumption increased in real terms about 50 percent.[78]

The longer period, 1929 to 1952, witnessed the establishment of a social security program which provides a substantial cushion against the hazards of old age, dependency, and unemployment. This system, coupled with other systems, public and private, covers nearly everyone with at least $245 billion of old-age and survivors insurance. This means that 9 out of 10 workers are now enjoying retirement protection. About 35 million workers are protected by an inadequate unemployment insurance program against the loss of a chance to earn a living.

This showing suggests at least that business is a tougher institution than it sometimes pretends to be.[79] Perhaps the time is at hand when we should shift the emphasis of tax policy from encouragement of investment to the revitalization of equity and the encouragement of consumption.

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[76] See authorities cited in note 4.

[77] Hansen, University of Minnesota Conference on Savings, Inflation, and Economic Progress May 1952.

[78] Hansen, University of Minnesota Conference on Savings, Inflation, and Economic Progress, May 1952. Inflation is not an adequate answer to these statistics. At this conference Professor Hansen went on to point out of the 82 months from mid-1945 to the spring of 1952 only 26 were months of rising prices; the other months were months of relatively stable or even falling prices. The 2½ years from January 1948 to Korea was a period of substantial price stability.

[79] See Strayer, Individual Income Tax and Income Distribution, 14 American Economic Review, pp. 430, 431 (1955).

CONCLUSION

Erwin Griswold has suggested that percentage depletion has come to stay.[80] Others have suggested that the only remedy for the discrimination involved in the percentage depletion deduction is to grant an equivalent to all taxpayers.[81] This may well be true of most of the inequities in the tax structure. They are men who came to dinner and do not mean to go home. If we are going to accept these conditions as facts of political life, we ought to know what we are doing and accept the unpleasant conclusion that our only recourse is to approach the problem of tax equity from another direction, granting balancing favors to taxpayers who have not received their share. We ought also to make what we are doing clear to the low bracket taxpayers, many of whom now think that the tax rates on the high incomes are what they pretend to be.[82]

At the very least our next major tax bill should give priority to a substantial adjustment of the first income tax bracket downward, or a split of the first bracket, and leave the other brackets unchanged.[83] Later, when conditions permitted perhaps other low brackets could be reduced or split. Since the income of taxpayers in the lower bracket consists mostly of salaries and wages, this would give relief principally to taxpayers who are unable to use the tax minimizing techniques now authorized by the statute. A reduction of this kind would help to restore balance and equity and furnish a basis for a new rate schedule which would distribute in a fair manner whatever tax burden was required to raise needed revenue.

I would also like to see the unrealistic high rates lowered to a top of, say, 70 percent. These rates produce very little revenue. This reduction would not be a bargain involving the reduction of the high rates in exchange for the elimination of special favors. If they were put to the test, most taxpayers with large incomes would prefer the existing state of affairs. They would hardly favor a revision which eliminated rates they do not pay and also eliminated provisions that bring their burden down to a level well below the level it would reach if the statute contained lower, but actually effective, rates for high-bracket incomes. The best argument for the elimination of the rates above 70 percent is that they mean next to nothing and misrepresent to the lower brackets the tax burden actually being imposed upon the high brackets.

A rate reduction in the upper brackets would also give relief to those high income taxpayers who are unable to reap any advantage from the tax-avoidance gadgets now in the code, and who therefore pay an income tax which is unfairly higher than the tax of other high-income taxpayers who are able to use presently available techniques for avoiding the impact of the high rates now appearing at the be-

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[80] See Baker and Griswold, A Correspondence, 64 Harvard Law Review, p. 361 (1951). In his classes at Harvard Law School Dean Griswold has suggested that percentage depreciation of earning capacity for all individuals would make about as much sense as percentage depletion of oil wells.

[81] John Kenneth Galbraith has facetiously suggested that percentage depletion be applied to professors. "There is no group," he ventures, "where depletion of what is called intellectual capital proceeds so immutably and leaves such a hideous void" (hearings before the Joint Committee on the Economic Report, 84th Cong., 1st sess., p. 391).

[82] See Paul, Taxation in the United States, p. 767 (1954).

[83] I do not suggest an earned income credit because of its administrative difficulties.

ginning of the code. This group of taxpayers consists largely of self-employed people who report substantial income from earnings.

One suggested way of accomplishing relief for high-bracket taxpayers who do not benefit from the alternative rates now contained in the code would be to permit some sort of postponement of income tax upon income set aside for retirement so that the tax on part of their high incomes in high production years will be deferred to later years when it will be subject to a lower rate of taxation.[84] I confess to an instinctive dislike of this remedy. It would take us further along the unhappy road we are traveling. It is, in fact, a camouflaged rate-reduction measure benefiting a particular group. A straightforward reduction of the higher brackets, which do not strike at most taxpayers but do strike at this group of taxpayers, seems to me a better remedy.

Next year may bring to Congress the issue of tax reduction. It is difficult to correct defects in the statute when tax reduction is not permissible. But when the economy is doing well and further incentive taxation is clearly unnecessary, the time is certainly propitious for a redistribution of a lower total tax burden in the direction of greater equity. Increased progression can come as well from a reduction of the relative burden upon low-income taxpayers as from an increase of the burden upon high-income taxpayers.[85]

If we wish to accomplish this result, we should carefully consider the advisability of a reduction of the lowest brackets as distinguished from a reduction across the board. A number of suggestions for averaging also deserve careful analysis. If we wanted at the same time to distribute the tax burden more fairly, we would at the very least incorporate in the statute a provision for withholding on dividends and interest. We would also eliminate the dividend credit introduced into the statute by the 1954 Code. If we keep dividend relief, we should certainly change the technique of relief to one of the preferable methods advocated a number of years ago by Ruml and Sonne and the Committee for Economic Development.[86]

These are halfway measures. I still entertain the hope that we are capable of môre heroic remedies. The restoration of our lost income-tax base requires the destruction of many venerable vested interests in tax avoidance. Vested interests always die hard. But we face an imperative need to remove discriminations and establish an income-tax system which refuses special benefits to some taxpayers because their income comes from particular sources, and which taxes alike all dollars of income. This would mean a subjection of all income to the same rates of tax, with some special provisions dealing with the bunching of capital gains and other forms of income.[87] The basic problem of taxing capital gains is, generally speaking, probably the most difficult problem in income taxation, but there is certainly little

[84] Hearings before Ways and Means Committee on H. R. 10 (Individual Retirement Act of 1955), June 27 and 28, 1955. See also hearings before Ways and Means Committee on H. R. 4371, 4373, 3456, 1173, 5847, and 7426, May 13, 1952.

[85] With the statute in its present condition any legislation of this character should extend its benefits to high-income taxpayers who do not secure the benefits now accruing to other high-income taxpayers.

[86] See Paul, *Taxation for Prosperity*, pp. 362, 365 (1946).

[87] Perhaps an averaging device and a more liberal treatment of capital losses. There is much to be said for the system of capital-gains taxation established by the 1936 act, later abandoned, under which the impact of the tax depended upon the period of holding of the capital asset—the longer the period the lower the tax.

merit in many of the provisions of recent years extending the benefits of the provisions to more and more types of income, and the provision[88] permitting capital-gains treatment on the sale of depreciable assets.[89] It would require the elimination of the many special statutory favors now operating in favor of the owners of certain types of income, such as income from oil and the extraction of minerals and income from investment in life insurance. It would include the taxation of interest upon future issues of State and municipal bonds.

I would like to see these things done. Until we do them, we shall not have a rate structure that says plainly what it means, or a statute which fairly distributes the heavy tax burdens forced upon us by the troubled times in which we live.

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[88] Internal Revenue Code of 1954 sec. 1231.

[89] One discrimination in the present structure is the one which permits escape even from capital-gains tax (1954 code, sec. 1014) in the case of those who refrain from disposing of capital assets prior to death. Vickery, hearings before the Joint Committee on the Economic Report, 84th Cong., 1st sess., pp. 301, 404; Paul, Taxation in the United States, p. 683 (1954).

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VII. RELATIONSHIP OF EXEMPTIONS AND DEDUCTIONS IN THE INDIVIDUAL INCOME TAX TO ECONOMIC STABILITY AND GROWTH

COMPARISON OF PERSONAL AND TAXABLE INCOME

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Our paper is designed to make the statistical circuit from the income receipts of persons to the amount of income actually subject to tax. The first part of the trip—from personal income as estimated by the National Income Division of the Department of Commerce to adjusted gross income (the income concept used on tax returns)—has been undertaken by Mr. Holland in part I of this paper. Part II, which contains the rest of the journey—from adjusted gross income to income actually subject to tax—is Mr. Kahn's work. The paper ends with a brief section on income splitting written jointly. Because of the separate authorship each section carries independent table numbers.[1]

I. FROM PERSONAL INCOME TO ADJUSTED GROSS INCOME

1. INTRODUCTION

The personal income tax cuts a wide swath through our population. Only a small proportion of our citizens are not called to account under it. In 1951, for example, out of the total population of 155 million, about 136 million taxpayers and dependents can be traced to the 54.4 million returns filed.[2] Either as taxpayers or dependents of taxpayers about 88 percent of the population can be accounted for on personal income-tax returns filed in that year. For more recent years the same orders of magnitude undoubtedly apply.

Such wide coverage in terms of population leads one to expect even a greater degree of tax-return representation for people's income, since those not required to file tax returns are at the lowest end of the income scale. Yet, on the face of it, such does not appear to be the case. For in 1952, the most recent year for which the available data permit fairly accurate estimates, personal income as estimated

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[1] The authors are both with the National Bureau of Economic Research. We wish to emphasize that the views presented in this paper are our own and should not be attributed to the national bureau. Further, it should be noted that the data cited from work in process at the bureau have not yet gone through that organization's usual review procedure.

[2] Because taxpayers tend to overstate their exemptions the number of people traceable to tax returns is probably slightly overstated. (See p. 14 of The Audit Control Program: A Summary of Preliminary Results, U. S. Treasury Department, Bureau of Internal Revenue, May 1951.) The tax return figures are from Statistics of Income for 1951, Part 1, p. 65, and exclude returns with only self-employment tax. The population figure includes Alaska and Hawaii (Statistical Abstract, pp. 18 and 940).

by the National Income Division of the Department of Commerce aggregated $271 billion, while income reported on tax returns before exemptions and deductions came to only $215 billion. At first glance, therefore, there appears to be a serious difference between the income that people receive and what they report for tax purposes. A gap of over $55 billion is not to be taken lightly. It is to this gap that the next section will be devoted. We will develop the point that in good part it has its origin in differences of definition between the two income concepts—personal income which is a category in the national accounts, and adjusted gross income which is the tax-law definition of the income of persons. But this does not explain all of it.

2. THE GAP BETWEEN PERSONAL AND ADJUSTED GROSS INCOME

How large is the annual flow of income to persons? How much of it comes under the scope of the income tax? How much should show up on tax returns? How much actually does show up on tax returns? To these direct and simple questions it is not possible to give precise and unqualified answers. Conceptual difficulties and the fact that the data are subject to ranges of error preclude this. However, the relevant magnitudes can be sketched out with a broad pen, thanks, in large part, to the personal-income data published (or made available) by the Department of Commerce and the careful estimates prepared by Dr. Joseph A. Pechman.[3]

What is the aggregate annual flow of income to individuals? The most relevant measure is the personal income item of the national accounts. Broadly defined, it consists of the sum total of wage, salary, and other labor income, the income of unincorporated business enterprises, personal interest income, dividends, rent, and transfer payments (such as OASI benefit payments and unemployment compensation). In all, personal income, abbreviated in the rest of this section, to PI, came to $271 billion in 1952.[4] Adjusted gross income, henceforth denoted AGI, is the basic income total derivable from the personal income-tax returns and is defined as "gross income minus allowable trade and business deductions, expenses of travel and lodging in connection with employment, reimbursed expenses in connection with employment, deductions attributable to rents and royalties, deductions for depreciation, and depletion allowable to life tenants and income beneficiaries of property held in trust, allowable losses from sales of capital assets and other property, and a deduction equal to 50 percent of the excess of net long-term capital gain over net short-term capital loss."[5] With the exception of capital gains, this sounds

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[3] To Dr. Pechman I owe a deep debt of gratitude. He has very generously made available to me the estimates that he has prepared of adjusted gross income and the worksheets used in their derivation. I have leaned heavily on these figures. I wish also to acknowledge the help received from the work of Selma Goldsmith who has pioneered in this area. In a later portion of pt. I of this paper we follow her procedures. In addition, Mr. Kahn, my colleague at the National Bureau of Economic Research, has made available to me materials that he has been working on and has aided in their interpretation.

The basic data on personal income and a description of how the estimates are made can be found in the National Income Supplement to the Survey of Current Business (1954 ed.), U. S. Department of Commerce, Office of Business Economics, Washington, 1954. (Revised estimates are in the Survey of Current Business, hereinafter abbreviated to SCB, July 1955.) Pechman's estimates of adjusted gross and taxable income appear in his article, Yield of the Individual Income Tax During a Recession, National Tax Journal, March 1954. A paper to be given before the National Tax Association in October 1955 includes more recent data and revisions of his earlier figures.

[4] SCB, July 1955.

[5] Statistics of Income for 1952, Part 1 (Preliminary Report), p. 3. For brevity this source will be cited as SI.

substantially similar to PI. Yet AGI, of all personal income-tax returns (of individuals), as we have seen, came to $215 billion, some $56 billion less than PI. There appears to have been a large slip 'twixt the cup of PI and the lip of AGI. What happened to the $56 billion? Part of the disappearance is definitional; part is due to the dishonesty and forgetfulness of some taxpayers. While only rough inferences can be drawn, it is reasonably certain that the major portion of the gap can be explained by conceptual differences between PI and AGI.

In table 1, we list the major items included in PI, but not required to be reported for personal income tax and, hence, not entering into AGI.

TABLE 1.—*Components of personal income not in adjusted gross income, 1952*

	Amount (billions)
1. Transfer payments	$13.2
(*a*) Benefits from Federal Government social insurance funds	4.8
(*b*) Pension, readjustment, mustering-out, etc., payments to veterans, and other Federal Government transfer payments	4.0
(*c*) State and local government payments (primarily direct relief and pensions)	3.1
(*d*) Business transfer payments	1.2
2. Other labor income [1]	4.9
3. Personal income and expenditure in kind	9.6
(*a*) Food furnished Government personnel including military	1.9
(*b*) Net rent of owner-occupied farm and nonfarm dwellings	4.7
(*c*) Food and fuel produced and consumed on farms	2.2
(*d*) Other	.8
4. Interest	6.3
(*a*) Net imputed interest	5.3
(*b*) Tax-exempt interest	.3
(*c*) Accrued interest on U. S. Government savings bonds	.7
5. Nontaxable military pay and allowances (other than in kind)	2.8
6. Property income of nonprofit organizations	.5
7. Miscellaneous	2.1
Total	39.4

[1] Consists of items not commonly regarded as wages and salaries such as employers' contribution to social insurance and private pension plans, compensation for injuries, etc.
Source: SCB, July 1955, and Joseph Pechman's worksheets.

All in all these items, components of PI but excluded from AGI, totaled almost $40 billion. Whether the grounds for excluding them are sensible or equitable is a matter beyond the scope of this paper. Others on this panel can more appropriately speak to this. A few general remarks may be in order, however. There is probably wide support for the noninclusion of most of categories 1, 2, 3, 4 (*a*), and 5 of table 1, because a social purpose is embodied in such payments as mustering-out pay or relief, or because as a practical matter it would be difficult to get at, say, net imputed interest or home-produced and consumed fuel and food, or because, as with the case of social-security benefits, contributions are not deductible. Accrued interest (4 (*c*)) is an ambiguous item. It is not excluded from AGI, but taxpayers have an option of reporting it either on an accrual or cash basis. Reporting on the former basis, if at all, is uncommon. Hence it is a subtracted item in the table. The two items whose exclusion from taxable income has aroused the greatest controversy are tax-exempt interest (4 (*b*)—interest on State and municipal bonds) and

the net imputed income of homeowners. Together they add up to just $5 billion, about one-eighth of total exclusions.[6]

On the other hand, there are items that do not fall under the personal income definition, but are reported for tax purposes and, therefore, show up in adjusted gross income. In 1952 they totaled $8 billion (see table 2). Employee contributions for social security are not exempt from the personal income tax, capital gains are taxable although only in part, but are excluded from personal income because they have no counterpart in currently produced goods and services. Other income is a miscellaneous category made up of a number of small items such as alimony, prizes, etc.

With $39.4 billion of PI not included in AGI, and $8 billion of the latter not falling in personal income, we get a net deduction of $31.4 billion definitionally explained in going from PI to AGI. Yet adjusted gross income reported on tax returns fell $56 billion short of the personal income total in 1952. How can we explain the missing $24.6 billion? By four factors: (1) The income receipts of those whose income was so low (under $600) that they did not have to file tax returns; (2) the income receipts of those who, being nontaxable because their exemptions and deductions exceeded their income, did not have to pay tax and, therefore, even though legally required to do so, failed to file returns; (3) underreporting either purposeful or through oversight; and (4) statistical error—for neither the Department of Commerce income estimates nor the tabulations in Statistics of Income are precise figures.

As regards (1) and (2), it should be noted that many of those with less than $600 of income nevertheless filed returns for refund because taxes were withheld on their earnings. It is very difficult to come up with any figure that is at all accurate. But a very rough estimate would put the sum total of AGI under (1) and (2) at between 1 and 2 billion dollars. This leaves us with something like a gap of $23 billion due to underreporting and statistical error. We conclude that something on the order of 10 percent of AGI remains unaccounted for. Waiving aside statistical error which is impossible to isolate, only this relatively small fraction of the total gets lost between its receipt and the tax collector. It is possible to view this in a confortable light. Taking an expansive view, it could be argued that any social device that achieves 90 percent of its purpose is doing mighty well. But before we get too complacent about it, a note of warning should be sounded. First, the absolute size of the unexplained residual is not unimportant. Undoubtedly, could it be traced, a significant addition to tax collections would ensue. But at least equally disconcerting is this consideration: The behavior of the aggregate masks significant diversities in its components. The degree to which underreporting exists varies markedly for the different sources of income.

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[6] Britain and a number of other countries in the Commonwealth tax the imputed income from homeownership. The State of Wisconsin from 1911 to 1917 required the inclusion of the net rental value of owner-occupied houses in taxable income.

TABLE 2.—*Items included in adjusted gross income and not in personal income, 1952*

Item	*Amount (billions)*
(1) Employee contribution for social security	$3.8
(2) Net gains or losses from sales of property reported on individual returns	2.4
(3) Other income reported on individual returns	.8
(4) Annuities reported on individual returns	.6
(5) Adjusted gross income of residents of Alaska and Hawaii reported on individual returns	.8
(6) Deductions for net operating loss carryover and depletion	—.4
Total	8.0

Source: SCB, July 1955, SI, 1952, and Joseph Pechman's worksheets.

And this is a matter of concern because it leads to continual taxpayer irritation and ultimate disrespect for the income tax whose success depends on a high standard of reporting by most taxpayers. If some kinds of income recipients are less strenuously subject to taxation than others, pressures are engendered that tend to lower the efficiency with which most taxpayers police themselves. Some taxpayers, because of the particular sources from which their income derives, are in a better position to play the game of tax evasion than others. A game not open equally to all is unfair, and there exists the strong possibility the taxpayers may seek increasingly to set the rules more to their liking so they can play under more favorable conditions.[7]

3. THE DIFFERENTIAL COVERAGE OF VARIOUS TYPES OF INCOME

In this section we present estimates for 1952 of the degree to which particular sources of income showed up on tax returns. It cannot be emphasized too strongly that these estimates should be interpreted very cautiously. It is not our intention to claim great numerical accuracy for them; but they are indicative, and something can be learned from them. Whenever a figure is given for the percentage of what should have been reported that was reported it should be recalled that this result is compounded both of underreporting and statistical error. The latter could be forgotten if it were the same for each type of income, but of course it is not. Nonetheless, the differences among income types that will show up are so great that they warrant the conclusion that underreporting of these sources of incomes varies greatly. Coverage estimates will be made for wages and salaries, dividends, interest, and entrepreneurial income. For these income sources we compare what actually did show up on tax returns with what should have been reported thereon.[8] (In these calculations no allowance is made for statistical error and only a rough and imperfect adjustment for the income of nonfilers.) The procedures used for the estimates discussed

[7] Note that these remarks and the estimates to be presented below deal with only one aspect of the problem of the degree of underreporting of particular types of income. There is a related matter that will not be discussed here that gives rise to the same kind of discontent. Persons in some kinds of occupations and business ownership status can more easily convert personal expenses to business expenses, and, while really as well off as other taxpayers, they will have a lower tax liability.

[8] Of the countrywide totals with which we start the derivation of what should have been reported, the wages and salaries figure and the dividend estimates are probably the most reliable, entrepreneurial income the least accurate (except for the income of the farm sector, which is deemed fairly precisely determined), with the reliability of the interest estimate somewhere in between. (See p. 63 of the 1954 National Income Supplement to the Survey of Current Business.)

in this section are based largely on those developed by Selma Goldsmith.[9]

By far the major portion of income arises as wages and salaries. As regards this source the opportunities for underreporting are at a minimum, since the tax is withheld at source for most wage earners. For 1952 we estimate that about $183 billion of wages and salaries should have shown up on tax returns, while from the returns filed we can account for about 95 percent of this total. So 95 percent of what should have been reported actually did show up. This is the same degree of coverage that Selma Goldsmith found for 3 earlier years, 1944–46.[10] As we shall see, this is a noticeably higher coverage ratio than for any other type of income.

Dividends, to a greater extent than any other source of income (except capital gains), flow to those with higher incomes. Yet the proportion of dividends that shows up on tax returns is lower than for wages and salaries. From the calculations detailed in the appendix, we found that only 87 percent of the dividends that should have shown up on tax returns actually did. Some 13 percent, over $1 billion, eluded the tax mill. It is interesting to compare this figure with a similar type of estimate made for an earlier year. For 1941, when exemptions were higher and only half as many returns as in 1952 were filed, Richard B. Goode found that only 6 percent of personal dividends could not be accounted for.[11] It is hard to escape the conclusion that individuals' propensity to report dividends suffered a decline starting with the high tax rates instituted during the war. Very rough computations suggest that the decline in the degree to which dividends were reported commenced in 1942, the reported percentage reached a low in 1943 and 1944 and then started to rise again, but by 1952 it was still well below its 1941 level.

Turning to the monetary interest receipts of individuals we find a strikingly lower degree of reporting. Our estimate for 1952 is that only 39 percent of what should have been reported on tax returns actually showed up thereon. In this respect, interest shows a lower degree of reporting than any of the other specific sources of income that are investigated in this paper (with the possible exception of farm income which is discussed below). We estimated the amount of interest that should be reported on tax returns at $5.7 billion, the amount that showed up as $2.2 billion; the gap as $3.5 billion. Apparently the fact that much of personal interest takes the form of small payments (or just bookkeeping entries as in the case of savings bank deposits) from a variety of sources helps to explain the difference in the degree of reporting between dividends and interest. Another factor is that interest receipts to a much greater extent than dividends flow to lower-income stockholders whose recordkeeping is meager and who are less apprehensive about the possibility that their returns may be audited.

The Bureau of Internal Revenue Audit Control Survey discovered about half a million returns with dividend errors and close to 2 mil-

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[9] Selma F. Goldsmith, Appraisal of Basic Data for Constructing Income Size Distributions, pt. VI of Studies in Income and Wealth, vol. 13 (NBE, 1951). Her estimates, which cover 1944, 1945, and 1946, are in a number of respects more refined and accurate than ours. An outline of the methods used in getting our estimates appears in the appendix.

[10] Ibid., p. 302.

[11] Richard B. Goode, The Corporation Income Tax (John Wiley & Sons, Inc., New York, 1951), p. 236.

lion returns with interest errors for 1948.[12] Reflecting the differences in the distribution of these two types of income among income classes, interest errors were concentrated to a much greater degree in the lower income classes.

TABLE 3.—*Dividend and interest reporting errors by income class, 1948*

Taxpayer's income class	Percent of total errors falling in each class	
	Dividends	Interest
Under $7,000	59.2	83.4
$7,000 and under $25,000	33.5	15.2
$25,000 and under $100,000	6.6	1.4
$100,000 and over	.6	.1
Total	100.0	100.0

The low degree of interest reporting in 1952 is not a freak phenomenon. Selma Goldsmith's estimate of the degree of interest reporting for 1946 is 37 percent, for example, and there is good reason to believe that it has hovered somewhere between 35 and 40 percent in the last 10 years or so. There is a suspicion that the reporting percentage for interest, too, declined noticeably after the early forties, but we can report this only as a suspicion, not yet having worked through the earlier data.

So far we have spoken about wages and salaries and two types of income from property. The last income type reported on—entrepreneurial income—is really a composite of labor and property income.[13] Individual proprietors and members of partnerships perform functions whose payments encompass returns both to labor and capital. For 1952 we estimate that about $35.1 billion of entrepreneurial income (income of sole proprietors and partners) should have shown up on tax returns, but we were only able to find $24.7 billion reported thereon. Some $10 billion or so disappeared for tax purposes. Only about 70 percent of what should have been reported actually was. It is interesting to note that the amount of wages and salaries not reported was slightly less (about $9.6 billion) than the amount of entrepreneurial income not reported, yet wages and salaries totaled more than five times as much as entrepreneurial income.

Our entrepreneurial income reporting percentage for 1952 is not very different from Selma Goldsmith's finding of 66, 68, and 71 for 1944, 1945 and 1946, respectively.[14]

Within the category of entrepreneurial income there is a significant difference between the degree of reporting of farm income and business and professional income. The data are not available for mak-

[12] U. S. Treasury Department, Bureau of Internal Revenue, The Audit Control Program: A Summary of Preliminary Results, May 1951, pp. 20-21. These figures include returns both with major and minor errors. There were, of course, overreporting as well as underreporting errors, but there are indications that underreporting errors exceeded overreporting errors by at least 10 to 1.

[13] We did not round out the traditional trilogy of property incomes by an estimate for rents and royalties, because this category could be estimated, at best, with a decidedly lower order of accuracy than the other income sources. There are a number of conceptual difficulties; the data are hard to come by and subject to wide ranges of error, and there was a basic uncertainty as to how many persons may have reported rental income as income from own business or partnership on tax returns.

[14] Goldsmith, op. cit., p. 302.

ing such a breakdown for 1952. The most recent year for which this could be done is 1947. Using the same methods employed in the 1952 estimates, we found a reporting percentage for all entrepreneurial income of about 66. For the farm-income component, however, the reporting percentage was only 38.5 percent. Slightly less than $6 billion of the $15 billion that should have been reported appeared on tax returns. The rest of entrepreneurial income—business and professional income—was characterized by a much higher reporting percentage. About $19.5 billion should have been reported, while a little over $17 billion showed up, leading to a reporting percentage of 87.5. These values are very close to Selma Goldsmith's findings for 1945.[15] While nothing can be said with certainty about the trend since 1947, it is likely that these differentials still exist.[16]

In table 4 we summarize the results of our investigation of the various income types. It is worth injecting the caution once more that these figures are imprecise. But they are substantially correct and there can be little doubt that the degree to which the various sources of income show up on tax returns varies significantly with the type of income.

TABLE 4

Source of income (1952)	Amount not reported on tax returns	Percent of total income from this source not reported on tax returns
	Billions of dollars	
Wages and salaries	9.6	5
Dividends	1.1	13
Interest	3.5	61
Entrepreneurial income	10.4	30

II. From Total Adjusted Gross Income to the Tax Base[17]

1. NATURE OF THE "GAP" BETWEEN ADJUSTED GROSS INCOME AND TAX BASE

In recent years two magnitudes have stood between total adjusted gross income and the tax base. These are the personal expense deductions and the personal exemptions. The deductions cover specific items of expenditures for nonbusiness purposes, such as philanthropic contributions, interest paid, State and local personal taxes, and medical expenses. The exemptions have since 1948 consisted of a $600 allowance for the taxpayer and his dependents, plus an additional $600 in case the taxpayer or his spouse have passed their 65th birthday, and an additional $600 in case either is blind. Had it not been for

[15] Ibid., p. 302. She got 86 percent for farm income and 87 percent for nonfarm entrepreneurial income.

[16] For wages and salaries, dividends, and interest, our estimates incorporate a rough adjustment for those income recipients whose AGI was below $600 ($500 in 1947) and who were, therefore, not legally required to file. (No such adjustment appeared necessary for entrepreneurial income in 1952.) But we do not do anything about the possibility that many persons with incomes above $600 did not file returns, even though legally required to do so, because their exemptions and deductions were high enough so they did not incur any tax liability. It might be argued that for farm income particularly this would account for a good portion of the so-called underreporting. But this does not appear to be the case. For 1947 on liberal assumptions as to the returns falling in this category, the farm income reporting percentage would have risen only slightly—from 38.5 to 41 percent.

[17] Much of the material in this section is taken from a study of personal expense deductions in the income tax, which the author is currently conducting at the National Bureau of Economic Research.

these two types of reductions, adjusted gross income would, in effect, have constituted the tax base.[18]

In table 1 we show how, by the subtraction of deductions and exemptions, the tax base is derived from the adjusted gross income reported on taxable returns, and we estimate how adjusted gross income not reported on taxable returns was removed from the tax base due to deductions, exemptions, and a certain amount of leakage. The estimates covering adjusted gross income not reported on taxable returns are very rough and are intended primarily to give us a complete picture of the relative importance of personal deductions and exemptions in removing income from the base. The table shows quite strikingly that we would not have obtained a true picture of the movement in the importance of the exemptions if we had confined our attention to the income of taxpayers only (for whom our information is so much more reliable than for the rest). For, remarkably enough, the ratio of the total amount of exemptions claimed on taxable returns to the total of income on these returns has remained roughly one-third between 1918 and 1952.[19] When we look at the figures for the aggregate adjusted gross income we find that personal exemptions removed something like two-thirds of this from the tax base in the years that we selected for the pre-World War II period and somewhat over one-third in the most recent years for which there are data. In contrast to this decline in the importance of personal exemptions, the personal deductions have risen relative to income from about 6 percent in 1918 to 11.2 percent in 1952.[20]

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[18] By tax base is here meant the amount of income to which any of the rates constituting the individual income tax were applied in computing tax liability. Our tax base concept is thus a broad and synthetic one. Any income to which either the normal tax, surtax, or capital gains tax applies has been included.

[19] The reason for this, and any inferences to be drawn from it, lie outside the scope of this paper. Suffice it to note briefly that a possible reason for the constancy of the above ratio over time, even though the level of income and exemptions have changed drastically during the period examined, may be found in a certain amount of regularity in the taxpayer distribution of income over the range in which the income tax has been operative since its inception. This is to say that when we slice off all incomes below a given level, we find that for incomes that remain the value of income below the cutoff level is a fairly stable proportion of the total of incomes above the cutoff level, no matter what the cutoff point provided it is not below the mode of the distribution of taxpayer income. The fact that the value of personal exemptions of taxpayers have changed little over time, when expressed as a percent of their income, leads to the tentative conclusion that the United States income tax has, with the probable exception of the World War II years, been operative either at or above the mode of the distribution of taxpayer income. The reasons for this are set forth in an article by William Vickrey, Some Limits to the Income Elasticity of Income Tax Yields, Review of Economics and Statistics, May 1949, p. 140 ff.

Following Vickrey one step further, the above finding furnishes us with information concerning the income elasticity of the tax base as a whole, which in turn leads us to the built-in flexibility of the tax. The income elasticity of the tax base has been fairly consistently in the neighborhood of 1.5 to 1.6. For recent years this may be taken as equivalent to the income elasticity of the tax, for as Pechman found the average rate of tax with respect to the tax base has remained virtually unchanged for the past 8 years (see his Yield of the Individual Income Tax During a Recession, National Tax Journal, March 1954, p. 9). Multiplying the income elasticity of the tax by the ratio of income-tax yield to total money income of individuals in 1951 (25,447 divided by 213,387 equals 0.105) gives us a built-in flexibility coefficient of about 0.16 to 0.17 for 1951 with respect to money income of individuals. This computation is based on the assumption that the incomes of taxpayers fluctuate by the same relative amounts as the aggregate. It should be noted that the estimate of built-in flexibility that we obtain is almost the same as Pechman obtains by a different method in the article referred to above.

[20] To get these figures, we had to add to the amount of exemptions and deductions reported on taxable returns, the amount of estimated exemptions and deductions for adjusted gross income whose recipients were not taxable. Ideally, the latter would merely have had to be divided between deductions and exemptions. However, as has been shown above a considerable amount of income is lost due to underreporting or statistical error. Our information on this is of course extremely scant as we go back in time. For 1947 we found it to amount to somewhat over 10 percent, which is close to the 1952 figure. No figure for earlier years was available to us. We therefore proceeded on the assumption that the leakage amounted to 10 percent in the 6 years examined. The adjusted gross income still unaccounted for was then divided between deductions and exemptions in the same proportions as these two allowances constituted of the combined total reported on nontaxable returns in each year.

TABLE 1.—*Relative importance of personal deductions and exemptions in accounting for gap between total adjusted gross income and tax base, selected years, 1918–52*

	Amounts in millions of dollars						
	1918	1926	1929	1939	1946	1951	1952
1. Total adjusted gross income [1]	49,999	68,676	74,557	63,718	155,550	228,547	239,776
2. Minus: Adjusted gross income on taxable returns [2]	15,223	19,476	22,776	17,834	118,721	183,935	197,205
(a) Minus: Personal deductions on taxable returns	1,330	2,087	2,312	1,783	13,245	22,400	25,002
(b) Equals: Statutory net income on taxable returns	13,893	17,389	20,464	16,051	105,476	161,535	172,203
(c) Minus: Personal exemptions on taxable returns	5,772	6,244	6,270	6,564	39,654	61,428	66,806
(d) Earned income credit on taxable returns				946			
(e) Equals: Tax base	8,121	11,145	14,194	8,541	65,822	100,107	105,397
3. Equals: Adjusted gross income of nontaxable individuals and leakage [3]	34,776	49,200	51,781	45,884	36,829	44,612	42,571
(a) Assumed leakage (10 percent of line 1)	5,000	6,868		6,372	15,555	22,855	23,978
(b) Adjusted gross income of nontaxable individuals	29,776	42,332		39,512	21,274	21,757	18,593
(c) Personal deductions	1,635	5,008		2,544	1,815	2,119	1,785
(d) Personal exemptions	28,141	37,324		34,903	19,459	19,638	16,808
(e) Earned income credit				2,165			
	Percent						
4. Adjusted gross income on taxable returns removed from tax base due to—							
(a) Personal deductions (line 2a ÷ line 2)	8.7	10.7	10.2	10.0	11.2	12.2	12.7
(b) Personal exemptions (line 2c ÷ line 2)	37.9	32.1	27.5	36.8	33.4	33.4	33.9
5. Total adjusted gross income removed from tax base due to—							
(a) Personal deductions (lines (2a+3c) ÷ line 1)	5.9	10.3		6.8	9.7	10.7	11.2
(b) Personal exemptions (lines (2c+3d) ÷ line 1)	67.8	63.4		64.9	38.0	35.5	34.9
6. Tax base as a percent of total adjusted gross income (line 2e ÷ line 1)	16.2	16.2	19.0	13.4	42.3	43.8	44.0

[1] Estimates of total adjusted gross income beginning with 1929 are Commerce Department personal income figures adjusted for differences in concept as shown in tables 1 and 2 of pt. I above. Prior to 1929 the figures are income payments estimates from Simon Kuznets, National Product in Wartime and National Income and Its Composition, tentatvely adjusted for differences in concept by Lawrence H. Seltzer.

[2] Statistics of Income, pt. I. For years prior to 1944 the figures are our estimates based on data in Statistics of Income.

[3] The division of this residual item between deductions, exemptions and "leakage" is explained in footnote 26 above. See p. 316 for an explanation of the leakage assumption.

These figures reveal two important features in the development of the modern income tax. First, they show how surprisingly large is the amount of income that is eliminated from the tax base by statute even within the aggregate that is conceptually designated as the tax base (as opposed to income types that lie conceptually outside the tax base and are hence not included in adjusted gross income). It amounted to about 46 percent in 1952. While this is considerably less than our 1939 estimate of 72 percent, it also means that, after taking account of leakage, we are left with only 44 percent of total adjusted gross income in the actual tax base. The second feature worth noting is the change in the composition of the amount of adjusted gross income eliminated from the tax base. It is less than formerly related to family size, that is population, and more to certain types of personal expenses and even size of income due to the proportional character of the optional standard deduction up to $10,000 of income. The personal exemptions, at one time 10 times as large in total dollar value as the deductions are now merely 3 times as large.

2. SIZE OF "GAP" IN TERMS OF TAX LIABILITY

Perhaps the most relevant method of appraising the importance of the personal deductions and exemptions would be to examine their effect on the tax liability itself. The quantitative relationships between deductions and exemptions when thus viewed are not quite the same as when compared in terms of their original dollar amounts. This is due to their different distribution among income groups who are subject to varying marginal tax rates. Table 2 shows the 1951 distribution of deductions and exemptions by adjusted gross income groups as reported on taxable returns. Two-thirds of the exemptions are claimed on returns with less than $5,000 of adjusted gross income, but only one-half of the deductions fall into that income range. Beginning with the $20,000-$25,000 income level, the deductions exceed in absolute amount the exemptions, even though for all returns they are only a little over one-third their size. The exemptions vary, naturally, only from $600 to a few thousand dollars per return, and they therefore tend to decline relatively to adjusted gross income except for a small range at the bottom of the income scale. The deductions vary on an average from about $70 per return at the bottom to over $1 million at the top. Their distribution, as is seen in table 2, closely parallels that of income.

To show the effect of deductions and exemptions on tax liabilities we constructed four tax base variants on the basis of 1951 taxable returns. The first corresponds to the actual 1951 tax base, with both deductions and exemptions allowed; the second omits all deductions but allows personal exemptions; the third omits the exemptions but allows deductions; and the fourth allows neither exemptions nor deductions, which means in effect that adjusted gross income was used as the tax base. It should be understood at the outset that these computations are merely expository, intended to isolate the effect of deductions and exemptions on the amount and distribution of tax liabilities, and do not amount to a proposal to abolish one or the other.

The results of these computations are shown in table 3. The tax liabilities with the current (1951) tax base are shown in column 2. In

the adjoining column they are shown with personal deductions eliminated. While the total of liabilities for the taxable return group is thereby raised from $24.2 to $29.9 billions, their distribution by income groups is shifted slightly downward. The share of those reporting less than $5,000 rises from 33.6 to 35.1 percent, and the share of those reporting incomes of $5,000 and over falls from 66.4 to 64.9 percent of the total. This may appear somewhat paradoxical in view of the facts that the deductions are a fairly stable percentage of adjusted gross income throughout the income scale, and that they are subject to a progressive rate structure. The explanation is found in the circumstance that, due to the concurrent existence of per capita exemptions, the deductions are a much larger percent of the present tax base in the low-income groups than they are further up. Hence the omission of the deductions would raise the taxable net income of the low-bracket taxpayers more drastically than that of those with relatively high incomes. The "true" effect of the deductions on the distribution of the tax liability can only be seen when we start out with a tax base from which the exemptions have already been eliminated (col. 4), and then move to a base that omits both exemptions and deductions, that is, adjusted gross income itself (col. 5). With the omission of personal expense deductions the increase in tax liabilities is now accompanied by a slight upward shift in the distribution of liabilities. The share of the group with incomes of $5,000 and over rises from 55.5 to 56.0 percent. Thus we find that with 1951 incomes and tax rates, the elimination of the deductions by themselves would increase the share in the total tax liability of the $5,000 and under group. But if we compare the distribution of tax liabilities with and without deductions prior to the allowance of personal exemptions, the removal of the deductions has a slightly opposite effect.

TABLE 2.—*Personal deductions and exemptions claimed on taxable returns by adjusted gross income groups, 1951* [2]

Adjusted gross income groups (in thousands)	Adjusted gross income		Personal exemptions		Personal deductions	
	Amount (in thousands)	Percent of total	Amount (in thousands)	Percent of total	Amount (in thousands)	Percent of total
0 to $2	$10,253,533	5.60	$5,390,733	8.78	$1,178,912	5.26
$2 to $3	20,108,150	10.97	9,292,404	15 14	2,396,539	10 70
$3 to $5	61,963,063	33.81	26,734,279	43.55	7,717,274	34 45
$5 to $10	55,838,698	30.47	16,783,670	27.34	7,199,459	32.14
$10 to $25	18,449,620	10.07	2,526,490	4.12	2,130,685	9 51
$25 to $50	8,207,317	4.48	494,511	.81	806,161	3 60
$50 to $100	4,500,312	2.46	133,741	.22	458,165	2 05
$100 to $500	3,228,663	1.76	37,436	.06	408,731	1.82
$500 and over	694,334	.38	1,161	(1)	104,236	.47
Total	183,243,590	100.00	61,394,425	100.00	22,400,162	100.00

[1] Less than 0.01 percent.
[2] Data were adjusted to exclude returns with self-employment tax liability only.

TABLE 8.—*Tax liability estimated from 1951 distribution of income reported on taxable returns with varying tax base assumptions, by adjusted gross income groups*

Adjusted gross income groups (in thousands)	Adjusted gross income (in thousands)	Tax liability computed with 1951			
		Exemptions and deductions	Exemptions only	Deductions only	No deductions or exemptions
	(1)	(2)	(3)	(4)	(5)
Less than $2	$10,253,533	$751,819	$1,006,159	$1,850,425	$2,091,824
$2 to $3	20,108,150	1,720,529	2,212,916	3,636,206	4,147,587
$3 to $5	61,963,063	5,663,265	7,262,804	11,192,313	12,868,649
$5 to $10	55,838,608	6,617,669	8,198,641	10,295,386	11,985,559
$10 to $25	18,449,520	3,321,481	3,966,867	4,052,798	4,749,220
$25 to $50	8,207,317	2,298,973	2,699,434	2,530,707	2,943,884
$50 to $100	4,500,312	1,769,398	2,067,465	1,852,830	2,154,015
$100 to $500	3,228,663	1,630,277	1,954,050	1,655,680	1,990,286
$500 and over	694,334	416,368	503,731	421,370	508,213
Total	183,243,590	24,189,779	29,872,067	37,490,715	43,439,277
	Percent of total				
0 to $2	5.60	3.11	3.37	4.94	4.82
$2 to $3	10.97	7.11	7.41	9.70	9.55
$3 to $5	33.81	23.41	24.31	29.85	29.62
$5 to $10	30.47	27.36	27.45	27.46	27.59
$10 to $25	10.07	13.73	13.28	10.81	10.93
$25 to $50	4.48	9.50	9.04	6.75	6.78
$50 to $100	2.46	7.31	6.92	4.94	4.96
$100 to $500	1.76	6.74	6.54	4.42	4.58
$500 and over	.38	1.72	1.69	1.12	1.17
Total	100.00	100.00	100.00	100.00	100.00

In table 4 the pattern of average effective rates (tax liability divided by adjusted gross income) that resulted with each of the four tax-base variants is shown. The effective rate schedules for the two variants that allow either exemptions or deductions, but not both, differ markedly (cols. 2 and 3). For the variant that allows only exemptions the rates in the lower half of the income scale are close to the current-tax-base rates, and in the upper part they approach the rates that would result with the adjusted gross income base. If exemptions are omitted and only deductions allowed we obtain the opposite effective rate pattern; at the bottom it is similar to that of the adjusted gross income base and at the top it resembles the current base pattern. The two schedules cross slightly below the $25,000 level. The most striking difference between deductions and exemptions is their effect on the progression of effective rates. When deductions alone are eliminated, the ratio of tax to income rises from 10 percent in the lowest income group to 73 percent at the top. When exemptions are disallowed it rises only from 18 percent to 61 percent. Without personal exemptions the ratio of tax to income shows hardly any increase for the income group up to $10,000, an indication of the extent to which the exemptions are at present responsible for effective rate progression among the great majority of taxpayers.

The overall effect on the tax liability of removing either the deductions or exemptions, or both, is estimated in table 5. As we enlarge the tax base in this manner the number of taxable returns increases, and hence also the aggregate amount of adjusted gross income reported

on taxable returns.[21] We assumed in our computations that all of the adjusted gross income not reported on taxable returns due to deductions and exemptions (see table 1) would have been taxable at the lowest bracket rate in the absence of these allowances.[22] The resulting estimates show a reduction of the total tax liability due to the combined effect of deductions and exemptions from $48 billion to $24.2 billion, a decrease of almost 50 percent. If there had been no deductions and only exemptions permitted, the total liability would have been approximately $30.3 billion, a loss of $17.7 billion or 37 percent. The deductions by themselves accounted for the lowering of liabilities by $6.4 billion, or 13 percent. Viewed in this manner, we may say that the exemptions were about 2.77 times as important as the deductions, given the 1951 rates.

TABLE 4.—*Estimated 1951 tax liability as percent of adjusted gross income, with and without allowances of personal deductions reported on taxable returns, by adjusted gross income groups*

Adjusted gross income groups	Effective tax rate with—			
	Exemptions and deductions (1)	Exemptions only (2)	Deductions only (3)	No deductions or exemptions (4)
0 to $2,000	7.33	9.81	18.05	20.40
$2,000 to $3,000	8.56	11.01	18.08	20.63
$3,000 to $5,000	9.14	11.72	18.06	20.77
$5,000 to $10,000	11.85	14.68	18.44	21.46
$10,000 to $25,000	18.00	21.50	21.97	25.74
$25,000 to $50,000	28.01	32.89	30.83	35.87
$50,000 to $100,000	39.32	45.94	41.17	47.86
$100,000 to $500,000	50.49	60.52	51.37	61.64
$500,000 and over	59.97	72.55	60.69	73.19
Total	13.20	16.30	20.46	23.71

Source: Table 3.

Once more, the alternative way of viewing the revenue importance of these allowances is to start out with the existing tax base and liabilities and show the increases in tax liabilities that would result from including one or the other in the tax base. Here the absolute amounts involved, as well as the relationships, are somewhat different since in this case deductions, for instance, are eliminated while exemptions remain whereas in the estimates of revenue decrease the deductions were allowed in the absence of exemption allowances. The first measure shows the relative importance of the allowances in cutting down the tax base and hence tax liability. The second measure shows what increases in tax liability we can obtain if one or the other were omitted. If deductions are omitted, bearing in mind 1951 incomes and rates, the increase in liabilities is $6.1 billions, or 25 percent. If the exemptions are left out, we get an increase of $17.4 billion, or 72 percent, which is 2.85 times as much as that from deductions.

[21] This was not taken into account in tables 3 and 4 since our data for income not reported on taxable returns are too sketchy to be distributed by income groups. Tables 3 and 4 thus show only the redistribution and increase of tax liability that takes place within the adjusted gross income aggregate reported on taxable returns in 1951

[22] This is undoubtedly true for all but a very small amount of the income not reported on taxable returns except, of course, the amount that was not reported due to error or evasion, which was not included in the estimates of table 5.

It may to some appear more relevant to show by how much individual income tax rates could be cut, rather than how much more revenue could be obtained at existing tax rates, if the tax base were not reduced by personal deductions and exemptions. This way of viewing the change has considerable merit since one may argue that rates would not have been raised to their current level to begin with, had it not been for the type of tax base in existence. Thus, if we desire, to hold the tax liabilities approximately constant, the increase in the tax base from $99.4 billions to $124 billions (see table 1) resulting from removing the deductions would have permitted an overall rate reduction of about 20 percent in 1951.[23] The countrywide average rate of tax (tax liability divided by tax base) would have been 19.5 instead of 24.3 percent.

TABLE 5.—*Estimated total tax liability obtained with 4 tax base variants, 1951*

Tax base variants	Tax liability on income		Total
	Reported on taxable returns [1]	Not reported on taxable returns [2]	
	(1)	(2)	(3)
1. No deductions and exemptions (AGI)	43,439	4,579	48,018
2. Deductions only	37,491	4,133	41,624
3. Exemptions only	29,872	446	30,318
4. Exemptions and deductions	24,190		24,190
Decrease in total liability (starting from AGI base) due to—			
5. Personal deductions: line (1)−(2)			6,394
Line (5)+(1), percent			13.32
6. Personal exemptions: line (1)−(3)			17,700
Line (6)+(1), percent			36.86
7. Deductions and exemptions: line (1)−(4)			23,828
Line (7)+(1), percent			49.62
Increase in total liability (starting from current tax base) due to—			
8. Personal deductions: line (3)−(4)			6,128
Line (8)+(4), percent			25.33
9. Personal exemptions line (2)−(4)			17,434
Line (9)+(4), percent			72.07
10. Deductions and exemptions: line (1)−(4)			23,828
Line (10)+(4), percent			98.50

[1] See table 3.
[2] Obtained by applying lowest bracket rate to figures in line 3 b, c, and d of table 1.

3. BREAKDOWN OF PERSONAL DEDUCTIONS BY TYPE AND INCOME GROUPS

While it may have been proper to treat the personal exemptions in the aggregate, as was done in the preceding discussion, the same is much less defensible in the case of the personal deductions. The latter differ, of course, quite significantly as to the type of outlay they cover, the intent with which they were enacted, and—most importantly—in the way in which they affect different taxpayers. The overall quantitative relationships within the personal deductions total for the years 1944–52 are presented in table 6. We have chosen 1944 because that was the year in which the current system of optional standard deductions on a large scale was introduced into the income tax framework. In the latest year for which we have data, we find that of the total of $25 billion reported on taxable

[23] This was obtained by dividing the total of line (4) by that of line (3) in table 5 and taking the complement thereof. Thus, $1-\frac{\$24.19 \text{ billion}}{\$30.32 \text{ billion}}=.202$.

returns, somewhat over one-half were taken in itemized form and the rest via the standard deduction. There has thus been a considerable shift away from standard deductions, and hence a return to the itemized form, since 1944. In that year 63 percent, compared to the most recent 49 percent, were taken in the simplified form.

TABLE 6.—*Personal expense deductions, by major types, claimed on taxable individual returns, 1944–52*

[Millions of dollars]

Year	Contributions	Taxes paid	Interest paid	Casualty losses	Medical expenses	Miscellaneous	Standard deductions	Total	Adjusted gross income
1944	1,235	1,136	688	149	721	665	7,853	12,477	114,761
1945	1,424	1,205	674	[illegible]	836	991	7,873	13,131	117,561
1946	1,559	1,247	685	137	906	1,180	7,455	13,169	118,050
1947	1,875	1,524	845	193	1,156	1,517	8,541	15,651	135,302
1948	1,756	1,479	892	179	1,040	1,601	9,545	16,492	142,057
1949	1,897	1,789	1,097	171	1,170	1,610	9,082	16,816	138,566
1950	2,129	2,044	1,360	248	1,260	1,881	10,135	19,057	158,545
1951	(1)	(1)	(1)	(1)	(1)	(1)	11,549	22,398	183,244
1952	2,991	3,023	2,093	296	1,868	2,383	12,232	24,886	198,508
	Percent of adjusted gross income								
1944	1.08	0.99	0.60	0.13	0.63	0.58	6.87	10.87	....
1945	1.21	1.02	.57	.11	.71	.84	6.70	11.17	....
1946	1.32	1.06	.58	.12	.77	1.00	6.32	11.16	....
1947	1.39	1.13	.62	.14	.85	1.12	6.31	11.57	....
1948	1.24	1.04	.63	.13	.73	1.13	6.72	11.61	....
1949	1.37	1.29	.79	.12	.84	1.16	6.55	12.14	....
1950	1.34	1.29	.86	.16	.79	1.19	6.39	12.02	....
1951	....	....	....	....	....	....	6.30	12.22	....
1952	1.51	1.52	1.05	.15	.94	1.20	6.16	12.54	....
	Percent of total deductions								
1944	9.90	9.10	5.51	1.19	5.78	5.33	63.18	100.00	....
1945	10.84	9.18	5.13	.97	6.37	7.55	59.96	100.00	....
1946	11.84	9.47	5.20	1.04	6.88	8.96	56.61	100.00	....
1947	11.98	9.74	5.40	1.23	7.39	9.69	54.57	100.00	....
1948	10.65	8.97	5.41	1.09	6.31	9.71	57.88	100.00	....
1949	11.28	10.64	6.52	1.02	6.96	9.57	54.01	100.00	....
1950	11.17	10.73	7.14	1.30	6.61	9.87	53.18	100.00	....
1951	....	....	....	....	....	....	51.56	100.00	....
1952	12.02	12.15	8.41	1.19	7.51	9.58	49.15	100.00	....

[1] Not available.

Of the $12.8 billion of itemized personal deductions claimed in 1952, $3 billion were for philanthropic contributions, another $3 billion for State and local taxes, and $2.1 billion for interest payments, while only $1.9 billion were taken for medical expenses. Until 1950, the claims for medical expenses exceeded those for interest paid. But the postwar upsurge in consumer debt, interest rates and home ownership caused interest deductions to grow more rapidly than any of the other deductible items. This, of course, does not explain why the level of interest-paid deductions has been so close to that for medical expenses deducted, for the countrywide aggregate of medical expenses of the deductible type has always been much larger than that for personal interest. As late as 1952 the medical expense aggregate was over twice as large as the interest aggregate (see table 7), and yet the latter exceeded the former on tax returns. The explanation lies, of course, in large part in the circumstance that interest payments are deductible without limits as to amount whereas medical expenses are subject to both a minimum, which is excluded, and a maximum that cannot be exceeded.

TABLE 7.—*Estimated aggregate philanthropic contributions, interest payments, and medical expenses of individuals in the deductible categories compared to amounts deducted on taxable returns, 1944–52*

[Amounts in billions]

Year	Philanthropic contributions			Interest paid			Medical expense				
	Total [1]	On taxable returns		Total [2]	On taxable returns		Total [3]	On taxable returns		Estimated total medical expense of claimants [4]	(10)÷(7)
		Amount deducted	(2)÷(3)		Amount deducted	(5)÷(4)		Amount deducted	(8)÷(7)		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1944	2.5	1.2	0.49	1.3	0.7	0.53	4.7	0.7	0.15	1.2	0.25
1945	2.8	1.4	.51	1.3	.7	.52	5.0	.8	.17	1.3	.26
1946	3.0	1.6	.53	1.6	.7	.43	6.1	.9	.15	1.5	.24
1947	3.0	1.9	.62	2.0	.8	.42	6.8	1.2	.17	1.9	.28
1948	3.4	1.8	.52	2.5	.9	.36	7.4	1.0	.14	1.7	.24
1949	3.6	1.9	.54	2.9	1.1	.38	7.7	1.2	.15	2.0	.25
1950	3.8	2.1	.57	3.5	1.4	.39	8.3	1.3	.15	2.1	.26
1951	4.0	(5)	----------	4.0	(5)	----------	8.8	(5)	----------	(5)	----------
1952	[6] 4.3	3.0	[6] .70	4.8	2.1	.46	9.4	1.9	.20	3.3	.35

[1] Estimated as follows: For years prior to 1944 tax return data were used to estimate the aggregate of philanthropic contributions. Due to the introduction of enlarged standard deductions in 1944 this was not deemed possible for years later than 1944. We, therefore, used an unpublished Commerce Department series for certain types of gifts and bequests as a basis of estimating 1944–51 by extrapolating the 1939–43 relationship between the Commerce and our own series forward.

[2] Unpublished estimates of Federal Reserve Board.

[3] Survey of Current Business, National Income, 1954 edition (supplement), table 30.

[4] To the figures in column (8) we added 5 percent of the adjusted gross income of those claiming medical expenses for the years 1944–50. For 1952 a special adjustment was required since the 5-percent exclusion did not apply to the medical expense of persons over 65 years of age.

[5] Not available.

[6] The $4.3 billion figure is a preliminary estimate made without benefit of the Commerce figures described in note [1] above.

NOTE.—The figures are rounded and do therefore not necessarily yield the same ratios.

TABLE 8.—*Personal deductions as percent of adjusted gross income, by income groups, 1952 (taxable returns)*

Adjusted gross income group	Itemized deductions (percent of adjusted gross income of those itemizing)							Standard deductions (percent of adjusted gross income of those taking standard deductions)	Total deductions (percent of total adjusted gross income)	
	Philanthropic contributions (1)	Taxes paid (2)	Interest paid (3)	Casualty losses (4)	Medical expenses (5)	Miscellaneous (6)	Total itemized (7)	(8)	Including miscellaneous (9)	Excluding miscellaneous (10)
Less than $2,000	6.4	4.7	2.3	0.6	7.9	2.8	24.7	10.0	11.7	11.3
$2,000 to $3,000	5.4	4.4	2.7	.5	6.0	2.7	21.7	10.0	12.1	11.6
$3,000 to $5,000	4.4	4.1	3.5	.5	4.1	3.1	19.8	10.0	12.7	11.9
$5,000 to $10,000	3.8	4.2	3.6	.5	2.4	3.7	18.2	10.0	13.0	11.7
$10,000 to $20,000	3.7	4.4	2.6	.3	1.7	4.0	16.7	7.8	12.1	10.2
$20,000 to $50,000	3.3	4.2	1.6	.2	.8	2.7	12.7	3.7	10.5	8.5
$50,000 to $100,000	3.7	4.0	1.3	.2	.4	2.6	12.2	1.6	11.4	9.0
$100,000 to $500,000	5.8	4.2	1.6	.2	.2	3.3	15.2	.7	14.8	11.6
$500,000 and over	10.1	3.5	.8	.1	.1	3.0	17.4	.1	17.4	14.4
Total	4.2	4.2	2.9	.4	2.6	3.3	17.6	9.7	12.5	11.3

Source: Statistics of Income, pt. I, for 1952 (preliminary).

As table 7 shows, the medical-expense deductions are small when compared to the total of medical and dental costs eligible for deduction. In the period 1944–50 they amounted to a mere 15 percent of the total. In 1952 they rose to one-fifth, primarily because medical expenses of taxpayers over 65 years of age have been exempted from the 5-percent exclusion since 1951, if made for the taxpayer or his spouse. The ratios for philanthropic contributions and interest payments are strikingly higher, and so is that for taxes paid (although our estimated aggregates for the latter are at the moment still too rough to be included in the table). If we include 5 percent of the adjusted gross income of those who were able to claim medical costs (the amount of the lower exclusion) we find that even then only 35 percent of medical expenses are accounted for. This, of course, is because many taxpayers have medical expenses not exceeding 5 percent of their income. As the figures in tables 8 and 9 show, the medical-expense deductions decline very rapidly relative to the incomes of those who itemize (or actually claim them). The minimum exclusion was evidently set so as to be in close conformity to the average medical-expenditure pattern of those with incomes below $10,000.[24] For those who are not 65 years old and have income above that level it is very difficult to claim medical expenses. This is shown by the 1950 ratios of medical-cost claimants to all taxpayers (in 1950 the age provision was not yet in effect, and all other 1950 ratios are practically identical to those for 1952):

Income class:	*Claimants as percent of total*
Less than $2,000	6.0
$2,000 to $3,000	9.2
$3,000 to $5,000	13.3
$5,000 to $10,000	13.5
$10,000 to $25,000	9.9
$25,000 to $50,000	7.5
$50,000 to $100,000	5.4
$100,000 to $500,000	3.2
$500,000 and over	.7
Total	10.8

Thus, while the minimum exclusion was set in such a manner as to make the low-income group the chief beneficiaries of the medical-deduction allowance, it is also precisely that same group for whom the standard deduction was designed. A family's medical expense has to be frequently much larger than the median 4 percent before it can get relief in the form of less tax than it would have had to pay ordinarily. In the extreme case in which a family may have no other deductible items besides medical expense, the latter would have to be in excess of 13 or 14 percent of its income (assuming this to be less than $10,000) before it would obtain any real relief under the present arrangement.

From the data available to us it is very hard to draw meaningful conclusions as to trends over time and on variations between income groups. This is largely because the existence of the optional standard deductions raises too much interference in both cases. It is, however, worth noting that for those income groups in which the

[24] See National Resources Planning Board, Family Expenditures in the United States, pp. 1 and 5; also Odin W. Anderson, National Family Survey of Medical Costs and Voluntary Health Insurance, Health Information Foundation, New York, 1954, table 14, p. 45.

standard deduction has played a relatively minor role, the philanthropic contributions have displayed a slight upward trend over time when viewed relatively to income. The total of contributions has of course been rising, relatively to income, because taxpayers have been gradually moving "out from under" the standard deductions. In 1952 the percent of tax returns with standard deductions was still as high as 73.9 (table 9), but in 1944 it was 81.7. It has been declining in every year since 1944, except in 1948, and the latter is easily explained by the broadening of the standard deduction in that year in connection with the introduction of income splitting. Even in the period 1948–49, when incomes fell, the relative importance of standard deductions continued to decline (table 6). This suggests that the explanation for the shift lies not solely in the rise in incomes.

In this connection the reader should also note (column 9, table 8) that the overall ratio of deductions to income has been a fairly stable one throughout the income scale except at the very top (and in prior years even this upturn has been almost imperceptible). This was by and large true even before the standard deductions were inaugurated. It must therefore be concluded that the reason for the change from a flat percent to a flat absolute amount at the $10,000 level is one of protecting the deductible expenditures from the inroads of the tax rates that are operative above that level.

TABLE 9.—*Major itemized deductions as percent of adjusted gross income of claimants, by income groups, 1952 (taxable returns)*

Adjusted gross income groups	Number of claimants as percent of total number of taxable returns					
	Philanthropic contributions (1)	Taxes paid (2)	Interest paid (3)	Casualty losses (4)	Medical expenses (5)	Standard deductions (6)
Less than $2,000	9.4	8.9	3.2	0.8	6.2	89.5
$2,000 to $3,000	16.8	16.7	8.5	1.7	11.0	82.0
$3,000 to $5,000	26.4	26.6	18.8	3.8	15.6	72.6
$5,000 to $10,000	36.1	36.2	29.5	6.4	16.0	63.2
$10,000 to $20,000	45.3	45.1	32.2	7.1	14.7	53.9
$20,000 to $50,000	73.0	73.1	43.8	8.9	16.6	25.[illegible]
$50,000 to $100,000	90.4	90.4	52.2	12.2	20.7	8.1
$100,000 to $500,000	95.6	95.2	58.9	15.6	27.6	3.3
$500,000 and over	97.3	98.2	67.0	19.9	36.2	[illegible]
Total	25.2	25.1	17.5	3.7	13.2	73.9
	Amount of deductions as percent of adjusted gross income of claimants[1]					
Less than $2,000	7.2	6.6	7.4	8.3	13.6	...
$2,000 to $3,000	5.8	4.8	5.8	5.1	9.7	...
$3,000 to $5,000	4.6	4.2	5.4	3.8	7.2	...
$5,000 to $10,000	3.9	4.2	4.5	2.8	5.5	...
$10,000 to $20,000	3.8	4.5	3.7	2.1	5.4	...
$20,000 to $50,000	3.4	4.2	2.7	1.7	3.4	...
$50,000 to $100,000	3.8	4.0	2.3	1.4	1.8	...
$100,000 to $500,000	5.9	4.2	2.5	1.0	.8	...
$500,000 and over	10.3	3.5	1.1	.2	.1	...

[1] The average adjusted gross income of claimants of a specific deduction item was estimated by multiplying the average income of those who itemized by the number of those claiming the specific deduction. This was done for each separate income group given in Statistics of Income, 1952, and since the original class intervals were much smaller than those given in this table the amount of error is relatively insignificant.

Source: Statistics of Income for 1952, Part I (preliminary).

III. Income Splitting

Because the amount of revenue an income tax brings in is dependent not only on what we have discussed so far—the amount of income reported and the exemptions and deductions allowed against it—but also on the rates applicable to income subject to tax, income splitting falls within the purview of our assignment. Our treatment of income splitting is brief and makes no pretense at adequate coverage of the problems raised by this provision of the tax law.

The most obvious feature of income splitting is that it leads to a very different schedule of tax rates for single and married persons, that on married persons, of course, being considerably lower. But it is not all married taxpayers who get the benefit of this provision. Those with taxable net incomes lower than $2,000 are subject to the same rate as single individuals, and it is in this class that more than half of the married taxpayers fall. In 1951, for example, there were close to 25 million taxable joint returns, of which 13.1 million, 52.8 percent reported taxable net income under $2,000. Less than half of the married taxpayers who filed jointly had lower tax liabilities because of income splitting. While relatively small in numbers, this group nonetheless accounted for a substantial fraction of taxable income. In all, the returns that benefited from income splitting constituted less than 29 percent of all (separate and joint) taxable returns in 1951, but received 59 percent of taxable net income.

How big was the tax saving due to income splitting? In other words: How much higher would the tax liabilities of married persons have been had the family been required to report its income as a single unit for tax purposes, and had all taxpayers been subject to the bracket rates that actually applied for separate returns? We have answered this question in two ways—as regards individual taxpayers and by reference to the aggregate effect on Federal tax revenues.[25]

As already noted, at the lower end of the income scale, taxpayers' liability is not affected by income splitting. But as income rises the difference between what would have been due without income splitting and the actual tax liability increased constantly, reaching a peak for those at about the $35,000 adjusted gross income level where the tax liability without income splitting would have averaged some 40 percent higher than what they did pay—and then declining gradually. The tax saving at selected income levels appears in table 1. Our conclusion here is simple and well known. The beneficiaries of income splitting are few in number and concentrated at the upper end of the income scale.[26] These conclusions, based on 1951 data, apply to 1955 also, although the precise values are different now.

[25] These estimates are based on materials prepared by Mr. Kahn for the personal income tax study headed by Lawrence H. Seltzer now being undertaken at the National Bureau.

[26] The very highest income recipients, however, get only a slight reduction in tax liability because of income-splitting.

TABLE 1.—*Percentage increase in tax liability for married taxpayers assuming compulsory joint returns with no income-splitting, at selected income levels, 1951*

Adjusted gross income:	*Percentage increase in tax liability*
$2,000	0
$5,000	2
$10,000	11
$25,000	37
$50,000	35
$100,000	27
$500,000	11
$1,000,000	6

A sizable proportion of taxable net income is involved in income splitting. How much more revenue would the income tax have raised had married persons been subject to the same rates as single people, with families required to pool their income for tax purposes? We ask this question not because we necessarily favor such a change in the tax law, but to point up how much revenue is foregone by income splitting. In 1951, had this procedure been adopted about $2.5 billion more in personal income tax would have been raised. Right now, with higher incomes than in 1951, the figure would probably be closer to $3 billion.

It will serve to place this revenue "loss" in perspective if we relate it to some changes that might be made in the personal income tax—changes that would involve substantially the same amount of tax liability. If, in 1951, income splitting had been abolished and families, reporting their income as a single unit, had been subject to the rates then applicable to separate returns, enough additional revenue would have been raised to permit any one (but, of course, not all) of the following alterations in the tax law, with total personal income tax revenue maintained at the level that actually prevailed. In other words these changes would lose about as much revenue as the abolition of income splitting would bring in.

First, exemptions could have been raised by $100. This would have provided relief concentrated in the lower income brackets. Alternatively, a flat 40 percent limitation could have been placed on marginal rates, i. e., the highest marginal rate would have been 40 percent, the rest of the rate schedule up to this point remaining unchanged. This would have meant relief concentrated in the upper income brackets, and would be in line with the suggestions of those who emphasize the disincentive effects of high marginal rates of tax. Or, finally, the whole rate schedule could have been cut by about 2.5 percentage points in every bracket. (This is almost equivalent to dropping the normal tax and keeping only the surtax rates.)

While these conclusions are based on the 1951 data, they are probably descriptive of today's orders of magnitudes as well.

Appendix to Part I

Derivation of wages and salaries reporting gap, 1952

[Billions of dollars]

Item	Amount
1. Wages and salaries[1]	$185.1
2. Subtract:	
(a) Nontaxable military pay and allowances (other than in kind)[2]	2.8
(b) Imputed (in kind) component of wages and salaries[3]	2.7
(c) Estimated civilian wages and salaries of those not required to file tax returns[4]	1.6
3. Add:	
(a) Items included in entrepeneurial income but probably reported as wages and salaries[5]	1.6
(b) Employee contributions for social insurance[6]	3.8
4. Equals: Wages and salaries to be reported on tax returns	183.4
5. Wages and salaries reported on tax returns[7]	174.4
6. Subtract: Wages and salaries of returns from Alaska and Hawaii[8]	0.6
7. Equals: Wages and salaries reported on tax returns	173.8
8. Actually reported as a percent of what should have been reported [(7÷4)×100]	95

[1] SCB, July 1955, p. 9, line 3.
[2] Estimate by Joseph Pechman.
[3] SCB, July 1955, table 39, p. 21—sum of lines 2, 3, 4, and 7.
[4] Rough estimate based on data in table 1 of Ulric H. Weil, A Note on the Derivation of Income Estimates by Source of Income of Persons Making Less Than $500 per Annum, 1944–48, Journal of the American Statistical Association, vol. 45 (1950), pp. 439–446. He estimated $2.14 billion of civilian wages and salaries for 1948 in the income class under $500. From Census Current Population Reports, P–60, No. 6 for 1948 and No. 14 for 1952, we estimated 7.8 percent more people in the under $500 class with wages and salaries only and stepped up Weil's figure accordingly. Then we increased it by 25 percent more because in 1952 the filing requirement covered all those with over $600. This gave us $2.89 billion from which we subtracted $1.33 billion of wages and salaries tabulated in Statistics of Income for the under $600 nontaxable group. This left $1.6 billion as the amount of wages and salaries obtained by those who did not file because not required to do so.
[5] Estimated, following Selma Goldsmith's procedure (see p. 356 of her article, Appraisal of Basic Data Available for Constructing Income Size Distributions, in Studies in Income and Wealth, vol. 13, NBER, 1951). Equals 0.35 of unincorporated business income from contract construction (SCB, July 1955, p. 15) plus the estimated income of newsboys, office solicitors, and private-duty nurses. These latter 3 items were estimated roughly at $155 million, $300 million, and $115 million, respectively, on the basis of the 1951 data supplied by letter from the National Income Division of the Department of Commerce.
[6] SCB, July 1955, p. 20.
[7] Statistics of Income for 1952, pt. 1 (preliminary report), p. 10, line 39.
[8] Estimated using the 1946 ratio of wages and salaries to adjusted gross income of Hawaii and Alaska returns. (See p. 360 of Goldsmith, op. cit.) An adjusted gross income figure for Alaska and Hawaii of $820 million was obtained from Pechman's worksheets.

Derivation of dividends reporting gap, 1952

[Billions of dollars]

Item	Amount
1. Personal dividend receipts [1]	$9.000
2. Subtract:	
(a) Dividend receipts of mutual life insurance companies [3]	.100
(b) Taxes withheld on dividend payments to foreigners [3]	.109
3. Equals: Adjusted personal dividend receipts	8.791
4. Subtract:	
(a) Dividend receipts of nonprofit organizations and noninsured corporate pension funds [4]	.337
(b) Dividend receipts of those not required to file tax returns [5]	.008
5. Equals: Personal dividend receipts to be reported on tax returns	8.446
6. Dividends reported on tax returns [6]	5.860
7. Add:	
(a) Dividends traceable to individuals' income from estates and trusts [7]	1.034
(b) Dividends retained by taxable fiduciaries [8]	.410
(c) Dividend receipts of partnerships [9]	.076
8. Subtract: Dividends of returns from Alaska and Hawaii [10]	.026
9. Equals: Personal dividend receipts accounted for on tax returns	7.354
10. Actually reported as a percent of what should have been reported [(9÷5)×100]	87

[1] SCB, July 1955, p. 11.

[2] Joseph Pechman's worksheets.

[3] Estimated by assuming 1948 ratio of this item to dividends applied in 1952. The 1948 figure for taxes withheld was obtained from NID.

[4] Irwin Friend, New Influences in the Stock Market, Fortune magazine, March 1953, estimated stockholders of nonprofit organizations (universities, foundations, churches, etc.) at $5.1 billion. Breaking this down into 82.5 percent common and 17.5 percent preferred (his ratios for all institutional holdings) and applying yields of 5.5 and 4.1, respectively, we arrive at $268 million as the estimated dividend receipts of nonprofit institutions. (This is considerably larger than the Federal Reserve Board money-flows study estimate of $100 million. Use of the larger figure makes for a smaller dividend reporting gap.)

The SEC Statistical Series Release No. 1335, of October 12, 1955, Corporate Pension Funds, 1954, gives $223 million as the income from interest and dividends of all uninsured pension plans of corporations other than banks, insurance companies, and railroads. Applying 2 percent to the tabulated total of U. S. Government security holdings and 3 percent to their corporate bond holdings gives $167 million of interest, and the rest—$56 million—is dividends. To take account of the omission of bank insurance company pension plans (railroad plans are unimportant here coming for the most part under the railroad retirement system) we raised the $223 million combined interest and dividend total to $275 million, to which we applied the respective ratios for interest and dividends in the $223 million total. This furnished $206 million of interest and $69 million of dividends.

The addition of $69 million for pension funds and $268 million for nonprofit organizations furnished the figure of $337 million for the dividend receipts of nonprofit organizations and pension funds.

[5] Ulric Weil, full citation in notes on wages and salaries, gives $50 million for the interest and dividend receipts of those with under $500 of income in 1948. Because the totals of such payments were higher in 1952 and because the income level below which filing was not required was $600 we very crudely set dividends and interest in the under $600 income recipient category at $50 million each. But $42 million of dividends (and the same of interest) was reported on nontaxable returns with under $600 of AGI in 1952. This left $8 million of each as traceable to those who didn't file because they were not required to do so.

[6] Statistics of Income for 1952, pt. 1 (preliminary volume), p. 10.

[7] Obtained by multiplying the Statistics of Income total of individual income from estates and trusts, p. 11, by a weighted average ratio of dividends as a proportion of total income for taxable and nontaxable fiduciaries. (Data from pp. 20–22 of Statistics of Income.)

[8] Estimated by applying the fraction that dividends comprised of total income of taxable fiduciaries to their retained income. (Data from pp. 20–22 of Statistics of Income.)

[9] The reported total of dividends received by partnerships in 1947 (Statistics of Income) came to 0.85 percent of net corporate dividend payments. Assuming this same percentage to apply in 1952, we get $76 million as the dividends of partnerships reported on tax returns as partnership income.

[10] Estimated by applying to the adjusted gross income of Hawaii and Alaska returns (Joseph Pechman's worksheets) the ratio of dividends to adjusted gross income for such returns in 1946 (Goldsmith, op. cit., p. 360).

Derivation of interest reporting gap, 1952

[Billions of dollars]

Item	Amount
1. Personal interest income [1]	$12.207
2. Subtract: (a) Net imputed interest [2]	5.208
3. Equals: Personal monetary interest	6.999
4. Subtract:	
(a) Tax-exempt interest paid to individuals (including estates and trusts) [3]	.266
(b) Accrued interest on Government bonds [3]	.711
(c) Interest receipts of nonprofit institutions [4]	.144
(d) Interest receipts of private pension funds [5]	.206
(e) Interest receipts of those not required to file tax returns [6]	.008
5. Equals: Personal interest receipts to be reported on tax returns	5.664
6. Interest reported on tax returns [7]	1.847
7. Add:	
(a) Interest traceable to individuals' income from estates and trusts [8]	.208
(b) Interest receipts retained by taxable fiduciaries [8]	.058
(c) Interest receipts of partnerships [9]	.105
8. Subtract:	
(a) Interest on returns from Alaska and Hawaii [10]	.007
9. Equals: Personal interest receipts accounted for on tax returns	2.211
10. Actually reported as a percent of what should have been reported percent [(9÷5)×100]	39

[1] SCB, July 1955, table 3, p. 11, line 6.
[2] Difference between lines 4 and 6 of table 37 on p. 21, SCB, July 1955.
[3] Joseph Pechman's worksheets.
[4] Estimated from data in Raymond Goldsmith, Capital Requirements Work Memorandum No. 36, unpublished manuscript prepared at the National Bureau of Economic Research, March 1952. He estimates bond holdings of all nonprofit institutions at $3.2 billion in 1945, and $3.9 billion in 1949. Assuming the same rate of increase in their bondholdings between 1949 and 1952 as between 1945 and 1949 and an interest rate of 3 percent, we get $144 million of interest received by nonprofit organizations in 1952. This is a very rough estimate. But it appears in line with the Federal Reserve Board money flows study's figure of $100 million.
[5] See note on nonprofit institutions and pension funds in the dividend adjustments.
[6] See similar item under dividends.
[7] Statistics of Income for 1952, pt. 1 (preliminary report), p. 10, line 39.
[8] Computed by a procedure similar to that described in connection with the corresponding item of the dividend estimate.
[9] In 1947, the special Statistics of Income tabulation gave $73.4 million of interest receipts for partnership returns. This came to 1.5 percent of personal monetary interest (personal interest income minus net imputed interest) for 1947. We assumed the same percentage to apply in 1952.
[10] Estimated similarly to the corresponding entry described under the dividend adjustments.

Derivation of entrepreneurial income reporting gap, 1952, farm entrepreneurial income

[Billions of dollars]

Item	Amount
1. Gross income of farmers [1]	$36.526
2. Subtract:	
(a) Net imputed rent on farm homes [2]	.400
(b) Value of home consumption [1]	2.144
(c) Total expenses of agricultural production [1]	23.027
3. Add:	
(a) Patronage refunds and stock dividends from cooperatives [3]	.109
(b) Net rental income from farm property received by farm owners [4]	.72[illegible]
4. Equals: Farm entrepreneurial income to be reported on tax returns	11.784

Footnotes at end of table, p. 838.

Derivation of entrepreneurial income reporting gap, 1952—Continued

BUSINESS AND PROFESSIONAL ENTREPRENEURIAL INCOME

Item	Amount
5. Income of unincorporated enterprises, business and professional[3]	25.410
6. Subtract:	
(a) Entrepreneurial income probably reported as wages and salaries[6]	1.558
(b) Income in kind[7]	.520
7. Equals: Business and professional entrepreneurial income to be reported on tax returns	23.332
8. Total entrepreneurial income to be reported on tax returns [(4)+(7)]	35.110
9. Business and partnership income reported on tax returns[8]	24.754
10. Subtract:	
(a) Business and partnership and farm income reported on returns from Alaska and Hawaii[9]	.149
11. Add:	
(a) Business and professional income traceable to individuals income from estates and trusts[10]	.064
(b) Business and professional income retained by taxable fiduciaries[10]	.051
12. Equals: Entrepreneurial income reported on tax returns	24.720
13. Actually reported as a percent of what should have been reported [(18+12)×100] percent	70

[1] Statistical abstract of the United States 1954, p. 60

[2] Rough estimate based on data supplied by NID; 1950 was $356 million.

[3] SCB, July 1955, p. 13, table 12, line 20.

[4] Difference between total net farm rents and same to persons not on farms, SCB, June 1953, p. 23, table 5. The assumption is that this would be reported as farm income.

[5] SCB, July 1955, p. 13, table 12, line 21.

[6] See explanation of this item in wages and salaries notes.

[7] Rough estimate based on NID data for earlier years. For 1950 it was $450 million; for 1951 it came to $480 million.

[8] Statistics of income, pt. 1, 1952 (preliminary volume). Net business or professional income and partnership income. Equals: columns 15 and 19 of table 2 minus columns 17 and 21.

[9] Estimated by assuming the 1946 ratio of nonfarm and farm entrepreneurial income to adjusted gross income for returns from Alaska and Hawaii applied in 1952. The 1946 data are from Selma Goldsmith, Appraisal of Basic Data * * * etc. (see full reference in wages and salaries notes); the 1952 figure from Joseph Pechman's worksheets.

[10] Estimated in the same way as the corresponding items for dividends.

NOTE.—Calculations similar to those described in footnote 4 under wages and salaries indicated no adjustment was necessary for the entrepreneurial income of those not required to file returns.

THE SIGNIFICANCE OF EXEMPTIONS AND DEDUCTIONS FOR LOW-INCOME TAXPAYERS

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The broadening of the base of the individual income tax to include most low-income families and individuals has been the most significant development in the field of taxation in recent years. The lowering of exemption levels in the 1940's, and the effects of inflation and the rise in real incomes in the postwar period have steadily increased both the number of taxpayers and the size of the tax base. These changes have been made possible by the development of collection at the source on a pay-as-you-go basis. As a result, the equally radical increase in revenue requirements has been met, for the most part, without resort to indirect taxation or taxes on spending which are less capable of being adjusted to the individual circumstances of the taxpayer.

These developments have led some critics to object to the burden on the low-income taxpayer and the failure of the individual income tax to provide for the complete exemption of a minimum of subsist-

ence. It is, therefore, desirable to review these changes critically and to consider the need for an adjustment of exemption levels. In this review both the question of the relation of exemptions to the equitable distribution of the tax burden and the economic effects of low exemptions will be considered.

From the beginning of the income tax in 1913 until World War II the exemption levels were so high that only the relatively wealthy top income brackets were brought within its scope. As recently as 1934 only 4 million returns were made in contrast to the roughly 50 million in recent years. In the prewar years it could be said that exemptions provided for more than a minimum of subsistence. But it would be misleading to suggest that those in the lower income brackets were free from necessity of contributing toward the cost of Government. In the years of high exemptions much greater relative reliance was placed upon indirect taxes with the result that, although hidden, the burden upon the low-income groups was substantial and generally believed to be regressive over a wide range. The progressive income tax became, therefore, a progressive superstructure added to a regressive base. Although valuable insofar as it applied, it was not of great significance in determination of the real burden of the mass of the taxpayers with modest incomes. A review of the history of income taxation in this country and in England from its first use in 1799 leads to the conclusion that, in spite of the claims of many writers in the field of taxation, the exemption of a minimum of subsistence from all taxation has never been seriously attempted. Actual policy has been determined by revenue requirements, administrative capacity, and political consideration.[1] For example, in World War II the choice faced by the administration and the Congress was between more or less dependence upon inflationary financing of the war and additional taxes of wide applicability. Granted the decision to attempt to increase the tax yield the choice of means was between the extension of the individual income tax to bring the mass of the public within its scope and the use of indirect levies of equal severity but less capable of being used in a manner designed to adjust the tax liability to the individual circumstances of the taxpayer. It is to the credit of the administration and the Congress that they chose to emphasize the use of the income tax rather than the cruder instrument of sales taxation of some kind.

Perhaps the most significant economic result of the greater role of the individual income tax has been the increased sensitivity of the Federal tax system to fluctuations in the level of income and employment over the business cycle. Once considered an objection to the use of income taxes by those who favored the annual balance of the Federal budget this feature of the Federal revenue system is widely accepted by those who wish to increase the extent of automatic or built-in flexibility of revenues to temper the severity of the business cycle. The growth in acceptance of this viewpoint is evidenced by its endorsement by many congressional leaders and even business groups. It must be remembered, however, that while the sensitivity of the total revenue system of the Federal Government has been increased by the broadening of the base of the income tax, the relative sensitivity of

[1] Strayer, Paul J., The Taxation of Small Incomes, New York, 1939.

the individual income tax alone has not necessarily been increased. A major advance in the same direction has been reduction in the lag between receipt of income and payment of tax liabilities made possible by collection at the source and the requirement that taxpayers not subject to source deductions estimate their tax liabilities in advance and pay on this estimated tax during the year of income receipt. From most points of view this is a great improvement over the old system of permitting the taxpayer to settle his tax in the year following receipt of income. The necessity of requiring large tax payments in a year of sharply declining income or of small tax payments in a year of rapidly rising income is avoided. Even more important is the knowledge that a change in tax rates or exemption levels can be made effective at once and reflected in the take-home pay of the mass of wage earners.

Two features of the income tax add greatly to its sensitivity in response to changes in levels of national income. These are the exemptions which, if left at constant levels, affect contracyclically the amount of the total income which will be subject to tax and the progressive rate structure which will increase the average tax rate as incomes rise and reduce the average tax rate when incomes fall. As a result, a given percentage change in gross income payments will result in a larger percentage change in tax receipts. This will offset, in part, the forces leading to either a rise or fall in income levels. Coupled with a similar tendency for expenditures to vary countercyclically the result is to temper somewhat the tendency for the economy to become vulnerable to cumulative periods of deflation or inflation. Although the advantages of this built-in flexibility can be exaggerated it is not to be ignored as a step in the right direction.

One other change in the income tax that has occurred in recent years deserves special mention. This is the fact that the inclusion of the low-bracket income recipient within the scope of the tax and the increase in the level of the initial rates applicable to the first bracket of taxable income have changed the possibility of using the tax as a means of income redistribution. The income redistribution potential of the tax has been further modified by the increase in the means offered under the law for the legal minimization of the nominally confiscatory rates applicable to large incomes. Although it is theoretically possible to achieve a great variety of results under a tax of the general dimensions currently imposed in the United States, the resistance to high rates as described in other papers at these hearings and elsewhere, and the necessity of heavy taxation of the lower brackets where the bulk of all income is concentrated, makes the practical possibility of greater redistribution of income by taxation a remote possibility. The most disturbing fact is that at the same time there is evidence that significant differentials in tax burden are developing not on the basis of total income but on the basis of source of income. This trend leads to the conclusion that more attention should be given to questions of equity and avoidance of distortions in the impact of the tax rather than nominally punitive rate schedules which are ineffective. Exemption policy must seek to achieve equity for all. Recent extensions of extra exemptions and deductions for the aged and for certain retirement income suggests that discrimination can become as great at low-income levels as high. Looked at from another point of view the heavier the

tax load the more important the pattern of expenditures. With an ultimate ceiling of 100 percent at the top, the larger the revenue requirements the higher the basic rate and the lower the exemption level will tend to be. Both the higher basic rate and the lower exemption level have the effect of lessening the spread between the relative burden at bottom and top.

Critical Appraisal of Current Practices

A critical appraisal of current practices requires a balanced judgment that is based not only upon the effects of exemptions and deductions upon economic stability and growth but also the effects of current law upon revenue, equity, administrative practicality and other widely held objectives of a more subjective nature such as the level of exemptions and deductions required to maintain family strength and stability.

The main features of the current law can be outlined briefly. Each taxpayer is allowed to deduct from his net income $600 for himself, $600 for his wife if he files a separate return, and $600 for each dependent. Additional sums of $600 are deductible for those over 65 years of age and for the blind. The deduction for dependents is limited to children under 19 years of age and to close relatives for whom the taxpayer contributes over half of the support. In the 1954 code an exception to the general rule that no deduction would be allowed if the dependent made $600 or more was made in the case of students so long as the taxpayer continued to contribute over half of his support.

A second group of deductions is found in the area of business expenses, depreciation, and business losses. These items are deductible from gross income to arrive at adjusted gross income and conform rather closely to the prevailing accounting concepts of deductions necessary to arrive at net income. These deductions are not considered within the scope of this paper, but are fully discussed by Professor White.

A third group are deductions from adjusted gross income required to arrive at taxable income. These include expenses not connected with a trade or business, expenses incurred in connection with employment for which the taxpayer is not reimbursed, and the special deductions allowed for charity, unusually heavy medical expenses, and so forth. This group includes such important items as deductions for nonbusiness taxes paid by the taxpayer to State and local governments, interest, including mortgage interest, and casualty losses and thefts. This area is also covered by Professor White, but some aspects must be included in this analysis. To provide a means of avoiding the complications which would arise if all taxpayers were required to itemize each deduction in this category the law permits the use of a standard deduction of 10 percent of adjusted gross income in lieu of an itemized statement for this whole group of items. This is limited to $1,000 maximum for each taxpayer. If the standard deduction is used, no other deduction will be permitted. The Statistics of Income for 1951 indicate that, of approximately 43 million taxable returns, only some 10 million were returns with itemized deductions. Although this is a larger percentage of itemized returns than that found in previous years, it is an indication of the relative generosity of the

sums allowed under the standard deduction. The latter figure is a little high because the category in the tables includes those returns without any deductions (itemized or standard) and all returns with no adjusted gross income whether or not deductions are itemized.

A final point must be discussed in this outline of the main features of the law. This is the extension of the community property treatment to the income of married couples and its recent extension to a limited extent to heads of families. Although the justification for this provision is entirely different than that of the deductions and exemptions, it has the significant effect of sharply reducing the effect of the progressive rate schedules upon some married couples and leaving the single individual to bear the full brunt of progression. Thus, when the comparative burden of single and married couples is analyzed the effect of income splitting is of even greater importance than the effect of additional exemptions when the husband is the primary wage earner and his taxable income is large. It is impossible to discuss the merits of the personal exemptions without reference to this fact.

The major criticisms of the current provisions of the law permitting the above outlined exemptions and deductions can be divided into two categories. First, those that criticize the law on the grounds of equity or on the basis of the social repercussions of current practices. Second, criticism is based on the belief that the economic effects of current practices are adverse. On the first ground two major objections are raised: (1) That the exemptions are too low and place an undue burden upon the low-income groups; and (2) that both the exemptions and deductions are arbitrary and discriminate without reason or justification among taxpayers. On the first count, frequent reference is made to the failure of the tax law to reflect the change in cost of living since low exemption levels have been in effect. The one increase from $500 to $600 made at the end of the war obviously fails to fully reflect the rise in prices since that time. Another and perhaps more insidious aspect of this reaction has been the tendency for labor to claim that take-home pay after deduction for income and social-security taxes should be the measure of their wage scale rather than income before taxes. This is insidious because it would, if followed as a policy, negate the effect of a tax increase designed to stop an inflationary development of serious proportions. The fact that similar claims to profits after taxes have been made by business in periods of inflation suggests that this may well become a problem of major proportions in the futre. The more reasonable argument that the level of exemptions should be raised to improve the distribution of income after taxes must be considered both from the social and economic viewpoint. In face of large current revenue requirements and the existence of heavy excise taxes upon this same group, such as the transportation, cosmetics, tobacco, admissions and liquor taxes, a reduction of these levies before increasing the level of exemptions seems to be the more desirable course. The argument that this would further emphasize the reliance upon a single source of revenue is deemed important by some, but in the circumstances that would permit a real reduction in revenues there is much to be said for giving the priority to the elimination of selective excises not only upon the ground of equity but also to relieve the industries affected of the arbitrary effects of the current law.

A final reason to make some effort to raise the level of individual exemptions is found in the borderline area which stresses the discriminatory nature of current exemption provisions. Greatest objection is raised about the burden borne by the single individual with low income as compared to the married couple. With the standard deduction a single individual will pay a 20 percent tax on income above $666.66, while the married couple will not start paying tax until their income is $1,333.33. The 20-percent tax on the difference is $133.33 no small sum for the single man to pay on an income of only minimal levels. The need for the community property provision of the 1948 act to remove the discrimination between the residents of community property States and non-community property States is clear and no particular objection is raised to the method used to remove the discrimination. There is, however, no justification for the discriminatory burden upon the single. A solution may be found in the more realistic relation of the exemption levels of the single person to the married and in the adjustment of the tax brackets or rates of either the single or the married to bring the two into line. At the present time the effect of income splitting is to give the married a set of rate brackets just twice as wide as the single person. Thus the married couple must have $4,000 of taxable income before the second bracket rate applies whereas the single person will pay the second-bracket rate on taxable income above $2,000. When the rates become even more progressive in the upper brackets this difference becomes substantial and can be expressed in vivid terms by thinking of the benefit the wife brings to her husband as a dowry that become increasingly valuable as the income of the husband rises through the brackets until he has reached the top and then diminishes in value as the husband's income rises further and further above the point where progression in rate brackets stops.[3]

Objection to the income splitting features of the law are centered upon the benefit given to the wealthy individual who marries the woman with no income of her own and finds that in addition to the benefits they jointly share from her unpaid contribution to the running of the household his tax liability is greatly reduced by the community property provision of the law. At the other extreme the current practices allow only a reasonable adjustment in the tax status of a married couple that continue to earn the same income after marriage that they individually earned before marriage. It is difficult to see how the taxpaying capacity of 2 individuals earning $5,000 a year before marriage is increased as the result of their marital status. Between these two extremes are found a multitude of possible cases. As a rough adjustment to correct some of the discrimination against the single it is suggested that the brackets used in case of married couples be made somewhat narrower than is now the case. The increased revenue should be applied to the reduction in rates across the board.

A final source of discrimination among those to whom the exemption level is important and who are at the margin in terms of living standards is the relative ease with which the income tax can be

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[3] Ludwig S. Heilborn has estimated that under the terms of the 1951 law a wife with no income had a cash value of as much as $11,457,000 if her husband earned $309,000, and was subject to maximum tax rates on this sum. Heilborn, Ludwig S., Uncle Sam's Dowry, National Tax Association Proceedings, 1951, pp. 310–314.

assessed against the wage earner subject to deduction at the source and the difficulty of getting comparable coverage of the self-employed with similar incomes. This latter group includes farmers, small shopkeepers, many in service trades and professionals. Although this discrimination arises because of administrative limitations it cannot be ignored in the appraisal of the individual income tax.

One may conclude that the problems of the relative burden assessed against the single and married and the problem of evasion and avoidance are valid objections to current practices. However, so long as the Federal revenue system relies as much as it does at the present time upon indirect levies of an even more arbitrary impact which discriminate against individuals, firms, and industries, there is a strong presumption in favor of the maintenance of current levels of exemption with only minor adjustments and concentration upon the reduction of the more objectionable levies as declining revenue requirements permit.

The second objection to current levels of exemption and deduction mentioned above is that the economic effects of taxation of the lower income brackets will be adverse to the maintenance of both economic stability and continued growth. The group that holds this view stress the necessity of maintaining high levels of consumption demand and fears the development of another period of stagnation due to the imbalance between savings and investment intentions in an economy characterized by widespread inequality of income distribution. This same group will often hold that the redistribution of the tax burden in favor of the lower income groups and against the upper would give the Government the resources with which to support a program of public investment that would be more productive of the national interest than the private investment that it might replace. This view was presented with some vigor in the recession of 1953 and earlier in the slump of 1949.

A careful appraisal of this view and its emphasis upon the desirability of strengthening consumer demand must lead to a critical analysis of the prediction that there will be a stagnation of investment opportunities and a tendency for redundant savings. Also required is an estimate of the effect of a redistribution of the burden of taxation from bottom to top upon the investment outlook or, if the burden is to be relieved at the bottom without increases at the top, the effectiveness of such action as opposed to an equal reduction of top-bracket rates. Finally there is need to calculate the threat of inflation which would follow a policy of general tax relief.

The basic principle that the maintenance of aggregate demand is essential if both stability in the short-run and long-term growth are to be assured is not subject to dispute. The importance of consumer demand as a determinant of investment prospects is also granted. But there are many other forces affecting the decision of the investor. One of the most important is the effect of taxation upon the return realized after taxes and thus upon the judgment of the investor about the future. The latter aspect of the problem may be even more significant than the former due to the emphasis often found among the investor groups upon such considerations. A favorable climate may stimulate the investor as much or more than an increase in yields on outstanding investments. It follows, therefore, that even if the stagnation thesis is accepted a policy designed to stimulate consumer de-

mand alone would be less successful than one granting some tax relief to both consumer and investor groups. Such a policy could be helpful as it would raise the expectations of the investor group as both consumer demand and return of capital would be improved. Any other policy would be viewed with suspicion by the investor who is probably as interested in the attitude of the Government as he is in the specific measures it adopts.

At the present time the lowering of the tax burden upon the lowest income group can be considered only as revenue requirements permit or as other sources of revenue are found. As indicated above, priority should be given to the reduction or removal of excise levies as they are both discriminatory among individuals and industries. In view of their magnitude there is little chance that any substantial reduction in income tax can be permitted unless there is a radical change in the level of public expenditures.

If there is a depression and there is need for counteraction on the fiscal front, then it would be wise to grant some relief to both low- and high-income-tax brackets. But in view of the possible need for later action to offset a boom or inflationary tendencies the relief to the lower brackets should take the form of a reduced rate rather than an increase in exemption levels. This is recommended because there is reason to believe that once the level of exemptions is raised there will be little chance of reversing the action short of a major catastrophe, such as war. We may conclude, therefore, that in the event that revenue requirements are permanently reduced priority should be given to the reduction of excise levies while countercyclical variations in levels of taxation can be best accomplished by variation in rate structure rather than exemption level. Finally, there is little evidence that the stagnation thesis is a basis for a selective policy of tax reduction. In the first place, there is grave doubt about its validity in the current economic situation. In the second place, if such a difficulty should arise, there is a strong case for action that would stimulate both consumption and investment spending.

Conclusions

The most significant effect of the level of exemptions under the individual income tax is that of determining the size of the tax base. High levels of exemption decrease the tax base. Low exemption levels increase the tax base. In a similar fashion the generosity of the tax authorities with regard to deductions will affect the base against which tax rates are applied. So long as revenue requirements continued at present levels the increase in exemptions would require the imposition of some other tax. On the other hand, if tax reduction becomes possible a decision to raise exemption levels must be made only after the reduction in other taxes is considered. In spite of the many imperfections of the individual income tax it is to be preferred to most other sources of Federal revenue and it is generally agreed to be vastly superior to the miscellaneous excise-tax system that has grown up over the years. We may conclude, therefore, that if tax reform is possible priority should be given to the removal of the discriminatory indirect levies and the strengthening of the individual income tax rather than the raising of exemption levels. If tax reduction becomes possible the same priorities should

apply—reduce or repeal many of the indirect levies while maintaining the individual income tax at current levels. In the event that a countercyclical tax reduction or increase is desired changes in rates are to be favored over changes in exemption levels. This position is based upon the belief that rates that have been lowered can be raised again as required by economic developments more readily than can exemption once raised be lowered as events require.

Low exemptions and high rates of taxation have led to much criticism of the tax as imposing an undue burden upon those in the lower income brackets. The failure of the exemption levels to reflect the inflation of the postwar period is cited as further evidence of the need for increases in exemption levels. Much of this criticism is based upon the belief that a minimum of subsistence should be completely exempt from taxation. So long, however, as indirect levies play the role that they do it is both unrealistic and unwise to raise the level of exemptions and subsistence will continue to be taxed. Priority should be given to the reduction or removal of these taxes before the exemption levels are changed. Until this is done there is no possibility of having a tax system that either exempts a minimum or subsistence or even imposes a progressive tax burden as income rises. In view of the pressing revenue requirements of the Federal Government the revision of the excise-tax system can occupy congressional and Treasury officials for some years to come.

The major sources of inequity arising under current practices are found in the comparative burden imposed upon the single and the married, and the uneven enforcement of the law upon different occupational groups and different sources of income. The latter problem can be met only as more effort is applied to the administration of the tax and as the law is revised to close the legal avenues of tax preference that have been growing in recent years. The former problem of the comparative burden upon single and married couples is impossible to solve to the complete satisfaction of all but it suggested that a narrowing of existing differentials is desirable. This could be accomplished by reducing the width of the brackets for marired couples making joint returns.

One of the greatest improvements in the Federal revenue system which has resulted from the greater dependence upon the individual income tax has been the increase in the sensitivity of tax yields to changes in national income. The progressive nature of the individual income tax results in a greater than proportionate decline in revenues in a period of falling income and a greater than proportional rise in revenues in a period of rising incomes. Both exemptions and rates are effective in creating the sensitivity. Thus, there has developed a built-in stabilizer which, although not sufficient to offset all fluctuations, can be useful in minimizing the problem. Any action which would reduce this flexibility should be opposed as leading to either greater instability or the requirement of greater discretionary action on the part of the Government. The claim that current exemption levels result in the imposition of an excessive burden upon the lower income groups which threatens the maintenance of consumer demand necessary to maintain a full employment economy cannot be proved on the basis of recent events. If there is need for strengthening of demand, the priority should again be given to the removal of excises.

It is also necessary to consider the effect of taxation upon investment as well as consumption. In the event that real deficiencies arise, a general tax cut granting concessions across the board is favored as against a cut favoring a single group.

Tax burdens on all income groups are high because Government expenditures are high and stability of the economy requires the restriction of consumer and investor demand to make possible the achievement of Government objectives without inflation. We should be proud of the fact that in face of such extraordinary demands we have been able to use the income tax as the primary source of revenue. As a result, both the economic repercussions of the heavy tax burden and the equity with which it is imposed are relatively favorable and have not led to major distortions in either the economy or the economic position of a single class.

ADJUSTMENT OF INCOME TAX SCHEDULES FOR SMALL INCOMES

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The adjustment of income taxes on small incomes cannot be considered in the abstract, but must take account both of the temporary or permanent nature of the adjustments proposed, and of the circumstances as to the characteristics of the remainder of the tax structure, such as the presence or absence of other taxes bearing on the same income groups, and the way in which the administration of the income tax dovetails with the administration of other taxes such as the social-security taxes. Temporary changes, such as those made for countercyclical purposes, may well be of a different character from those made as a permanent reform, while changes that might be thought desirable in themselves may well prove to be quite inconsistent with what is being done in other areas of tax policy.

COUNTERCYCLICAL VARIATIONS

When considering the proper form for countercyclical variations in income tax levels, it is necessary at least to consider the desirability of symmetrical changes in the upward and downward directions. A policy that consisted of systematically raising exemptions when the economy is to be stimulated, and of raising rates when inflation is to be restrained would of course soon result in a completely distorted tax structure, as would the reverse policy of lowering rates in recessions and lowering exemptions in booms. Given that the initial structure of the tax is reasonably satisfactory, the policy adopted should be a reversible one, either one of raising and lowering exemptions, or one of lowering and raising rates, or perhaps a combination of both types of change. These types of change can be evaluated in terms of their effectiveness in controlling the business cycle, their administrative facility, and their equity.

Effectiveness

Probably not too much weight should be attached to the factor of effectiveness in the choice between the different methods. Differences in the short-run marginal propensity to consume between income

classes are probably considerably smaller than the more obvious and more often cited differences in average propensities to consume; moreover, when these differences are averaged over the income classes affected by the various forms of tax change, the differences are still further reduced. Moreover, a formulation of the problem which implicitly takes the amount of the revenue reduction or increase as given and seeks to maximize the countercyclical effect (or seeks to produce a given effect with a minimum of revenue change) is to a considerable extent starting from a false premise: It is by no means clear that there is any great advantage to producing a given anticyclical effect with the smallest possible budgetary impact; if a method involving a larger revenue loss seems desirable for tax reasons, the disadvantages of having to borrow on a larger scale are likely to be relatively small, aside from the psychological trepidations occasioned among those to whom the annually balanced budget is still a valued goal.

Even so, it is by no means certain that an increase in exemptions is more effective, per dollar of revenue loss, than a reduction in the first bracket rate, since with the former the number of dollars of tax reduction increases with the bracket rate, while with the latter the reduction reaches a maximum at the top of the first bracket. Other forms of reduction that might have a more definite advantage, such as deducting a fixed amount from each tax bill, tend to be of a nonreversible character that makes them poorly suited for countercyclical policy, since the restoration of the fixed amount of dollars to each tax bill without other adjustments in the rate structure is likely to have a cool political reception. Among acceptable forms of countercyclical income tax variation, differences in effectiveness are likely to be slight and even these differences are likely to be of little relevance.

ADMINISTRATIVE FACILITY

The question of administrative facility is not as important as it once was, since with the inauguration of collection at source and the coordination of income tax and social-security tax collection there is relatively less to be saved in terms of administrative effort by an increase of the exemption level. The desirability of keeping the administrative load at a fairly constant level, and the diminishing returns encountered in pushing the administration of the income tax down to lower levels of income would both argue for a cyclical rather than a countercyclical variation in the exemption level, so as to keep the proportion of the population that is taxable approximately constant. Keeping exemption levels constant would thus seem a reasonable compromise between administrative considerations and the demands of fiscal policy.

At the withholding level, there is also considerable administrative advantage in holding to constant exemptions and varying rates. If a need for fiscal adjustment becomes apparent in the middle of the income year, then at least for those whose income is fairly steady over the year a reduction in the rate for the year can be allowed for in the withholding for the latter half of the year: if exemptions are increased, there would be individuals below or slightly above the final exemption level for whom withholding over the first part of the year would exceed the final liability for the year and to whom refunds would therefore have to be paid. Not only would the number of refunds be in-

creased but the fiscal impact of the change would be delayed, which is of considerable importance, in view of the critical importance for the success of fiscal policy generally of minimizing the time lag between the development of the need for an adjustment and its actual impact.

Equity

The choice of a method of countercyclical tax adjustment can also affect the way in which the tax burden is distributed between those with fluctuating and those with stable incomes. It is well known that a progressive income-tax assessed on an annual basis imposes heavier burdens on fluctuating than on steady incomes. This phenomenon is often thought to relate primarily to high incomes where the progression of the rates is most apparent; however, the exemption level in effect represents a jump from a rate of zero to rates recently in the neighborhood of 20 percent; this is a much sharper jump than takes place anywhere else in the tax schedule, and the number of taxpayers who move back and forth between the exempt and taxable categories is large compared with the numbers who cross the other bracket limits. Countercyclical fluctuation of exemption levels would tend to increase the number of taxpayers who cross the exemption level from year to year as well as the total amount of "wasted" personal exemptions; thus the discrimination against fluctuating incomes in this area would be increased.

On the other hand cyclical fluctuation of rates also involves some increase in the discrimination against fluctuating incomes in that those whose incomes fluctuate cyclically will have more of their incomes taxed at the higher boom period rates than at the lower recession rates. This type of discrimination seems to be less intense and more widely diffused than that created by the change in exemption levels, however, and to occur at higher levels of income where the discrimination would be more tolerable Both the force and the direction of this argument will depend to a very large extent on the rate structure and its relation to the distribution of income. Extreme cases can certainly be imagined where the argument in terms of equity between fluctuating and steady incomes would be overwhelmingly in favor of rate changes, and others where the argument would be overwhelmingly in favor of changes in exemptions. And in any case the appropriate solution lies not in trying to make major shifts in the method of cyclical variation for the sake of relatively minor improvements in equity, but in attacking the inequity directly through some form of averaging or by the carry forward or backward of unused personal exemptions.

Thus it cannot be said that the arguments on theoretical grounds for advocating rate changes rather than exemption changes as a countercyclical measure are very strong. The strongest arguments of a general tenor seem to be of an administrative nature. These, however, are reinforced by the consideration that if we look at the question in its current political context it appears unlikely that should a need arise for increasing revenues, this need would be met by reducing exemptions. And if exemptions are currently increased as a means of imparting a cyclical stimulus to the economy, it appears very unlikely that once the need for such stimulus has vanished the exemptions could be again reduced to their present level without formidable political opposition. Thus even if initially exemptions were raised as a countercyclical move, it appears almost certain that such a change

would in fact become a permanent change in the structure and not a cyclical variation. It is necessary therefore to examine the advisability of such a step as a permanent change rather than as a method of applying countercyclical policy.

PERMANENT CHANGES IN THE STRUCTURE OF THE TAX ON LOW INCOMES

Are the exemptions too low?

Judged by any of the standards that have been used in the past to determine the appropriate level of personal exemptions, the present exemptions are extraordinarily low. They cannot be said to cover a wholesome minimum standard of living for typical urban families in the United States, unless by dint of fairly revolutionary changes in living habits, such as would be involved, for example, in the use of Stigler's minimum cost diet. For the past few years the real purchasing power of the exempt income has been lower than ever in the past in this country, even in wartime, and the proportion of the population subject to the tax has reached record levels. All of which might be held to indicate that there is room for an increase in the exemptions as soon as revenue needs abate. In the immediate context, however, almost every consideration by which such a move might be justified seems to lead to an inconsistency or self-contradiction.

Although looking at the income tax in isolation it might seem that restoring the proper pattern of progressivity would call for an increase in the exemptions, when it is considered that there are other taxes bearing heavily on the lower income groups, raising exemptions must be relegated to a second order of priority. While studies of overall tax burdens can be questioned on many grounds, not only with regard to the assumptions made as to incidence of various taxes but also as to the appropriateness of income as a standard of reference for the lowest income classes, nevertheless they do show a degree of progression over the lowest income ranges that falls considerably short of anything that could be said to correspond to ability to pay on almost any principle or definition. The main contributors to this lack of progression at the Federal level are the tobacco and beverage taxes and the taxes on transportation and communication, with corporation taxes also contributing, according to some theories of incidence. Before considering an increase in the exemptions, one should at least consider reductions in these more regressive taxes.

In particular, the taxes on communications and transportation are not only regressive in their incidence but are among the more economically harmful excises in that they apply to industries that have considerable long-run economies of scale. Not only must the users of the facilities pay the tax that is passed on to them, but they or the stockholders of the enterprises must in addition bear the burden of defraying that part of the overhead above the marginal costs that was formerly contributed by the traffic that is driven away by the increase in the gross rates. A recent study of the rate structure of the New York City subway system indicated that for every dollar of net revenue obtained by raising subway fares the subway riders would have to contribute as much as $1.60. While this may be a somewhat extreme case, it is clear that the excess burden of special taxes on public utilities is substantial and that such excises should be avoided

wherever possible. The taxes under consideration were perhaps justifiable during the war when the facilities in question were overloaded and revenue needs were such as to warrant the exploitation even of otherwise rather undesirable sources of revenue; they should have been repealed as soon as the special war conditions subsided, and their repeal is long overdue. Moreover, while repeal of such excises is probably about as effective in stimulating employment as an equivalent reduction in income tax, it is less likely, because of the consequent reduction in costs to carry the stimulus to the point of causing an inflation of the price level. It is clear that the repeal of these taxes should take absolute precedence over any increase in the income-tax exemptions.

The case for considering reductions in tobacco and beverage taxes before raising income-tax exemptions is somewhat less clear, in view of the accepted sumptuary justification for these taxes. But granting, *arguendo*, that smoking is significantly injurious to health, and also that it involves significant external diseconomies of consumption, such as its contribution to fire losses and discomfort to neighbors, it is fairly clear that the demand is highly inelastic, and that the effects of this tax on the distribution of income bulk large relative to the effects on the allocation of resources. It seems also fairly clear that the present rates of tax are higher than would fairly reflect the external diseconomies proper, while there is something slightly incongruous about a situation where the majority of the population decides collectively that smoking should be discouraged for reasons of health or morals, but individually decides to continue smoking. If improvement of the distribution of the tax burden at the lower end of the income scale is an objective, reduction in tobacco taxes appears to have a claim to be considered before increasing personal exemptions.

With beverage taxes, the data are less persuasive both of the regressivity of the burden and of the inelasticity of demand, while the external diseconomies of consumption are more difficult to evaluate, so that there is much more room for difference of opinion as to the relative priority to be accorded reductions in these taxes. On the other hand, evasion, negligible for the tobacco taxes, is a significant factor in liquor taxes, but this is a consideration that lies somewhat far from the issue of progressivity.

The other major taxes that bear heavily on the lower income classes are largely State and local taxes, and might thus be considered to lie outside the scope of Federal tax policy. But even here there are ways in which Federal tax policy may appropriately have an influence in the direction of encouraging the States to reduce the regressiveness of their own tax systems. Thus by retaining income taxes at a high level and reducing its own excises, the incentive provided by the deductibility of direct taxes for States to make use of such taxes is maintained at a higher level, although to be sure the extent to which the standard deduction is used, particularly at low levels of income, makes of this a relatively minor point. Another possibility is that increased grants-in-aid of various kinds to State governments could be considered as a possible alternative to reduction in income-tax yields on the basis that this would in turn enable States and localities to diminish the regressive burdens of their taxes. Possibilities of this sort are perhaps rather limited, particularly as the grants may give rise to further

State and local expenditures rather than to the reduction of regressive taxes, yet they merit consideration as possibly to be preferred to a direct reduction of income taxes on lower bracket taxpayers.

THE SIZE OF THE FIRST BRACKET

The initial bracket of $2,000 to which the minimum tax rate applies has remained constant for over 2 decades, but during that time its significance has undergone drastic change. In the thirties, a comparison of the British and the American rate structures showed the British rates to be dominated by a normal rate applying to the large bulk of the taxpayers, with trimmings consisting of the surtax at the top and the reduced rate at the bottom, while the American structure was one of more regular graduation. The wartime reduction in exemptions, plus the adoption of income splitting has virtually reversed this picture: the initial bracket rate in the United States now covers a range of incomes comparable to those covered by the normal rate in Britain, while the graduation supplied in Britain by the reduced rate at the bottom end of the scale is lacking with us. One taxpayer may have an income as much as four times as great as another with the same family status and still be subject to the same marginal rate. To be sure, progressivity is to be found in the average rate, but this would seem an inadequate expression of the variation in ability to pay. Moreover the present scheme of graduation, to the extent that it involves a relatively high initial rate, tends to concentrate the discrimination against fluctuating incomes on those incomes that fluctuate around the exemption level and thus lose full benefit of their exemptions, which loss is converted into an extra tax burden at the relatively high rate differential that occurs at this margin.

While it would be hard to put very much weight on any particular rule of graduation, it would seem that the amount by which one income must be greater than another in order to warrant the application of a different marginal rate would be roughly proportional to the amount of the income, and that accordingly the ratio between the income corresponding to the upper limit of a bracket and that corresponding to the lower limit should be roughly constant for the different brackets. Obviously this cannot be the case for all different family sizes at once, but some rough correspondence is possible. One suggestion would be to split the first $2,000 bracket into three brackets of $300, $500, and $1,200, respectively. One might at the same time note that to provide separate rates for the $80,000 to $90,000 bracket and for the $90,000 to $100,000 bracket seems more detail than is really warranted, particularly when it is considered that the next bracket runs from $100,000 to $150,000. But this is a relatively minor matter.

In any case, the proposal to subdivide the first bracket is in some ways an alternative to another proposal for carryback of unused personal exemptions, and should be considered with that possibility in mind.

Exemption carryback

Among small-tax payers, the bulk of the relative disadvantage suffered by the taxpayer with a fluctuating income is represented by the waste of exemptions that occurs when his income falls temporarily below the exemption level. This is particularly true when a

relatively high initial rate applies to a very wide first bracket. Preventing this waste of exemptions, as by a carryforward or carryback, would thus go a long way, in these areas, toward the elimination of discrimination against fluctuating incomes.

As applied to individual incomes, however, carryforward of unused personal exemptions is subject to the very serious drawback that at any given time many returns with unused exemptions are being filed, and while many of these exemptions would never in fact be effectively carried forward, it is not possible to know in advance which these are, and thus it would become necessary to have a rather large and costly volume of auditing of obviously nontaxable returns in order to avoid later giving credit for exaggerated claims of unused exemptions, or having to audit very old returns with problems arising from the application of statutes of limitations.

Formerly, carryback of unused exemptions would have been subject to the objection that it would call for the payment of large numbers of refunds. But with the administrative machinery presently set up for handling such refunds expeditiously and efficiently, this is no longer a serious objection. Carryback has the advantage as compared with carryforward that at the time the return is filed it is already apparent whether or not the amount of the unused exemption is of consequence. There is thus no additional difficulty created for the efficient organization of the auditing program. Another very important consideration is the cyclical impact of such a carryback: the payment of refunds in years of reduced income, as contrasted with the abatement of taxes in years of increased income as would occur with carryforward, should greatly enhance the effectiveness of the income tax as a built-in stabilizer. To be sure, the fact that the actual payment of the refund is likely to occur about a year after the diminution of income has been experienced somewhat impairs the promptness with which this stabilizing effect will take place; nevertheless the existence of such a provision may be expected to have substantial direct and indirect announcement effects that may take hold considerably before the actual payment of the refunds takes place.

Finally, if the period over which an exemption carryback is allowed is made long enough, the refunds allowed may assume the form of a supplementary retirement income. This would form an acceptable and equitable substitute for the many proposals that have been advanced for exemption or deferment of taxation of sums set aside in various ways for retirement. But it is only a partial substitute for this unless it is considered in conjunction with some form of similar refund proposal applicable to larger income levels. For this purpose the use of cumulative assessment for the higher bracket taxpayers would be an appropriate complementary measure.

DEDUCTIONS FOR NONBUSINESS EXPENSES AND AN ECONOMIC CONCEPT OF NET INCOME

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Of the group of items referred to as nonbusiness expenses or personal deductions, most are not fully consistent with a systematically defined economic concept of personal income; their justification must depend on the efficiency with which they serve other economic or social

objectives. It is the main purpose of this paper to amplify this observation by analyzing individually the major items included in the personal deductions category.

In the first section attention is focused on the basic question of the content of an applicable definition of income and the entangled issue of the recipient unit. Stress is laid on those aspects of the definition specifically relevant to examination of the personal deduction items and some consideration is given to the role of the personal exemption and credit for dependents. The second section discusses the specific deduction items in an order which is analytically convenient. Legal and administrative issues are not discussed; nor is there any attempt to estimate the revenue effects of suggested changes. The major policy implications of the paper are summarized in the final section.[1]

The Income Concept

General relation to equity

Consistency of the legislatively defined tax base with a stated, measurable concept of income is the ultimately reliable test for adherence to the principle of equity in personal taxation. The "equal treatment of equals" means that individuals similarly circumstanced with respect to income pay the same tax bill. In a complex modern economy individuals differ in a multitude of ways, some relevant and some not. Whether or not two individuals should be considered similarly circumstanced can only be determined by defining an independent measure of income against which each separate circumstance can be tested. The ultimate effect of allowing any specific deduction (or requiring any particular inclusion) on all the multitudinous equity relationships of individuals to one another is almost impossible to determine.

There is also the question of the treatment of unequals. A well-defined tax base that represents an acceptable index of relative economic status is necessary if there is to be a controlled degree of progression, determined by the statutory rate schedule. Ambiguity and inconsistency in the definition of the base can result in a substantial gap between appearance and reality; the effective rates can turn out to be considerably less progressive than the statutory rates would lead one to believe. Thus if proper treatment is to be accorded both equals and unequals, a working relationship must be maintained between a theoretically defined concept of net income and the tax base as defined from accounting categories. The theoretical concept may then serve as a guide in the organization of accounting records and an "ideal" against which actual statutes defining the tax base may be continually evaluated for the accuracy with which they reflect relative economic status.

Formal definition

Economic status, of course, may be given a psychological interpretation so that it becomes completely individualistic, noncomparable, and not susceptible to quantitative summarization. Now, however true it may be that the personal experience of status has its ultimate

[1] This paper is primarily a statement and application of views and ideas of wide currency within the profession. However, in addition to the work of Prof. Henry Simons referred to below, I would like to acknowledge specifically the influence of Prof. William Vickrey's book Agenda for Progressive Taxation, the Ronald Press Co., 1947. I would also like to acknowledge participation of Anne White in the preparation of this paper.

reality in the psychic realm, no guide to tax policy can be derived from insistence on such an interpretation. On the other hand, it is not necessary, in an excess of pragmatism, merely to seize upon some convenient accounting starting point and muddle through a series of ad hoc adjustments or refinements to a final determination of the tax base. There does exist a concept of income from economic analysis which, with modifications, can be made to yield a satisfactory index of the relative economic status of persons.

Personal income has been given its most considered and rigorous definition by Prof. Henry Simons. The summary statement of his definition is that income over a period of time is the algebraic sum of the exercise of claims by an individual for purposes of consumption, plus the net change in his store of claims—both evaluated at market price, with the latter computed on an accrual rather than a realization basis. Claims may be in the form of cash or assets generating explicit or implicit yields. This is an ex post concept, and defines income in terms of what has been done with it over a given period of time—its disposition rather than its source.[2]

The "exercise of claims on behalf of consumption" includes all the things obviously suggested by the term and also the less obvious items of leisure (which would be valued by imputing an estimate of foregone earnings) and income in kind resulting from personal effort or the owner-use of durable goods. Included here would be housewife services, depreciation, and interest on durable goods including household equipment, automobiles, owner-occupied houses, and similar items.

Change in the stock of claims includes not only changes in the market value of securities and additions to cash balances but also changes in the stock of durable goods. New assets, whether purchases of durable goods or gifts, represent additions to the stock of claims, while depreciation on old assets is a reduction. Growth in valuable capacities embodied in the person is not included in the concept, although the ultimate result of activating these capacities is, of course, income under the appropriate headings.[3]

Specific content

It is impracticable to estimate or compute directly the sum of each taxpayer's consumption outlays and changes in cash balances and other asset holdings. A first step in practical application is to translate the definition, to reformulate it in familiar accounting "income" categories. The table below lists in the left hand column the components of income following the original Simons definition in terms of disposition. In the right hand column are the categories of income by source which would have to be included for strict correspondence to the disposition side.

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[2] Henry C. Simons, Personal Income Taxation, University of Chicago Press, 1938. Although the discussion which follows is based on this definition, some freedom is exercised in interpretation.

[3] The history of assets prior to the moment they come into the possession of the taxpayer is irrelevant; this is a point of importance in considering the issues of "double taxation" and "double counting."

It should be clear that personal income for tax purposes in no sense represents a share in the national income. The meaningless total of personal incomes will not only greatly exceed the value of the national product but the relationship between the personal income total and national product will vary with the size of the interpersonal flow of claims not related to current production.

TABLE 1.—*Alternative views of the personal-income concept for a given period*

Disposition	*Source*
Consumption:	Factor receipts (including income in kind):
Explicit outlays:	Wages and salaries
Purchases of nondurable goods	Interest and dividends
Purchases of services	Net business and professional income
Imputations:	Net farm income
Depreciation on durable goods	Gifts and inheritances
Net interest on durable goods	Net capital gains
Value of personal services in the home	Imputations:
Value of leisure time	Interest on durable goods[1]
Change in stock of claims:	Value of time spent in the home
Change in cash balances	
New acquisitions of securities	
New acquisitions of durable goods	
Change in market value of owned securities	
Change in market value of owned durable goods:	
Depreciation (negative item)	
Change in market value net of depreciation	

[1] Depreciation not included; it is a positive consumption item and a negative change in claims item, it thus cancels out.

Net income defined in this way takes account of most of the commonly accepted criteria of relative economic status. However, even at this level of abstraction which permits the most comprehensive interpretation of the concept it does not perfectly reflect all the subtleties of our notions of relative status. For example, it permits no distinctions as to source of income—such as those between property and nonproperty income, or between windfall or other capital gains and regular income. Nor does it allow adjustment for geographic differences in price levels.

And as the concept is moved down the ladder of abstraction, the limitations of data require a contraction of its borderlines and the replacement of measurement by estimation. The inclusion in income of the value of leisure time and many other imputations, such as income generated in the home by personal effort or through the owner-use of consumer durables other than housing, must be given up for practical reasons; but the fact that they logically belong remains a qualitative influence in assessing the issues connected with items that are susceptible to estimation.

Definition of unit

Entangled with the problem of income definition is that of defining the recipient unit, of establishing a basis for discriminating among family units of varying membership. Under a strictly proportional tax the issue would be of no consequence, but under a system of progressive rates it is of material importance to the taxpayer whether a given income must be attributed to one person or can be split among two or more.

Insofar as units consisting of man and wife are concerned, a community consensus has probably been established on the equal partner in a pooled income, or per capita, approach implied in the split-income provisions of the present law. However, this approach does not properly imply a splitting of the income aggregate precisely by 2. Individuals living together and pooling their income can achieve a higher

economic status from a given income than can two individuals living separately, each on half the income and economies of scale continue to operate as the family unit grows in size. The limitations imposed on the practical calculation of the tax base probably reinforce the inequitable tendency of income splitting by two, since imputed income which is not taxed is higher in most two-person families than in single units. Fortunately the arithmetic of tax computation does not require that the taxable income be split by an integral divisor. It would be more equitable for family units consisting of man and wife to use a divisor somewhat less than 2.

An extension of the fractional income splitting device could well be made to include children and adult dependents as additional members of the unit.[4] This approach would have to be justified primarily on the equality of community concern for household members rather than on a presumption that all members of the household in actuality share equally in a pooled income. Some quantitative differential could be allowed for minors. A child equivalent of a given adult economic status can probably be achieved with a smaller allocation of income, and hence the increments in the divisor used for income splitting for children should be less than for additional adults. And successive increments should be smaller.

Because the tax advantage of the split becomes so important for high incomes, there may be a strong incentive for high-income recipients to add additional members to the household, and this will place considerable burden on the criteria for distinguishing dependents. Perhaps it would be useful to set an absolute upper limit on the amount of income that can be allocated to dependents.

This per capita treatment of recipient units would, of course, displace the present personal exemptions and credit for dependents[5] and would eliminate the special rates for single persons with head of household status. The tax advantage of the income divisor method would clearly be greatest for large families in the middle and upper income groups. In general there would be a lessening of the effective progressivity of the tax but this could be offset by a proper adjustment of the rates. Some rate adjustment would be necessary in any case to compensate for the loss in yield.

Specific Deductions

Mortgage interest and property taxes

All economic activity has a time dimension. Consumption is no exception although the time element is not always obvious in its manifestation. "Current" consumption represents a choice by the household not only among immediately available goods, but the choice to have goods now rather than later. The service or outright ownership of an automobile today is an economically different commodity from

[4] A possible alternative viewpoint is that the expenses of raising children are a form of consumption and do not entitle a taxpayer to any special treatment. The present credit for dependents from this viewpoint is an incentive subsidy for a socially desirable form of consumption

[5] If it is considered desirable to have a tax free minimum, a zero-rate bracket would be a more progressive method than the use of exemptions.

that of an automobile 1 year from today. The consensus of the market place is that it is also a more valuable commodity. From the individual's point of view, this fact is reflected in an interest cost—whether explicitly paid out or implicitly incurred through a foregone interest return. Thus interest cost is pervasive; it is involved in the consumption of food and other daily recurrent items as well as in the decision regarding acquisition of durable goods. However, it is easiest to analyze the relationship between interest and the income concept in connection with durable goods financing, particularly the case of housing.

For this problem, three significantly different institutional arrangements for financing a year's consumption of housing services must be kept in mind. One is the case of the tenant in which financing is entirely on a pay-out-as-you-consume basis. Another is the owner-mortgagor, which requires the explicit payment of interest. And the third is the clear-owner, in which owner equity covers the full value of the house. The consumption component of income for all three is equal to the gross rental value of the space occupied. An explicit payment of the rent is made by the tenant; in the other two cases the gross rental value must be established by imputation. The tenant's rental is sufficient to cover maintenance expenses, depreciation, property taxes, managerial services, an allowance for vacancy rates, and net return on invested capital.[6]

The tenant, in making an outpayment for housing service, has his stock of claims reduced below the level that he would otherwise have been able to hold by an amount just equal to the value of housing services consumed. Thus no net income is generated for him in connection with his home. For the clear-owner a similar reduction in claims results from items of depreciation, maintenance, and taxes, but the reduction is less than consumption as measured by the gross imputed rental. The difference is the amount of return on invested capital and for managerial services. Thus the consumption of his own property generates an imputed net income for him. In the case of the mortgagor, the net income generated is less than for the clear owner by the drain on his stock of claims to make the interest outpayment on the mortgage.

The table below gives a numerical example of the income computation for three similarly circumstanced taxpayers, each of whom elects one of the alternative ways of financing a year's occupancy of a $10,000 house. As can be seen from the table, their income properly defined is equal and their tax bills should be the same. Present tax provisions, by failing to include imputed rentals, discriminate against the tenant. The provision for the deduction of property taxes and mortgage interest are logical only as deductions from gross rent. So long as imputed rentals are not included, the property-tax deduction serves only to increase the discrimination between the renter and the homeowner.

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[6] The imputed gross rental for owner-occupied houses should probably be less than the tenant rate for comparable space; the costs are less since there is no need to cover a vacancy rate and correspondingly the services are less as the owner is not as free to move.

TABLE II.—*Income computation for taxpayers with alternative methods of financing home*

	Tenant	Mortgagor	Clear owner
Assets at beginning of year:			
(1) Cash	$1,000	$1,000	$1,000
(2) Securities	10,000	5,000	
(3) Equity in home		5,000	10,000
Total	11,000	11,000	11,000
(Mortgage)		(5,000)	
Income and expenses during year:			
(4) Wages	5,000	5,000	5,000
(5) Yield on securities [1]	500	250	
(6) Gross rent (actual or imputed)	1,000	1,000	1,000
(7) Other consumption	4,000	4,000	4,000
(8) Property tax		200	200
(9) Maintenance		50	50
(10) Depreciation		250	250
(11) Interest on mortgage		250	
(12) Net imputed rent (6)−(8)−(9)−(10)−(11)		250	500
Income computed by disposition:			
(13) Gross rent	1,000	1,000	1,000
(14) Other consumption	4,000	4,000	4,000
(15) Change in cash:			
(4)+(5)−(6)−(7)	+500		
(4)+(5)−(7)−(8)−(9)−(11)		+750	+750
(16) Change in value of house		−250	−250
Total	5,500	5,500	5,500
Income computed by source:			
(17) Wages	5,000	5,000	5,000
(18) Yield on securities	500	250	
(19) Net imputed rent		250	500
Total	5,500	5,500	5,500
Income computed from present tax provisions:			
(20) Wages	5,000	5,000	5,000
(21) Yield on securities	500	250	
(22) Less property taxes		−200	−200
(23) Less mortgage interest		−250	
Total	5,500	4,800	4,800

[1] The rate of interest on the mortgage loan, the rate of return on the equity in the owned home and the yield on securities are all computed at 5 percent. Differential returns would spoil the comparison by giving rise to different incomes. Managerial return and the vacancy rate allowance are ignored.

Inclusion of imputed net rentals could be accomplished by adding an estimated gross rental value in the gross income of the owner and permitting depreciation, maintenance expenses, taxes, and any mortgage interest to be deductible.[7] A less complicated alternative would be to compute a reasonable interest return on an estimate of the owner's equity, an estimate which could be based on assessment rolls, adjusted by the kind of equalization ratios now in use in many States.

Without the inclusion of an imputed net rental there is no clear-cut equity criterion for the treatment of mortgage interest. To permit the deduction as does the present law is to put the mortgagor on a more equitable basis with the clear owner but aggravates the inequity to the tenant. This well exemplifies the inadequacy of attempts to solve equity problems on a partial basis—that is, without reference to the underlying income concept.

The most popular justification for the property deductions is that they represent a fiscal encouragement to homeownership. Laudable though the general objective may be, the suitability of subsidizing homeownership by use of deductibility provisions is open to serious

[7] This, roughly, is the British method.

question. The subsidy not only becomes larger the more expensive the home but for a given home it increases with the size of the taxpayer's income. And to the extent that there is a positive relationship between size of income and value of home, the effect of the subsidy becomes even more sharply regressive. Surely Federal action to aid homeownership can be achieved with less sacrifice of equity by direct action in the housing and home finance area and perhaps through fiscal aid to local governments.[8]

Personal and installment interest

It is convenient, and probably realistically in order of importance, to consider first the proper treatment of personal and installment interest when the proceeds of the loan are for purposes of acquiring durable consumer goods (other than houses). The three cases outlined above in connection with mortgage interest are applicable here. The role of "tenant" is filled by customers of the laundromats, and commercial launderers, the automobile rental establishments and taxis and so forth, as well as by tenants in buildings that furnish services of durable goods. The installment purchaser is in the position of the mortgagor and the outright purchaser in that of the clear owner. Again the ideal solution is to impute return to the owner-user of durable goods, permitting installment (or other personal) loan interest as a deduction for the borrower-owner. This would then put the pay-out-as-you-use renter, the borrower-owner, and the clear owner on a consistent basis.

It is, however, impractical to make such imputations for most durables. Again, as with mortgage interest, the lack of imputation leaves the deduction for loan interest in an ambiguous status. However, for many consumer durables, particularly automobiles, the renter population is comparatively small. In this case it may well be argued that a larger measure of equity results if the treatment of the borrower-owner is made consistent with that of the clear owner by permitting deduction of installment and personal interest.[9]

With regard to recurrent household expenses, everyone falls in the role of tenant—that is, is on a pay-out-as-you-consume basis. A person who has sufficient receipts or a cash balance from which to finance a given level of such expenses without borrowing has a higher income than one who does not. This becomes clear if he should choose to borrow for current living expenses anyway, and lend out his own cash at interest. Then he has the same consumption as the borrower and an equal interest payment to meet, but an offsetting inflow of cash adding to his claims which the borrower does not. Therefore, treatment consistent with the income concept permits the deductibility of personal interest where the funds are used for ordinary current expenses.

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[8] The implications for local finance are considered below. It may also be noted that the implied subsidy received by a given houseowner cannot be precisely determined without stipulation of changes in tax rates contingent on removal of deductions.

[9] It is sometimes said that the interest paid by the purchaser, say, of an automobile on the installment plan, is simply part of the price of the automobile, that part which arises because he is unwilling to wait until he has saved the purchase price. It is true as indicated earlier that the interest represents the cost of having the use of the automobile now rather than later. But this does not distinguish him from the clear owner: the latter pays the interest cost in the form of forgone earnings. The reason why the deductibility of the installment interest is necessary for the equitable treatment of the borrower relative to the clear owner is not related to the price aspect of interest but is simply to recognize that, with respect to this transaction, the clear owner has a higher income due to his possession of greater income earning assets—the cash necessary for the full purchase of the automobile.

Sales and excise taxes

Deductions for sales and excise taxes generally may be claimed by the person who is liable according to the law imposing the tax, which may or may not coincide with the economic incidence of the tax. If the economic incidence of the tax is not on the consumer, then there is obviously no justification for permitting deduction. But a question of consistency with net income still remains if it is assumed that the incidence of the deductible taxes is actually on the consumer.

One viewpoint is to regard all State and local taxes paid by an individual as a measure of his share in the social consumption of government services. Their deductibility would then clearly be disallowed. This viewpoint has greatest applicability to such taxes as gasoline taxes, where the tax bill is roughly correlated with consumption of a government service. But it is difficult to maintain for taxes that have no direct relationship to benefits bestowed.

The valuation of the consumption component of income is that of the market. The price paid by the consumer is the accepted measure of the value to him of the commodity he buys. If one consumer chooses to pay $5 for commodity A and another chooses to pay $5 for B, their consumption is equal, irrespective of the fact that the outlay for A included an amount to cover an excise whereas the outlay for B did not. The presence of the excise is just one of the influences producing a sufficient relative scarcity of the commodity to cause its value to consumers to rise to the $5 point. A deduction gives preference to the consumer who prefers A to B at the $5 price.

The presence of a general sales tax or a large number of excises in one area and not in another may cause price differentials on physically identical commodities. But, as already indicated, such differentials are not taken into acocunt in evaluating the consumption component of income. Furthermore, deductibility can scarcely be maintained consistently for all consumers of taxed commodities—either because consumption is indirect or because the tax happens not to be levied in a way that can be segregated. Finally, deductibility from the Federal income tax increases the regressive character of this type of local taxation.

State and local income taxes

State and local income taxation raises different issues. No adjustment of consumption or savings habits can alter the impact of a general income tax. Thus, an income tax does not produce differential tax payments unrelated to economic status which is the major cause of the equity issue in considering deductibility for other State and local taxes.[10] Of course, if all States and localities levied a proportional income tax at the same effective rate, no change of relative status would be effected and the question would become academic. But this is not the case; rate schedules vary significantly among States and localities and are generally progressive. Consequently, a person's economic status before levying the Federal income tax is properly measured after a State or local income tax.

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[10] For example, assume an excise is imposed on a commodity which is consumed in equal amounts by X and Y, and which produces a price rise. In response to the price rise consumer X shifts some income from the taxed commodity to other purchases whereas Y allocates income from other consumption in order to maintain his consumptions of the taxed commodity. Both are disadvantaged by the price rise, but Y has a larger offset in the form of an excise tax deduction from his Federal income tax. Nothing comparable occurs under a State or local income tax.

The desirability of deductibility for State or local income taxes is reinforced by the practical consideration that it automatically prevents combined Federal-State-local tax rates from exceeding 100 percent.

Implications for State and local finance

The import of the above discussion of deductibility of State and local taxes implies a decidedly unneutral role for the Federal income tax in the State and local tax picture. Property, sales, and excise taxes would be disallowed as deductions, but income taxes would be permitted. A fairly strong incentive would thus be established for State and local governments to increase the share of their total revenues from income taxation. The resulting increased sensitivity of State and local structures to changes in aggregate income may require, or perhaps more accurately, induce more advance planning at the local level than has been customary in the past. But this can hardly be a deficiency. A more sensitive revenue structure combined with some form of countercyclical reserve fund offers a more realistic adaptation to the kind of economic environment State and local governments are likely to have to cope with in the decades ahead. And from the point of view of economic stability, a more widespread adoption of income taxation would increase the countercyclical effectiveness of the American tax system as a whole. With respect to administration, my impression is that many difficulties could be alleviated by increased cooperation between Federal, State, and local authorities.

Medical expenses and casualty losses

The medical expenses and casualty loss deductions can be considered consistent with the net-income concept on the ground that they are not voluntary outlays providing satisfaction in the usual sense; they represent a nonconsumption exercise of claims and are thus a negative component of income. The difficulty here as with other attempts to segregate outlays that are partly involuntary, is that the argument is too readily extensible. Whether or not these deductions are consistent with net income is not in any case going to be determinant in treating medical expenses and casualty losses. For they are concerned with a matter as fundamental as any in the area of economic ethics—the proper handling of risk.

Our society is greatly concerned with risk and our economic system makes available to individuals a wide range of choice as to the degree of risk they wish to assume. Both public and private agencies contribute on the one hand to the elimination wherever possible of involuntary risks (insurance companies, unemployment compensation) and on the other hand to the protection of the dazzling rewards that occasionally accrue to those who undertake speculative projects and are successful. Income-tax policy is influenced by this dual concern with risk. The interest in protecting certain high rewards is reflected in sections of the tax law not under discussion here, but some note might be made of the generous treatment of firms engaged in natural resource development and of capital gains in general.

A medical expense and casualty loss deduction is an expression of the desire to protect against involuntary risk. Together they represent a kind of insurance covering contingencies to person or property

of a serious and unpredictable nature which are otherwise uninsured.[11] The premiums are in the higher tax rates necessitated by the deduction and the consequently higher bills paid by taxpayers in years when they do not have large medical or loss deductions. The premiums may be considered to rise proportionately with income since, were the deduction to be abolished, it would probably be compensated for by a general reduction in all rates. The benefit, the reduction in the tax bill when the deduction is claimed, is of fractional coverage and is proportional to the allowable expense or loss. The fraction covered rises progressively with income. Thus the system is probably biased to some extent in favor of the higher income groups. In addition these groups in general are more sophisticated in tax matters and are in a better position to incur the initial expense themselves; hence they are more likely to take full advantage of the system.[12]

This is perhaps not such a bad scheme for handling the medical expense problem until some form of direct medical insurance can be devised that wins widespread community acceptance, but it is certainly not an optimal long-run solution.

Child care

The recently introduced deductions for child care may be regarded as a step toward correcting an inequity in the present tax treatment of two-family situations—the working wife, and the single, self-supporting parent. The deduction is sometimes justified as a business expense necessary to permit the earning of income, but minimal food, clothing, and shelter, as well as numerous other outlays, could be so categorized equally well.

Services ordinarily performed by the wife in the home are a significant element of the normal family's income—an element which, as noted above, cannot in practice be taxed. Nor can the value of the wife's leisure time be included in the tax base where these services are performed by servants.[13] All that can be done is to allow some form of deduction to working wives and single parents which will moderate the discrimination against them.

Since the services given up are general household services as well as child care, perhaps some deduction is justified even where there are no children. One suggestion is that a basic stated deduction be given representing the cost of a servant at the going rates with an increment for child care. The deduction should be permitted whether an explicit expense for domestic service is incurred or not, since in the absence of a servant the working wife or single parent sacrifices leisure by doing housework in after-business hours.

The deduction for the working wife is to some extent in conflict with the community value still placed on having mothers remain at home. The fact that the present law permits the income generated

[11] There may be some point in calling attention to the distinction between uninsured and uninsurable risk. Properly it is only the latter that constitutes a truly involuntary assumption of risk. Those who do not take out insurance when it is readily available, but who can expect to get the loss offset in case of casualty, are thereby making a net saving as compared with those who pay the premium.

[12] However this should not be taken to imply that the inequity resulting from the present ceiling should be allowed to continue.

[13] On a strict theoretical basis, if a wife works there is no addition to the family's income, since her household services and leisure time are properly evaluated on the basis of potential earnings. The appropriate adjustment, then, is to impute to the income of nonworking wives the value of their foregone earnings.

by home activity to be tax free while outside earnings are fully taxed may be interpreted as a form of subsidy meant to provide an incentive. The recent child-care provisions conform to the value by limiting eligibility for the deduction in the case of working wives. As the law now stands, the deduction is apparently intended only for hardship cases—where the husband is incapacitated or where the joint earnings are quite low, implying a necessity for the wife to work.

There is real reason to doubt that the tax provisions represent an important element in a mother's decision. The effect of the tax law one way or the other is a relatively small part of the economic calculation; the degree of concern for social approval (whichever way any particular community makes the evaluation) and the relative aptitude for, and satisfaction in, home activities as compared with employment are probably the dominant considerations in any case.

Contributions

A charitable or other such contribution by an individual is a voluntary allocation of funds, presumably more gratifying than expenditure on goods and services. Its deduction is thus not an appropriate adjustment for the calculation of net income. The deductibility of these contributions can best be regarded as one means of implementing a policy of decentralization of control over social-welfare activities. Direct operation by the Government keeps the control of social-welfare institutions completely centralized. A direct subsidy implies governmental determination of the total value of resources to be committed to any particular institution, but the administration of funds once committed would be kept in private hands. Tax abatement leaves the decision both as to how resources are to be rationed among eligible institutions and the administration of funds in private hands. The availability of alternative sources of funds for social-welfare activities is important in a pluralistically valued society, and it is worthwhile to provide tax incentives in this direction.

However, present provisions of the law tend to concentrate control over the resources available to eligible institutions in the upper income groups. There are of course limitations on the size of deductible contributions, and the Government itself sets the eligibility criteria for recipient organizations. However, within these limits the higher the taxpayer's income the higher the ratio of the Government's contribution to the taxpayers. Thus at a marginal tax rate of 75 percent a taxpayer who decides to allocate $1,000 of his disposable income to an eligible institution of his choice can actually commit $4,000 worth of funds. At the 40 percent rate, a decision to contribute $1,000 of disposable income enables the taxpayer to commit only $1,667.

It cannot be expected that the policies and organizational structure of the recipient philanthropic institutions would be independent of the viewpoint and perhaps personal influence of those responsible for providing a major share of the funds. It would seem more consistent with the values of a democratic capitalism to encourage wide participation by the community in this area as well as other areas of social and economic activity. A tax credit device might well be an improvement over the present deduction. Some fraction, say one-half, of all contributions up to a specified limit might be made deductible

from the tax bill. This would weaken somewhat the incentive to contribute for the upper income groups but would substantially strengthen it for the middle and lower middle ranges. If effective, the device would tend to democratize the source of funds for philanthropic purposes, and it is not impossible that an increased total of funds at reduced cost to the Government would result.

Optional standard deduction

The deduction provisions are an instrument for dealing selectively with taxpayers and not with those elements of their position common to all taxpayers. Consequently a "standard deduction" is almost a contradiction in terms. The present standard deduction permits all taxpayers with deductible expenses not exceeding 10 percent of adjusted gross income or $1,000 to claim the same total deduction regardless of individual variations. It is obvious that the same result would be approximated by confining deductions to the portion of eligible expenses in excess of 10 percent of adjusted gross income and revising the tax rates downward. Once this is done, it would become apparent to all that the only persons benefiting from the deduction provisions are those with aggregate expenses in excess of the 10 percent limit. This is probably an unacceptably high floor considering that it is simply an administrative device; particularly would this be so if some of the present items are removed from the deductible category. It is doubtful that the practical advantage of the present standard deduction in simplifying the filing of returns, and minimizing the discrimination against the unsophisticated, is sufficiently strong reason to justify continuation of the option.

Summary

The main implications of this paper of direct relevance for policy may be summarized as follows:

1. Consistency of provisions defining the tax base with an economic concept of personal net income being the fundamental test for equity, should receive more official recognition. This might well take the form of an official publication—representing a professional consensus—containing a formal definition of personal income, a frank discussion of the difficulties in translating it into a measurable concept, and a detailed examination of the relationship borne to it by each of the important provisions of the tax law. Such an undertaking would undoubtedly have a salutary long-run effect on the level of equity actually achieved in our tax system.

2. (*a*) The treatment of household units of varying membership might well be improved by extension of the principle of income splitting to all household members. However, to allow more accurately for the economies of scale possible in household operations, the increments in the divisor should be fractional for additional members beyond the first, with smaller increments for children.

(*b*) To put working wives on a par with nonworking wives who have a higher imputed nontaxable income some deduction for the former is justified, with the deduction larger in the case of children. The deduction should be permitted whether or not an explicit expense for domestic service is incurred.

These changes would displace personal exemptions, credit for dependents, the head-of-household status, and present income-splitting provisions. A tax-free minimum income could be provided by an initial zero-rate bracket.

3. (*a*) An estimate of net imputed rent should be added to the income of the homeowner, thereby correcting a major discrimination against tenants. Mortgage interest and property tax deductions should be disallowed, except as a subtraction from an imputed gross rental. Alternative policies are available for inducing home ownership without the conflict with equity.

(*b*) The status of personal and installment interest is ambiguous, but a larger measure of equity may well be served by continuing their deductibility.

4. Deductibility of sales and excise taxes, which affect the consumer through the prices of goods and services which he buys, should be disallowed. On the other hand, from the Federal viewpoint, personal income is properly defined net of State and local income taxes and therefore the deductibility of the latter should be continued. The unneutral consequences for State and local financial structure are on the whole desirable.

5. The insurance-substitute-supplement function served by the medical and casualty loss deductions are an overwhelming consideration in justifying their continuance. The significance of the medical deduction may be expected to diminish over time as the community develops a more adequate approach to this form of involuntary risk.

6. Deductions for contributions to philanthropic institutions obviously are not implied by a net-income calculation, but they are an important instrument in restraining the direct role of Government in the conduct of social-welfare activities and in developing alternative private sources of funds. The technique of a fractional credit against the tax bill would be more democratic in its effects than the present deduction from taxable income.

7. The present optional standard deduction is essentially functionless and somewhat misleading as an instrument of equity. Its effect is to put a high floor under eligible deductions and thus to make the selective system of personal deductions nonoperative over a wide range. It should be removed and any floor on eligible deductions should be much lower.

VIII. ECONOMICS OF CAPITAL GAINS TAXATION

THE LOCKED-IN PROBLEM

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INTRODUCTION

Meaning of economic growth

What the individual's weekly paycheck, after taxes, will buy one year compared to the next is the real measure of economic growth. Fatter paychecks are the main spur to consumption and also the major source of all new personal savings.

Moreover, economists would agree that bigger paychecks, with bigger purchasing power, can only come about through real increases in productivity. They cannot come just through fatter pay envelopes for those in the best bargaining seats. For bigger pocketbooks alone, due to inflation, buy less goods and services for practically all, depreciate the dollar assets of most Americans, and melt the pension checks and savings of millions living on fixed incomes. The concept of economic growth which I wish to deal with in discussing the locked-in problem is that of real increases in personal incomes, not just dollar increases.

Relationship of locked-in problem to economic growth

The relationship of the capital-gains locked-in problem to economic growth is not a simple or direct one. It is as complex as our economy.

But it can be simply stated: Real economic growth depends on adequate capital formation. Adequate capital formation in turn will depend, in the coming decade on:

1. Greater incentives to attract new savings, especially into equity and venture capital opportunities:
2. Adequate mobility for the $600 billion of personal savings in the form of bonds, stocks, and other capital assets; and
3. Greater efficiency in the use of venture capital, because of the portending shortage of such capital in the investment decade ahead.

As of this moment, American investors are locked in with over $200 billion of unrealized capital gains. We know that, in stocks listed on the New York Stock Exchange alone, there is over $100 billion of unrealized appreciation just since 1949. That these investors continue to be locked in by the restrictive effects of the capital-gains tax constitutes one of the country's most serious obstacles to economic growth.

Before discussing how important increased productivity and increased capital investment will be in the next decade, and how the problems of locked-in capital in the past may be dwarfed in the

future, I would like to analyze in more detail the nature, causes, and extent of the locked-in problem as it exists today.

The Locked-In Problem

Nature of the problem

The term "locked in" customarily refers to the immobilization of capital—a hobbling of desirable capital transfers, if you will—due to the capital-gains tax rate and holding-period provisions of the Federal tax laws.

The key capital-gains tax provisions of the present law applicable to the locked-in problem concern percentage inclusion (now 50 percent), the alternative maximum rate (now 25 percent), and the holding period (now 6 months).[1]

In this paper the locked-in problem will be analyzed with particular reference to the present capital-gains treatment of equity securities owned by individual investors. The impact of the tax has been most severe on stockholders rather than owners of other capital assets and rather than corporate—as distinct from individual—owners. But much of the same harmful locking-in effect applicable to individual investors is also applicable to certain financial institutions, industrial corporations, and others subject to the capital-gains tax provisions.

Although the term "locked in" suggests a specific limit to action established by a physical barrier, the actual effect is more analogous to the hobbling of an animal, or the attractive force of an electromagnet rather than a locked door. For the effect of a hobble or a magnet will vary widely depending on the relative sizes and weights, the strength and makeup of the materials involved, and about as many other factors as are involved in getting an investor to transfer his capital funds from one asset into another.

Thus, the phrase "locked in," in essence, refers to the restraints of present tax rates imposed on individuals considering the transfer of capital assets in which they have incurred a gain.

Under the present law there are two scales of tax rates, both excessively high in terms of their adverse economic impact on capital mobility:

1. Regular income taxes on any realized gain for an asset held less than 6 months. Because of the high progressivity of our current income-tax rates, this means that the holding period itself acts as a locking-in or magnetic force repelling new investors and magnetizing present ones to their present investments.
2. The other tax-rate scale concerns the capital-gains-tax provisions, which are either half the regular income-tax rate or not over 25 percent (maximum alternative).

These two forms of locking up, tax rates and holding period, and how they actually lock people in, are illustrated in detail below:

Three examples of locked-in investors

Example A (investor considering switch from "blue-chip" to "venture company"):

> Bill Jones bought 100 shares of Du Pont common stock in June 1949 at a cost of $43.75 per share. As of September 30, 1955,

[1] The pertinent sections of the law are in subch. P of the Internal Revenue Code of 1954. Since 1942, the capital-gains-tax provisions of the law have remained virtually unchanged, with just two classes of capital gains—long term (for capital assets held over 6 months) and short term (for assets held under 6 months).

Du Pont was selling for $219.75 per share, and yielding 3 percent. If Bill should sell, he would realize a capital gain of $176 per share, imposing upon himself a capital-gains-tax liability of up to 25 percent or up to $44 per share. Ignoring the cost of selling commissions and stock transfer taxes, his capital would be reduced from $22,000 to $17,600, if he were single, by the impact of the capital-gains tax. Such a reduction obviously induces a strong desire in Bill Jones, and thousands of investors like him, to hang on to their present investments rather than to seek new and potentially more profitable ventures.

Bill Jones is locked in, because he is unable to justify selling the asset and transferring his capital elsewhere, due to the excessive tax penalty—in his case $4,400—required on the gain which would be incurred.

Whether he sells or not, the economy suffers. If the new investment opportunity seems worthwhile, in spite of the tax, the capital available for the new venture would first be subject to a capital levy of 20 percent. If no transfer takes place, the more promising venture must go without the effect on the price of its stock which Bill's bid would reflect. Lack of Bill Jones' bid, in turn, affects the company's ability to issue new stock and often its expansion potential. In the case of the newer and smaller companies in our highly competitive economy, this adds one more competitive disadvantage.

Example B (investor adding to price instability):

Tom Smith decides that a temporary imbalance in the supply and demand for Du Pont has put the price for the stock too high. But in deciding to sell, he must consider whether the stock could be repurchased—within some reasonable time—at a price lower by roughly the amount of his tax ($44 in the circumstances cited in example A above), or at $176 per share.

He is particularly badly locked in if another stock he owns should have a sharp rise and appears to him overpriced before the end of a 6-month holding period. Then, there would be an extra locking-in effect due to normal income-tax rates—at least double and often triple regular capital-gains-tax rates. This multiplies the magnetic force holding investors to their securities, substitutes the calendar for investment judgment, and intensifies the locked-in problem.

In either case, if Tom Smith decides to sell, the tax owing on his gain represents a net loss to the capital funds available to the private sector of our economy.

If he fails to sell, he is aggravating the shortage of stock already existing. His being locked in, thereby, contributes to economic instability by intensifying price fluctuations in the stock market.

This problem of price stability is one of the worst aspects of the locked-in problem, because relative stability—without short-term excessive price movements upward and downward in any major segment of the economy—is highly desirable for continuing economic growth.

From September 1, 1953, to September 1, 1955, the market value of all stocks listed on the New York Stock Exchange increased from $111

billion to $198 billion. There were many reasons for this increase of $87 billion.[2]

Certainly one of the most important was the reluctance of thousands of investors to add to the supply of stock because it did not make sense—it was not economically justified—to sell and pay the present capital-gains-tax penalty.

Here is what Dean Somers at the University of Buffalo has to say—in part—on the capital-gains-tax contribution to price instability and adverse effect on economic growth:

> The above analysis points to the capital-gains tax as an element of instability. The analysis of tax shifting indicates that the tax accentuates price rises and price falls. At a time when prices are rising the tax promotes higher prices than would otherwise prevail. At a time when prices are falling the tax promotes lower prices than would otherwise prevail. * * * The net effect, however, is that the tax accentuates upswings and downswings in security and other asset prices. * * * The destabilizing effect of the tax through its accentuation of price fluctuations is, however, of considerable importance and, insofar as cyclical fluctuations retard the long-term trend of capital formation, the capital-gains tax may be said to have a detrimental effect on economic growth.[3]

A careful consideration of this and other aspects of the locked-in problem suggests that the capital-gains tax—since it yields less than 3 percent of total tax revenues—is more harmful in its effects on stability and growth of the economy than is justified by the relatively small amount of revenue it contributes.

Example C (older investor):

> Mr. Roberts, 67 years old, typifies a third major type of locked-in investor. The present high-tax-rate provisions of the capital-gains and estate-tax laws practically preclude any action on his part in transferring capital assets in which there has been any substantial gain. This is because of the likelihood—within a relatively few years—of a double tax on his capital—once to pay a tax on the gains incurred in transfers when living, and once for an estate tax on the reinvested assets at the time of Mr. Roberts' death. Both of these taxes would be at substantially higher rates than are in the interest of maximum economic growth.

This typifies the straitjacket in which over 1 million investors, age 65 and over, owning over $50 billion of equity securities, find themselves. A large portion of their holdings have been locked in longer and more tightly than any other group of investors.

The problem for the older investor has been described clearly by Standard & Poor's Corp., in their January 17, 1955, issue of the Outlook:

> The age of wealthy investors ranges principally from 50 to 75 years. Selling advices to such clients must give full consideration to the tax factor. The combination of a current 25-percent capital-gains-tax liability and an ultimate estate-tax liability is too great a penalty on profit taking, as viewed by most well-to-do investors. * * *

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[2] For a discussion of the causes of the increase up to January 1955, see Factors Affecting the Stock Market, staff report to the Committee on Banking and Currency, United States Senate, April 30, 1955.

[3] Harold M. Somers, An Economic Analysis of the Capital Gains Tax, National Tax Journal, September 1948, p. 232.

Causes of the locked-in problem

The locked-in problem starts with a failure to differentiate between taxation of capital and of income. The problem has been greatly intensified in the last decade because of inflation and retained earnings. While there are other causes of increased security values, such as changes in public psychology and a decline of interest rates, inflation and retained earnings are so important as causes of the current locked-in problem that they deserve special analysis:

1. Inflation of security values—especially equities—comes about due to increases in the monetary, as contrasted with the real, value of securities. It is usually caused by an increase in the general price level, but—in a related sense—may also reflect a decrease in interest rates or a higher market evaluation of future earnings.

Inflationary engendered gains are largely fictional in terms of real purchasing power. Since stock prices roughly follow the movement of general prices, over which investors have little control, taxation of gains due to such price movements is clearly a capital levy. This is particularly so when there is virtually no tax relief given for capital losses due to inflation.

The inflationary factor has obviously been of tremendous impact in the last two decades, when the price level has more than doubled.

For any stock which has doubled in price, the capital-gains tax is—depending upon the income bracket of the seller—a transfer tax ranging from a minimum of 5 percent to a maximum of 12½ percent on the entire market value of the stock being sold. This is an exceedingly high transfer tax to place on capital assets.

Congress recently recognized the inequity of taxing illusory gains at such high rates, when it exempted appreciation in personal residences from the impact of the capital gains tax if the owner bought another home.

The problem has also been recognized in Great Britain and many other foreign countries, where there is a firmly established recognition of the distinction between capital and income, and no capital gains tax comparable to ours exists.

Here is what the British Royal Commission on the Taxation of Profits and Income, final report, June 1955, page 37, said in part in its conclusion on the Problem of Taxing Capital Gains:

> In the light of these general considerations we came to the conclusion that we could not safely attach any weight to the economic arguments that were advanced in favor of the tax. On the other hand we felt that we must give weight to the fact that such a tax would have some, even possibly a serious, disincentive effect on the private saving which now takes place * * *.

2. Retained earnings: In addition to inflation as a cause of the locked-in problem, there is the problem of retained earnings, which is largely another manifestation of the inflationary factor.

In the period of inflation prevailing from September 1939 to January 1953, corporate earnings, as reported publicly and for tax purposes, both before and after tax payments, have been overstated in terms of their true economic worth.

As Prof. Dan T. Smith expresses it in his book, Effects of Taxation: Corporate Financial Policy, Boston, 1952:

> A failure to retain earnings would commonly have led to the deterioration of a company's position absolutely, as well as relatively. Under continuing inflation, the problem of maintaining real capital will persist (p. 111).

On the inflation treadmill, corporations, as well as individuals, must go through the motions of going forward to keep from going back. The retention of the same amount of earnings without inflation would be a basis for real expansion and progress (p. 114).

Customary accounting practices—plus the revenue laws of the country—necessitated that these earnings be overstated, in a real economic sense, for the following reasons:

(*a*) Depreciation costs had to be calculated on the basis of the original investment. These allowances were much too low to permit replacement of the wornout facilities in terms of current cost. Thus, a substantial portion of retained earnings was needed to fill in the big gaps between depreciation reserves allowable on the old plants and actual construction costs of new plants.

(*b*) Profits occurring from underdepreciation and inventories at understated costs are all too often considered as corporate profits for the tax purposes, although they are often substantially fictitious. Moreover, such overstated profits were subject to corporate income taxes exceeding what should have been paid if the taxes had been levied on correctly calculated earnings.

In the case of corporate working capital alone, it took almost twice as much at the end of 1954 ($96 billion) as at the beginning of 1946 ($52 billion) to do business, according to SEC data. This is $44 billion additional working capital, the equivalent of half the earnings plowed back by corporations in the entire period. Such retained earnings were, of course, subject to a corporate income tax generally exceeding 50 percent. To subject the increased corporate monetary values inherent in these plowed-back earnings to an additional capital gains tax when an investor seeks to transfer his funds to other enterprises—results in dual taxation—all originating from the inflationary spiral.

Extent of the problem

It is impossible to estimate the precise amount of capital locked in by the holding period and rate provisions of the present tax law. But it is tremendous—certainly over $100 billion.

Just in 10 stocks alone listed on the New York Stock Exchange, for the price appreciation between January 1, 1949 and September 1, 1955, the minimum unrealized gains total about $25 billion, as shown in the following table:

Minimum unrealized gains in 10 selected issues listed on New York Stock Exchange—Jan. 1, 1949–Sept. 1, 1955

	Total market value shares outstanding		Total appreciation	Approximate average annual turnover [1]	Minimum unrealized gains
	Jan. 1, 1949	Sept. 1, 1955			
	Billions	*Billions*	*Billions*	*Percent*	*Billions*
Du Pont de Nemours	$2.1	$10.4	$8.3	3.0	$6.6
General Motors [2]	2.0	9.2	7.2	6.0	4.3
Standard Oil of New Jersey	2.0	8.9	6.9	4.6	4.8
Union Carbide & Carbon	1.2	3.1	1.9	4.1	1.4
General Electric	1.1	4.6	3.5	4.9	2.4
Sears Roebuck	.9	2.4	1.5	3.2	1.2
Standard Oil of California	.9	3.0	2.1	4.1	1.5
Texas Co	.7	2.8	2.1	5.2	1.4
Shell Oil	.5	1.7	1.2	3.8	.9
Amerada	.1	.7	.6	7.3	.3
Total	11.5	46.8	35.3	4.5	24.8

[1] Adjusted to reflect turnover on a basis of presently outstanding shares, by giving effect to stock splits since January 1949.

[2] Excluding Du Pont holdings of General Motors stock now aggregating 21 million shares.

NOTE.—These turnover ratios include specialist and other member trading, but do not give effect to odd-lot volume or sales on other exchanges, except to the extent of offsetting round-lot transactions on NYSE. These factors would approximately offset each other.

Since financial institutions such as insurance companies, pension funds, and investment trusts hold approximately a sixth of all listed issues, it is estimated that individuals, personal trusts, and other organizations subject to the full brunt of the capital-gains tax, hold over $20 billion of the total unrealized gain in these 10 stocks.

The above 10 stocks, as of September 1, 1955, comprised 24 percent of the total New York Stock Exchange market value. And, in turn, stocks listed on the New York Stock Exchange are estimated to total approximately half of the value of all equity corporate securities—both public and private. Therefore, as of September 1, 1955, stocks of United States corporations are estimated to have been worth roughly $400 billion. This may be compared to an estimated value of less than $90 billion in 1939. Thus, the total $310 billion appreciation in value due to both inflation and the growth in physical assets of all United States corporations—represents a potential supply of capital for thousands of new companies each month, providing it is sufficiently accessible to new entrepreneurs, on reasonable terms.

The economy's need to increase the disposition of investors to transfer their capital from large and successful companies to new ventures is what makes the locked-in problem so important. For, to the extent that desirable transfers of equity capital assets are hampered or held up entirely—due to various forms of locking up—there will be that much less capital available to finance new ideas, new entrepreneurs and new jobs of the next decade.

1956-65: THE INVESTMENT DECADE

Greater consumption is assured

There is one thing already assured about the decade ahead: Levels of consumption will chalk up new records virtually every week. This is guaranteed by the present rapid growth in our population (currently growing at the rate of 25 million net additional persons per decade), 40 million youngsters born since World War II, a unified CIO-AFL labor organization representing 15 million workers, unprecedented mass-marketing techniques, millions of workers covered by wage contracts promising 4 to 8 cents per hour annual productivity increases over the next several years.

The only limit on potential consumption will be the amount of tools and horsepower available to expand the earning capacity—and the real paycheck—of each American worker. The answer to that question will determine how much the average worker can earn in terms of purchasing power to buy more milk, more meat, more clothes, better houses, and newer cars.

Increased real income demands unprecedented investment

The question is important for the next decade because our economic performance in the last decade has not been as good as generally believed. It has actually been surprisingly poor in terms of real economic gains for everyone. Per capita disposable income (in 1954 prices) actually declined from $1,551 in 1946 to $1,525 in 1952. Even today, the average person is only 5 percent better off than he was in the first year after World War II, in terms of real purchasing power as measured by his disposable income (in 1954 dollars). Moreover, this gain has all been accomplished in the last 3 years—primarily due to a stable price level in the face of substantial wage increases.

To reach the desirable economic goals of the next decade—sufficient productive capacity to insure bigger real payrolls—we must have an unprecedented level of capital investment. It is only through such capital investment that we can achieve the economic growth that, by 1965, will mean 76 million Americans in our civilian labor force, food consumption up 50 percent, average family income up 21 percent to $8,600, in terms of 1955 dollars; and the physical output of goods and services up 39 percent above present record levels.

Capital investment to offset drags on productivity

The need for unprecedented capital investment in the decade ahead becomes even more vital when we recognize that there are two growing burdens dragging constantly at our ability to increase our real productivity:

1. The acknowledged desire of all of us for full pay but a shorter workweek, longer paid vacations, and guaranteed pay in cases of sickness, temporary unemployment, and permanent disability.

2. The rising proportion of people in our population who are not producing—generally children under 18 years of age, and those 65 years old and over. The impact of this factor by 1965, compared to 1954 and 1940, is shown in the following table:

Ratio of children and adults 65 and over to working force and total population

PER 100 WORKERS

	1940	1954	1965 (estimated)
Number of children under 18 years	85.1	87.7	91.4
Number of adults 65 years and over	18.9	22.2	23.7
Total	104.0	109.9	115.1
AS PERCENT OF TOTAL POPULATION			
Number of children under 18 years	30.6	33.1	35.1
Number of adults 65 years and over	6.8	8.4	9.1
Total	37.4	41.5	44.2

Sources: U. S. Department of Commerce, Bureau of the Census; Potential Economic Growth of the United States During the Next Decade, Joint Committee on the Economic Report, 1954, pp. 32-33.

This growing burden of nonproducers and more leisure time for all can only be achieved—without slashing our living standards—through a tremendous increase in the level of capital investment between now and 1965. The years 1956 through 1965 will have to be the investment decade if we are to achieve the better life that we all aspire to.

Indispensability of Greater Capital Mobility

How much capital formation?

To achieve an average per family income of $8,600 by 1965 (in terms of present dollars) will require an estimated $530 billion of gross capital investment in new plant and equipment in the next decade. In the corporate sector alone, new plant and equipment requirements will amount to $375 billion. In addition, corporations will need an estimated $145 billion for other uses, including increased working capital. For corporations, this is an average of about $50 billion a year, against which there are only these major sources:

1. Depreciation and amortization charges of corporations, which last year totaled about $12.5 billion; and retained earnings and depletion allowances of corporations—which were $7 billion in 1954.

2. That portion of personal savings which corporations are able to obtain for their capital needs—through rights offerings, new stock issues, and various debt instruments, including convertible bonds. Net savings out of current personal incomes decreased from $18.3 billion in 1954 to $16 billion (annual rate) in the first half of 1955. For both of these periods, new stock and bond issues totaled the equivalent of only about 40 percent of these net savings—the balance going into mortgage amortization, nonincorporated business, time deposits, and other forms of savings.

There are serious limitations to both these sources of capital for financing our future growth—in the corporate sector of our economy. Reinvested earnings and depreciation charges may be ample to supply many large and established corporations. But if we want to keep our economy competitive and dynamic, our tax laws should give ample opportunity to the expansion of the newer and smaller companies.

With respect to personal savings, over half of the $16 billion (including $6 billion flowing into life insurance companies in 1954) are contractual savings flowing through some 20,000 institutions. These institutions, because of their fiduciary capacities, must necessarily be conservative in their investment policies. Even the 5 percent a year being put into equities by life insurance companies is not what anyone would term venture capital.

The facts are that, based on present levels of personal savings, institutionalization of such savings, and anticipated levels of depreciation allowances and retained earnings, there will not be enough new equity capital to meet the next decade's tremendous investment demands.

How big will the gap be between sources and needs for capital funds? With internal sources of funds not adequate to cover all their anticipated investment needs, corporations will have to seek an estimated $160 billion of external capital for the 11-year period between 1955 and the end of 1965 or an average of about $14½ billion per year. Of this $160 billion, it would be highly desirable to the economy that at least half of it, or $80 billion, come from new equity stock issues.

A continuation of recent experience would produce only about $27½ billion in new outside equity capital from stock issues ($2½ billion per year) and about $75 billion ($7 billion per year) from debt financing. This means a total gap of about $55 billion ($5 billion per year), which should be 100 percent in stock rather than bonds, if we want to have the soundest possible corporate financial structure.

Relationship to "locked-in" problem

If we are going to be short of the necessary capital funds, especially equity capital, in order to finance the investment needs of the future, we must find ways to be more efficient with the use of the existing supply. Here are three ways by which unlocking even a relatively small portion of locked-in capital could improve capital efficiency:

1. A prompter transfer of investment funds into newer, more promising industries and companies, ranging from those making automatic machinery and electronically controlled plants to fiberglass, polyethelene, organic fertilizers, miracle drugs, aluminum wire, and thousands of other new products.
2. A more rapid flow of capital from relatively less profitable enterprises to those which are more profitable and have greater growth potentialities.
3. An increased availability of capital on reasonable terms for small and newer corporations which show above-average promise for the future, but suffer from inadequate internal funds to buy new tools, equipment, and labor-saving machinery.

A more efficient use of the present supply of capital can lead to a substantial reduction or even a complete wiping out of the estimated $55 billion gap between future equity capital needs and anticipated funds available for them. To the extent that the mobility of capital funds is improved over the next decade, the end result can only be

an increase in the rate of growth of our economy, greater real income and savings for the worker, and more funds available to overcome these shortages in equity capital, and especially venture capital.

This basic problem of greater capital efficiency and mobility for maximum economic growth warrants the fullest consideration of every possible solution, several of which are discussed briefly in the following section.

Possible Solutions

Elimination

Complete elimination of the capital gains tax is the only final solution to the locked-in problem which would insure complete mobility to capital movement—without the present distortions of tax considerations. This is the predominant solution in most leading industrialized countries of the world, including Great Britain and Canada.

In my opinion, from an economic point of view, complete elimination of the capital gains tax would so free the flow of present capital funds and provide such an incentive to the attraction of new savings into equity investment, that it would more than repay—through its stimulus to economic growth—any immediate, relatively minor, direct loss in revenue. It particularly would help small-business men, by providing a wealth of previously unavailable capital for their expansion plans and other investment requirements.

The two principal obstacles to complete elimination are not economic matters. One is a question of political practicality, for this country has never—since the beginning of the modern income tax—made a fundamental distinction between income and capital—a distinction which all economists recognize and which has prevailed for generations in the tax laws of most other countries. The other obstacle is a definitional one, for there are certainly many cases where the line between capital and income is not clear cut. One of the big advantages of the present holding period provision of the law is that, administratively, it is simple to understand and relatively free of legal interpretations.

Reduction

A second area of solution is, of course, to reduce the impact of the rate and holding period provisions of the present law by reducing the length of the holding period and cutting the applicable rates. The New York Stock Exchange has been one of the leading exponents of this approach for many years, advocating a 3-month holding period and a halving of the rates by reducing the percentage of gain on which a tax must be paid. Here are two statements summarizing this point of view taken from President Keith Funston's testimony before the Senate Finance Committee on April 12, 1954:

(A) First, there is the arbitrarily long holding period, which requires an investor to substitute a calendar for investment judgment. Now it is true that most investors do hold securities for more than 6 months. But the requirement that they must hold them for at least 6 months in order to qualify the transaction for capital gains treatment, not only places a severe limitation on an investor's freedom but, even more important, deters him, in many cases, from entering into the transaction at all.

(B) A second change that I would like to urge is a substantial reduction in the rate of tax. I recommend that this be done by requiring only 25 percent of the gain, instead of 50 percent as at present, to be included as taxable income. The Government could benefit by taking a smaller tax from a greater number of transactions, thereby substantially increasing the total tax yield.

Multiple holding periods

One solution frequently advocated for the "locked-in" problem is that of multiple holding periods and a sliding scale of rates or percentage inclusions. This proposal was actually enacted in 1934 and prevailed through 1937. There were five holding periods and various percentages of gain included in ordinary income, as shown below:

Capital gains holding period and percent inclusion—1934–37

Holding period	Percent inclusion	Alternative maximum rate
1 year or less	100	None.
1 to 2 years	80	
2 to 5 years	60	
5 to 10 years	40	
Over 10 years	30	

From 1938 to 1942, this was revised, as follows:

Holding period	Percent inclusion	Alternative maximum rate	Effective maximum
Months		*Percent*	*Percent*
Under 18	100	None	
18 to 24	66⅔	30	20
Over 24	50	30	15

Although such sliding scales have the theoretical effect of progressively unlocking as the holding period is extended, the impact on capital mobility is actually more damaging than a single holding period. The investor naturally tends to delay the sale of appreciated securities for the longest period and the lowest rate.

Thus, the impact of a multiple holding period is that of a multilocking rather than an unlocking device. Here is what a 1951 Treasury Department study on capital-gains taxes said on page 5 about the 1934–37 experience:

> A graduated percentage-exclusion method was employed for a short period during the years 1934–37. The system in force at that time provided for five age classes of capital gains and for large increases in percentages of exclusion between classes in relation to the holding period. This complicated the statute without necessarily producing more equitable results. The 1934–37 plan operated to postpone selling appreciated investments because of the tax advantage of the longer holding period.

Certainly, the results in terms of tax revenues collected in 1934 to 1937, and 1938 to 1942 suggest that the multi-holding-period procedure has not worked effectively. The estimated tax collected from capital gains and losses of individuals averaged $75 million per year in 1934–37 compared to $668 million per year from 1948–51—the latest 4 years for which data are publicly available. From 1938 through 1941, the tax collected from individuals on their capital gains and losses averaged a negative amount of $19 million per year.

Investment decisions are, of course, often based on factors other than just tax considerations and the calendar, but while such tax-calendar factors may not be controlling, they can be restrictive enough to be quite harmful. Anything which inhibits capital transfers as

much as multiple holding periods will result in artificial restrictions on the supply of stock and accentuate security price fluctuations. These, in turn, will affect economic growth.

Sliding scales and multiple holding periods would also undoubtedly have a serious adverse effect on the volume of the stock market. This would be a blow to economic growth, for recent correlation studies made by the exchange indicate that a reasonable level of New York Stock Exchange volume—approximately 3 million shares average daily—is needed to insure even a modest flow of new stock issues. New equity issues, in turn, are essential for the economic growth that is a prime goal of tax policy.

The "rollover"

Of the several possible solutions—partial or complete—to the locked-in problem, one which appears to offer perhaps the most significant possibilities is the "rollover" proposal. The term "rollover" refers to a tax provision, probably optional, under which transfers of capital assets, including gains, could be made without incurring a capital-gains-tax liability, as long as the asset was reinvested in productive enterprise, within certain specified limits. This principle is not new. It has already been adopted in the law in the case of exchanges in kind, the sale of personal residences, and involuntary conversions.

A regular tax would be levied on realizations which were not reinvested within a prescribed period, manner or type of investment. The proposal might be limited to an initial fixed invested amount per individual taxpayer, such as $100,000. Thus Mr. Williams could elect to set up such a personal investment with initial value, say in cash, not exceeding $100,000. He could buy and sell equity securities within the limits set up, but pay no capital-gains tax as long as he kept his funds reasonably fully invested in productive enterprise.

The possibilities of such a plan for improving the mobility of investment capital are readily apparent. There would be full freedom of investment action without tax deterrent, unless disinvestment or some other form of taxable event took place.

This proposal would, of course, involve some administrative compromises, and an immediate loss of tax revenue from those investors who elected the option. However, the overall value to economic growth—and the greater ultimate revenues from the long-range stimulus to the economy—would more than offset any immediate direct revenue loss.

Credit against estate tax

The solution to Mr. Robert's (age 67) financial incarceration—mentioned earlier—would appear to be in some form of estate-tax credit for all capital gains taxes paid after age 65, or perhaps within 5 years of death.

The full amount of all such capital gains taxes paid could be deducted from the gross estate tax. Thus, if Mr. Roberts were to die with a gross estate of $150,000, but in the several years prior to his death had paid capital gains taxes of $5,000, his gross estate would be taxed on $150,000, with full credit against his estate tax for capital gains taxes paid in the 5 years prior to his death.

Such a tax credit would be an equitable improvement in our tax laws that would go a long way toward unlocking the older investor.

Moreover, it would almost certainly occasion very little loss in revenue, because older investors can't afford to sell anyway under the present law.

Under the proposed credit, there would be larger tax revenues from the larger estates which would be left, from the fact that some older unlocked investors would pay a capital gains tax but outlive the credit period, and because of the general benefit to the economy of the country.

Other proposals

Included in the list of other proposals for alleviation of the locked-in problem are the following:

1. *Averaging.*—Averaging is a device which has been considered many times, especially in relation to ordinary income taxes. The possibilities of this solution are especially appropriate in sports, entertainment, brokerage (real estate and securities) and other specialized fields where incomes may be sporadically high or irregular. However, it would appear to be of interest for the tax treatment of capital gains only as part of a more general application to all income-tax policy.

2. *Automatic adjustments for price level changes.*—This proposal[4] suggests the adjustment of asset values and realized gains in accordance with changes in the general price level—using some recognized index of price changes such as is employed in building contracts, etc. It is designed to adjust for the inflationary component which exists to such a great extent today in capital gains and thus provide a more equitable basis for taxing such gains. Dr. Cloe, in his article, states that "the most significant effect of price correction might well be the freeing of so-called locked-in investments."

3. *Maximum tax limits.*—One of the greatest anomalies in the operation of the capital-gains tax is that persons who have scored the greatest gains—and who are often the most venturesome investors and best able to finance new enterprises—are the most badly locked-in. This condition often occurs in persons who have held investments for long periods of time. It may happen to those who are approaching old age, with a larger proportion of their total estate in one security, and a desire to diversify their holdings or at least liquidate part of their locked-in position.

To help unfreeze the investors in this situation, one suggestion—which appears to have real merit—is to establish a maximum percentage limit—say 5 percent—of tax liability based on the total value of the assets sold rather than a tax on the gains realized. For, in view of the fact that the capital-gains tax is in effect a self-imposed transfer tax, a maximum of 5 percent of the total assets being transferred would appear to be a heavy enough penalty under any circumstances, and would be of real value in increasing capital mobility. The effectiveness of this proposal for unlocking investors would, of course, depend primarily on the size of the fixed maximum percentage and the proportion of the capital gain to the total value of the property sold.

[4] Carl Cloe, Capital Gains and the Changing Price Level, National Tax Journal, September 1952, p. 207.

Conclusion

We now have mass markets to match our mass production economy. In the expanding decade ahead, we will need mass investment to insure expanding markets and expanding production. More capital investment is the key to bigger markets, and greater production cannot be achieved without it.

Thus, economic growth depends on additional incentives for equity and other capital investment. It means, particularly, greater incentive for the attraction and prompt movement of capital to those uses where it can do the greatest good for the economy. It will require much greater capital mobility—only possible through real tax help—by a solution to the locked-in problem, inherent in the present rate and holding-period provisions of the capital gains tax.

The present capital gains tax provisions of the law are the result of many compromises. A critical examination of those provisions—as they stand today and have evolved over the years—suggests that the provisions have been developed with insufficient regard for their harmful economic effects.

INVESTORS' DECISIONS, EQUITY, AND THE CAPITAL GAINS TAX

Walter W. Heller, University of Minnesota

The always difficult problem of achieving a balanced perspective in tax policymaking is nowhere more acute than in the capital-gains field. In the absence of conclusive evidence and a value consensus, the policymaker finds himself caught in cross-currents of facts, conjectures, and competing economic objectives. Even after he successfully navigates his way through these turbulent waters, he still faces hard choices between the accepted dictates of tax equity and the intensified demands for tax incentives to investment. The locked-in problem is an excellent case in point.

A balanced view of this problem begins with the available facts, buttressed by reasonable conjectures, bearing on this question: To what extent does the capital-gains tax lock investors in existing investments? The next step is to appraise the economic consequences of the lock-in effect, especially the charge that it interferes with market stability and investment mobility. But the appraisal is incomplete unless it also considers the possibility that the advocates of the lock-in argument have overlooked some offsetting beneficial effects. And perhaps the unlocking action they call for—reducing the capital-gains tax and shortening the 6-month holding period—would itself have some unwanted repercussions on market prices and investment patterns.

But even as thus rounded out, the lock-in analysis is far too restrictive a context in which to consider, much less to settle, the capital-gains tax problem. Even if the lock-in effect were accepted as both valid and controlling, it is by no means self-evident that a lower rate and shorter holding period are the only answer. Instead of lowering the capital-gains barrier at the front door marked "market transactions," it may be just as effective—and more desirable on equity

grounds—to close the back door marked "tax-free transfers at death" and the side door marked "tax-deferring transfers by gift."

Clearly, we have to back far enough away from the myopic confines of the lock-in controversy to bring into the range of our vision the other economic effects of the capital-gains tax, especially its impact on basic investor motivations and investment patterns. Yet no tax issue, least of all the capital-gains issue, can be resolved solely on economic grounds. Balanced decision making requires that we broaden our perspective to embrace equity considerations; e. g., whether the tax treatment of capital gains and losses is fair in terms of its relation to the tax treatment of other forms of income, and what distortions it introduces through conversion of ordinary income into capital gains. And finally, while focusing primarily on economic and equity criteria, we should keep the revenue impact and administrative feasibility of proposed solutions clearly in view.

Because so much has been made of the lock-in argument, a large part of the following analysis will be devoted to it. But since no sensible decision on the tax treatment of capital gains can be reached in terms of this problem alone, my paper presses the search for perspective through the thickets of other economic implications and on into the jungle of equity considerations. Perhaps I should note at the outset that I emerge with no pet panaceas.

EXTENT OF THE LOCK-IN EFFECT

More than in any other phase of the income-tax law, the capital gain and loss provisions offer the taxpayer options as to the application, timing, and even the size of his tax liability. On any given item of appreciated property, he can either incur tax liability by selling now, postpone it by selling later, transfer it by gift, or cancel it by death or charitable contribution. If "now" is less than 6 months since he bought the asset, he pays from 2 to 3⅔ times as much tax (the ratio rising with the size of his income) as he would if he sold after 6 months.

The holding period as a deterrent

To dispose of the last point first, it is abundantly clear that such a large tax differential—whether it occurs after 6 months, 3 months, or 2 years—will have a significant effect on the timing of investment transactions. That many sales are deferred until the lower rates apply is strongly suggested by income-tax statistics reflecting the reactions of investors to changes in the length of the holding period in the thirties.[1] Similar conclusions were reached in the Harvard Business School taxation study which approached the problem in terms of the investment behavior of 746 individuals in its "active investors sample" (drawn from the customer lists of investment banking firms cooperating in the study).[2] Roughly 21 percent of the entire group, and 41 percent of those with incomes over $100,000, reported that they tended to defer realization of capital gains until the 6 months' holding period had elapsed.

The postponement problem associated with the holding period will be with us as long as we retain the distinction between short-term and long-term gains and a sharp differential in their tax treatment. Any action that narrows this differential—either by raising the capital gains rate or lowering the rates on ordinary income—will moderate the

problem. Splitting the differential into many small steps by a multiple-holding-period system (with more and smaller stepdowns than the 1934–37 system) would also serve to dull the impact of the tax on timing decisions.[3]

Shortening the holding period to 3 months has also been proposed as a means of alleviating the postponement problem.[4] Any change in the length of the holding period at present tax differentials will delay some transactions and accelerate others. Many speculators and short-term investors who now wait till 6 months have elapsed would sell after 3 months. Others who now sell, say, between 1 and 3 months after acquisition would delay until 3 months had passed. The already negligible volume of "short-term gains"—$247 million out of total gains of $6.7 billion (100-percent basis) reported by individuals in 1951—would shrink to the vanishing point.

Lengthening the holding period to 12 or 18 months would also set up opposing forces in relation to the lock-in problem. Many security holders who now delay selling to take advantage of the drop in taxes after 6 months would be unwilling to risk waiting until 12 or 18 months after acquisition. In contrast, other transactions which now take place between 6 months and 12 or 18 months after acquisition might be postponed until the lower rate takes hold.[5]

Where the net advantage of shortening or lengthening the period would lie in relation to market liquidity and the relative roles of investors and speculators is not entirely clear. Even if it were, however, the decision on the length of the holding period has to take other, probably more compelling, considerations into account. For example, the 1951 Treasury recommendation that the holding period be lengthened to at least 1 year was based on the desire (1) to subject a larger proportion of speculative gains to full income-tax rates and (2) to make the holding period correspond with the annual basis on which the income tax is levied and thus make more sense in relation to the argument that, in the absence of income averaging, preferential treatment of capital gains is needed to compensate for the "bunching" of income often associated with realization of capital gains.[6]

The ceiling rate as a deterrent

The moment we leave the holding period behind, the appraisal of the lock-in effect has to proceed largely in terms of arithmetic and

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[1] Lawrence H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses, National Bureau of Economic Research, New York, 1951, pp. 167–172. Like others probing into the field of capital-gains taxation, I am more deeply indebted to Professor Seltzer's standard work on the subject than specific citations may reflect. Other basic studies on which I have drawn heavily are the U. S. Treasury Department study, Federal Income Tax Treatment of Capital Gains and Losses, Washington, D. C., 1951, and the Harvard Business School study by J. K. Butters, L. E. Thompson, and L. L. Bollinger, Effects of Taxation: Investments by Individuals, Cambridge, 1953. On the lock-in controversy, the hearings before the Senate Committee on Banking and Currency, Stock Market Study, Washington, March 3–23, 1955, and the staff report to the committee, Factors Affecting the Stock Market, Washington, April 30, 1955, are particularly illuminating.

[2] Butters et al., op. cit., pp. 339–348.

[3] The Treasury study puts the matter this way: "Use of large percentages of exclusion, either in connection with single or multiple holding periods, has provided significant inducements to continued holding of appreciated investments. For this reason, the use of a number of holding periods, with only a slight rate graduation for each, might be desirable. Moreover, slight rather than sudden drops in rates between holding periods might produce more equitable tax results." U. S. Treasury Department, op. cit., p. 55.

[4] See, for example, the article by Charles Klem, The Stock Exchange Point of View on Capital Gains Taxation, Proceedings, 1953 Conference of the National Tax Association, Sacramento, 1954, pp. 141–143; and New York Stock Exchange, Taxes—Equity Capital—and Our Economic Challenges, New York, 1953, p. 39.

[5] The New York Stock Exchange's Study of Public Stock Transactions on September 10 and 17, 1952, showed that 23 percent of the shares sold had been held less than 6 months; 26 percent from 6 months to 1 year; 48 percent, over 1 year; and 3 percent, no indication (ibid.).

[6] See U. S. Treasury, op. cit., pp. 53, 56.

conjecture. One of the few facts at our disposal is provided by the Harvard study already cited. Only 5.7 percent of the 746 investors interviewed reported that the timing of their investment transactions was affected by the tax on long-term gains.[7] The proportion was higher—7 to 10 percent—for investors with incomes above $25,000, a group which accounts for one-third of the "public individuals' share volume" on the New York Stock Exchange and over two-fifths of total capital gains.[8]

Such empirical evidence as we have, then, suggests that apart from postponement of profit-taking sales beyond the 6-months' line, the lock-in effect of the capital-gains tax is not a major force in the securities markets. But the evidence is meager, and the situation may have changed with the tremendous appreciation of stock-market prices since 1953. So a further inquiry into the logic and arithmetic of the matter is in order.

The long-term capital-gains tax affects the terms of trade of the potential seller of an appreciated asset in three ways: (1) if he postpones the sale, he postpones the tax and thereby saves interest on the postponed tax; (2) if he refuses to sell at all, he may save the tax itself, provided he holds the asset until he passes it on by gift, charitable contribution, or death; (3) if his income is in higher tax brackets this year than he expects it to be next year, he can reduce his taxes by delaying the realization of gains but taking his losses promptly, and vice versa. Where the motive for selling is to switch from one security to another in search of higher income or greater capital appreciation, the impact of the capital-gains tax is to increase the income or appreciation premium the investor demands of a new security as a prerequisite to selling the old. This can be readily demonstrated. Leaving out the interest and interyear income fluctuation factors, the following examples define this differential for several types of potential sellers in a variety of capital-gains circumstances.

The first set of figures applies to an income-minded investor who is seeking a higher yield than the 5 percent his present stock yields him. Assuming a purchase price of $10,000 and a present market price of $12,000, he would pay a capital-gains tax of $500 at the ceiling rate of 25 percent (which applies above $32,000 of taxable income for a married taxpayer and $16,000 for a single taxpayer). On the remaining $11,500 (ignoring broker's fees), any stock yielding more than 5.3 percent would produce a higher income than the 5-percent return on the $12,000 market price of his present stock. If his capital gain were 50 percent instead of 20 percent, the yield would have to exceed 5.5 percent to justify the switch; if his gain were 100 percent, the breaking point would be 5.7 percent; with a 200 percent gain, it would be 6.0 percent.

Turning to the appreciation-minded investor, what prospective gain in an alternative stock is required to lure him out of a present holding from which he expects no further gain? If he has experienced a 20-percent gain on his present stock, any expected gain of more than 4.4 percent in the market price of the alternative stock would make a switch worth while. If his existing gain were 50 percent, the break-

[7] Butters et al., op. cit., p. 330.

[8] New York Stock Exchange, Stock Market Activity—A New Portrait, New York, August 1955, p. IV, and Senate Committee on Banking and Currency, Factors Affecting the Stock Market, p. 78.

ing point would be 9.1 percent; at 100 percent, it would be 14.3 percent; and at 200 percent, it would be 20 percent.

Another group of potential sellers consists of those seeking to sell and then buy back the same stock at a lower price. To "shake out" the capital gains tax, i. e., buy back the stock at a price far enough below the selling price to recoup the capital-gains liability, would require a price decline of at least 4.2 percent for the seller who had experienced a 20-percent capital gain; 8.4 percent in the case of a 50-percent gain; 12.5 percent at 100 percent; and 16.2 percent at 200 percent. Stockholders who accurately gaged the pulse of the market during the summer and fall of 1955 had ample opportunity to "shake out" substantial gains taxes. Out of one group of 30 major stocks, the prices of one-third (including Du Pont, General Electric, and Johns-Manville) were more than 10 percent below the year's highs at the close of business Tuesday, September 27. Another third (including Bethlehem Steel, Eastman Kodak, General Foods, and Standard Oil of New Jersey) were down more than 7 percent.[9]

From the preceding figures, it is apparent that only where the accrued gain is large and the expected differentials in yields or price movements are small does the tax on long-term capital gains make switching financially unattractive. Thus, even with a 50-percent gain on his present holding, the potential seller subject to a 25-percent gains tax can (a) improve his income position by any switch promising a yield increase of one-half of 1 percent or more; (b) improve his capital position by any switch promising a differential gain of 10 percent or more; or (c) "shake out" the capital-gains tax by selling and then buying back at any price 8½ percent or more below his sales price. Our dynamic economy and dynamic security markets present myriad opportunities to cross these modest tax thresholds. Moreover, for a large proportion of potential transactions, the foregoing figures overstate the height of these thresholds. Income-tax statistics suggest that nearly two-thirds of all long-term gains are realized by persons paying less than the 25-percent ceiling rate.[10]

Not only is the capital-gains barrier low relative to dynamic market opportunities, but many decisions to hold or sell securities fall largely or entirely outside of its sphere of influence. First, a substantial and growing share of stockholdings is in the hands of institutional investors, i. e., either colleges, pension funds, and other institutions exempt from the capital-gains tax or financial intermediaries less directly responsive to it. Of the potential market supply of $268 billion of capital stock in all American corporations at the end of 1954, $66.5 billion, or 25 percent, was held by institutional investors.[11]

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[9] Business Week, October 1, 1955, p. 166.

[10] Of net long-term capital gains reported on taxable individual returns in 1951, only 35 percent were subject to the "alternative tax" at the 25-percent rate. Of the $6.6 billion of gains (100-percent basis) reported by individuals in that year, nearly 60 percent were realized by persons with adjusted gross incomes (before personal deduction and exemptions) below $25,000; 40 percent by persons with incomes below $10,000; and 10 percent by persons with no net income. In other words, 10 percent involved no tax, while that part of the additional 30 percent under $10,000 which accrued to married persons paid a tax of no more than 12.3 percent (and would pay no more than 11 percent under present rates). (Statistics of Income for 1951 (pt. I), especially pp. 77-79.)

[11] This represented an increase of 44 percent in the market value of institutional stockholdings as against 28 percent in individual stockholdings in 2 years. More than half of the institutional holdings ($37 billion were in the hands of bank-administered personal trusts. (Senate Committee on Banking and Currency, Factors Affecting the Stock Market, pp. 89-92.)

Second, a large proportion of security holders fall outside of the category of "potential but undecided sellers" whose decisions might be influenced by the capital-gains tax. On one hand, many holdings are "frozen in" by the desire to maintain control of family type corporations or listed corporations retaining a strong owner-director-manager interrelationship;[12] sheer inertia—the observed tendency of persons outside the "active investor" group to stay in a given investment unless somehow forced to make an overt choice among alternatives—also takes its toll of market transactions. On the other hand, many realizations take place irrespective of tax considerations, e. g., in the case of called stocks, maturing bonds, and liquidations to finance extraordinary purchases like a house or car, living expenses of retired persons, or emergency cash needs for personal or business purposes.

Third, even when we have worked our way down to the hard core of those for whom "to sell or not to sell" is an active question, we find that the point of maximum gain for the confirmed profit takers (i. e., those not lured by the alternative of tax-free transfers by gift or death) is in no way affected by the long-term capital-gains tax. Rational behavior for profit seekers is to buy at the bottom and sell at the top, i. e., to follow their investment judgment without reference to the tax (except, of course, for interyear tax differentials).[13]

After screening out the investors and market situations that are more or less immune to the long-term-gains tax, how much scope is left for its lock-in effect? Far less, certainly, than our worst fears (ably translated by the officials of the New York Stock Exchange) would suggest. But can we dismiss it as insignificant? In the absence of more adequate and decisive facts, the answer is "no," for three main reasons: (1) After all the screening, there remain rational investors at or near the margin of selling whose decisions are affected by the tax, i. e., whose reservation price is higher than it would be without the tax; (2) in the face of uncertainty, many investors will not trade the likelihood of a more-than-compensating improvement in yield or capital appreciation on a new security (or drop in price of the old) for the certainty of an immediate diminution of capital via the gains tax; and (3) in the light of frequent investor inertia and irrationality, the tax may exert a psychological effect not limited to its actual cost (though it does not follow that the capital-gains tax is actually guilty in the many cases where it is made the scapegoat for failure to sell at the most advantageous point). One should add that, however limited the net impact of the lock-in effect may be, 2 years of stock market boom have given it a greater volume of unrealized gains to work on than ever before.

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[12] To cite but one example from the New York Stock Exchange, roughly 80 percent of the stock of the Stauffer Chemical Co. (annual sales: $100 million) is held by its directors, officers, associates, and their families.

[13] In his column, Business Outlook, J. A. Livingston stated this general position very effectively, as follows: "Taxes are beside the point. The sophisticated investor doesn't allow the tax collector to make his market decision * * *. If you no longer like a company or an industry, if you think the stock is overpriced, then you ought to get out, taxes or no. You might want to sell part of the stock in the fall and part in January, to spread your capital gain over 2 years—so as to reduce the amount of tax. If you held a stock for 5 months, you might want to hold it another month to take advantage of the 6-month long-term holding period. But that's about as far as tax considerations go." (The Washington Post and Times Herald, October 12, 1954.)

ECONOMIC CONSEQUENCES OF THE LOCK-IN EFFECT

What adverse economic consequences are said to flow from such lock-in effects as the capital-gains tax may have? First, by making realization of gains less attractive and losses more attractive, the tax is said to accentuate upswings and downswings of the stock markets. Second, to the extent that it dams up funds where they are instead of letting them flow into new and expanding enterprises, the tax is said to interfere with economic efficiency and growth.

Impact on market stability

In the 1954–55 bull-market setting, the instability argument has quite naturally centered on the alleged contribution of the gains tax to the upward pressure on stock prices.[14] This pressure is said to arise from the "artificial scarcity" the tax induces by inhibiting sales. Harold Somers has put this point in formal supply-demand terms based on the reasonable proposition that the "real, definite, and calculable" tax liability facing potential sellers curtails the supply of securities more sharply than the "vague and indefinite" tax liability facing potential buyers curtails demand. The net effect is to accentuate upward movements of stock prices (while the corresponding effects in the case of losses accentuate downward movements).[15] But this reasoning, which is often used to bolster the case for a lower capital-gains tax, overlooks several important aspects of the relationship between the tax and supply-demand conditions in the security markets.

First, in focusing on the incentives to enter or leave the market rather than the flow of funds within the market, it seems to lose sight of the "Say's law of the stock market": Especially in a rising market, supply largely creates its own demand in that most of the proceeds of security sales reenter the market as demand for other securities. This being so, will tax reduction exert a bearish influence in a boom market? George Shea, columnist for the Wall Street Journal, provides the following answer:

> The real question is what the presently unwilling sellers would put their money into if they sold. If they simply kept the cash, or bought goods or real estate, the effect might well be to put downward pressure on stock prices. But if they simply switched to other stocks as most investors do when they sell an investment, the net effect on the stock market could be nil.
>
> Indeed, a suggestion of Mr. Funston's for easing the burden of the capital gains levy was self-defeating as far as any effect on the price level would be concerned. He proposed that a switch from one stock to another be freed of the tax. Obviously, however, in such ca e the level of the market might not be affected at all.[16]

Second, in the largely circular flow of market funds, the gains tax drives a sizable wedge between the amounts realized on the sale of appreciated assets and the amounts that go back into the market as a demand factor. At present levels, the tax on capital gains of individuals is yielding well over $1 billion, more than four-fifths of which

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[14] See, for example, the hearings before the Senate Committee on Banking and Currency, op. cit., pp. 77, 100, 205, 253, 276.

[15] Harold M. Somers, An Economic Analysis of the Capital Gains Tax, National Tax Journal, September 1948, pp. 226–232.

[16] Wall Street Journal, March 7, 1955, p. 1. Similar judgments on the relation of the tax to security price levels were expressed several times in the 1955 stock market hearings, e. g., by J. K. Galbraith (hearings, op. cit., pp. 276–277), Marriner Eccles (p. 483), and Benjamin Graham (p. 547).

is attributable to gains on the sale of securities.[17] Cutting the tax would release some of these moneys to reenter the market as a demand and price stimulant.

A third factor often overlooked in assuming that lowering the gains tax will ease upward pressure on market prices is the magnetic attraction which the preferential treatment of capital gains exerts on investible funds. If we shift our perspective from the absolute level of the tax as a deterrent influence in security markets to its relative level, i. e., to the tax advantage of long-term gains over ordinary income, the responses to reduction of the tax appear in a very different light. For reduction means widening the tax gap between ordinary income and capital gains and correspondingly increasing the preference for those savings outlets which promise capital appreciation. The resulting increase in demand for stocks would hardly have a bearish impact on a bull market. Quite the contrary. Given a sharp reduction of the tax, the lock-in effect might give way to the flock-in effect.[18] This suggests that if we seek abatement of bullish pressure in the stock market, perhaps a higher rather than a lower gains tax is the answer.

The foregoing three points, largely addressed to the problem of dampening the speculative fervor of a boom market, make clear (*a*) that the tax on capital gains exerts opposing influences—some bullish, others bearish—and (*b*) that reducing it is neither a cure nor perhaps even the right medicine for a bloated market. Space does not permit spelling out the lessons for a falling market implicit in the three points. But a fourth and separate point relating to the stabilizing force of the "lock-in" effect during a market decline following a long and strong advance (more or less the current situation) merits further examination.

To moderate or stop a market decline requires, above all, stoppage of the outflow of funds into cash balances, bonds, other forms of savings, and consumption. Therefore, in a market which, though falling, still represents substantial or even huge unrealized gains, the lock-in effect may well come into its own. On one hand, to the extent that the investor's choice changes from a stock-to-stock switch to a stock-to-bond or stock-to-cash switch—that is, when improved income or appreciation prospects are ruled out of the investment calculus—the lock-in effect may gather strength. On the other, to the extent that it impedes liquidation of stocks, it will exert a welcome stabilizing influence. To be sure, as prices fall from their peaks, loss taking becomes possible and, especially near the end of a year of zestful gains taking, attractive taxwise. This is the familiar accentuating effect of the capital gains tax structure in a downswing. But a correct assessment of the influence of gain and loss provisions on market sta-

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[17] This proportion is derived from findings by Seltzer, op. cit., p. 145.

[18] The pulling power of the capital-gains tax was acknowledged by several witnesses in the stock-market hearings. For example, the president of the Midwest Stock Exchange, Mr. James E. Day, stated: "Yes, I think the capital-gains tax of just 25 percent is a real argument to get into the market. Yes, sir. Advantage and a good selling point" (hearings, op. cit., pp. 205–206). The statement by Mr. Benjamin Graham in this connection was also illuminating. After noting that the argument for a lower gains tax to unfreeze holdings showing large profits has "some merit," he went on to say: "But I regret that the issue has usually been presented by Wall Street—of which I am proud to consider myself a part—in an incomplete and rather one-sided fashion * * * while a lightening of the tax might well increase the supply of common stocks by persuading holders to take large profits, it might at the same time stimulate further speculative buying, attracted by the new tax advantage. The net result of such a move cannot be foretold" (ibid., p. 547).

bility requires that we take full account not merely of whether the market is rising or falling, i. e., its direction, but whether it is high or low relative to its previous position, i. e., its level.

Impact on investment mobility

Apart from stability considerations, it is argued that capital-gains taxes interfere with fluidity in financial markets and thereby impede the mobility of physical resources which is essential for economic efficiency and growth. Tax reduction is urged to help dislodge funds from old, well-established, oversized, inefficient, and stagnant companies or industries and make them available to new, unseasoned, small, efficient, and growing producers. But it is questionable, first, whether the existing tax is guilty as charged and, second, whether the beneficial effects of reducing it would outweigh the detrimental effects.

It is worth recalling, first of all, that only irrational investors will let the capital-gains tax lock them into a stagnant or declining company. Further, the capital appreciation possibilities provided by dynamic newcomers on the national scene will readily pull funds out of old investments over the capital-gains threshold. But some interference with the free flow of investment funds will unquestionably occur, especially as long as the alternative of tax-free transfers at death or gift remains open.

Perhaps the most serious criticism on this score is that the tax will impede the flow of capital into the venturesome undertakings that keep the economy active, competitive, and growing. But this charge seems to arise from a faulty perspective which views the imposing barrier of the capital-gains tax only from below, i. e., from a no-tax position, rather than balancing this with a view from above, i. e., from the high platform of rates up to 91 percent on ordinary income. The view from the tax heights puts the long-term gains tax in an entirely different light as one of the lowest sections of the tax wall. Apparently this is the view taken by a great number of active investors. The Harvard study concluded that the capital-gains tax has caused venturesome individuals "to shift funds out of relatively conservative investments, offering little or no opportunity for capital appreciation, and into more venturesome types of investment such as relatively speculative marketable common stocks, closely held companies, new ventures, real estate, and oil properties." [19] In other words, quite contrary to the indictment, the facts established by cross-examination of investors show that it is precisely in drawing funds into new ventures and unseasoned securities that the capital-gains tax at present rates exerts its strongest investment influences.

Turning to the effects of lowering the tax, one can readily visualize some unlocking of appreciated investments and redirecting of the released funds into other investment outlets. Insofar as this would replace "decisions by inertia" with active choices among investment alternatives, an improved allocation of financial and physical resources would result. But other, unwanted, activities might also be stimulated.

To remove all tax restraints on market transfers might convert many investors into speculators and traders. Market activity, in other words, is not an end in itself. To the extent that it represents a diver-

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[19] Butters et al., op. cit., p. 42.

sion into market gambling of energies and resources that would otherwise go into useful productive activity, it worsens rather than improves the allocation of human and material resources. Further, insofar as such activity exercises a destabilizing effect on the security markets and the economy, it increases economic uncertainty. Since uncertainty tends to discourage capital investment, the end product of removing or gutting the capital-gains tax might be to interfere with rather than promote economic growth.

The inviting option of tax-free transfer of appreciated assets by gift or death may well have more to do with the undesirable pinning down of investment funds than any other single aspect of the gains tax. If the investor knew that there would surely be a day of reckoning on his unrealized gains, he might press the search for improved investment opportunities more actively than he does today. This move would tend to convert passive into active investors rather than investors into speculators, thus not merely promoting financial activity but improving the allocation of resources.

OTHER ECONOMIC EFFECTS

A number of the economic effects of the capital gain and loss provisions have already been brought out as points or counterpoints in the lock in controversy. But it is important to move the economies of the capital gains tax out of the narrows of that controversy and into the broader context of the basic issues raised earlier in this volume. In other words, how does the present treatment of capital gains and losses affect the level and composition of investment? Are these effects in harmony or conflict with national economic policy?

Clearly I can do no more here than indicate the nature of these issues. With respect to the level of investment, it seems clearly established that the preferential treatment of capital gains has been a powerful magnet for investment funds. It is one of the chief factors that has held the tax rate on income beyond $50,000 to 50 percent or less in the face of marginal rates ranging as high as 91 percent.[20] By blunting the cutting edge of the top progressive rates in their application to investment proceeds cast in the form of capital gains (either naturally or by dint of skillful manipulation), it has increased the total volume of investment substantially. Apart from the price that may have been paid for this stimulus in reduced tax equity, this raises two main questions.

First, is there any limit to the amount of investment that is good for the economy? That is, although it can be demonstrated that we have huge capital needs, are we not in danger of getting too much of a good thing in the sense (*a*) that productive capacity may outstrip consumption capacity and thereby lead to the idling of resources; (*b*) that we may devote a larger proportion of our income to capital formation than a sensible balancing of the interests of present and future generations may justify; and (*c*) that a high-investment economy may be difficult to keep on an even keel?[21] Given our growing understanding of, and increasing willingness to use, fiscal and monetary tools to keep the economy at full employment, these limits are more remote

[20] Butters et al., op. cit., p. 85.

[21] For an examination of some of these points, see Walter W. Heller, Appraisal of the Administration's Tax Policy, National Tax Journal, March 1955, pp. 18-23.

than they were in the past. But in determining capital-gains tax policy, it would be unwise to rate the investment-stimulating effect an asset under any and all circumstances.

Second, is the pattern of investment stimulated by the huge rate differential between ordinary income and capital gains a desirable one for the economy? To be sure, the stimulus to venturesome investment is widely welcomed as a source of economic progress. But some limits must be observed here, too: (1) If the capital-gains lure is made too powerful, it may pull investment resources beyond the boundary between reasonable and foolhardy risk taking and thus invite business failures and consequent resource waste; (2) as already noted, if all capital-gains restraints are removed, markets may become so speculative that they will send out the wrong signals to the economy as to how its resources should be deployed for optimum growth and output; (3) the sanctity of the capital-gains tax as a venture capital stimulant in preference to other tax measures (and nontax measures, too) should not be taken for granted.

In reference to the third point, it is worth reminding ourselves that preferential capital gains treatment does not achieve its status as a desirable or necessary stimulant in a vacuum but only in relation to other characteristics of the tax system. The primary factor is the severity of the tax rates under which investment returns would otherwise be taxed, but other features such as tax-exempt securities (which draw potential investment funds into riskless channels) also play a role. All tax advantages represent an economic stimulus, an attraction to resources. Over the years, we have in effect set up a system of tax subsidies and penalties which invite resources into some uses and repel them from others. It is always open to us to redress the balance of this system by terminating the subsidies and lowering tax rates accordingly. Whether the more natural allocation of resources that would result is preferable depends not only on economic tests but on value judgments. With specific reference to the gains tax, the issue appears as follows: In its present form, the treatment of gains and losses redirects resources from natural channels not only into venturesome investments but also into more questionable directions associated with cloaking ordinary income with the capital-gains mantle and gaining the advantages of specific extension of capital-gains treatment to timber, coal royalties, certain farming situations, and the like. Should the incentive to devote resources to these later uses be sharpened by reducing the capital-gains rate? Or should it be dulled by narrowing the tax gap between ordinary income and capital gains? These questions can be resolved only by matching the influence of the gain and loss provisions on investment patterns against national policy on resource allocation.

EQUITY CONSIDERATIONS

Three main charges against the present capital-gains tax have been brought forward by proponents of the lock-in argument to buttress their case for lower taxes on capital gains: (1) Capital gains are not income and do not represent taxable capacity; (2) a large proportion of capital gains are the outgrowth of inflation and hence illusory; and (3) since only realized gains are taxed, the capital-gains tax discriminates unfairly against active investors who realize gains and in

favor of passive investors who do not. This section examines each of these assertions briefly and comments also on the use of capital-gains provisions for tax-avoidance purposes.

The assertion that capital gains are not income is frequently supported by reference to the observable fact that investors ordinarily view capital appreciation in a different light from income from salaries, interest, dividends, and the like. Can their view be accepted as controlling in formulating capital-gains-tax policy? The answer is clearly "no" on grounds that I have stated elsewhere in the following terms:

> Many, if not most, of us have at one time or another gone through the pleasant experience of having an investment grow in its capital value, and we tend to think of that as a growth in the fund of our capital rather than in the flow of our income. Even if we switch from one investment into another, we like to think that we have a right to maintain the investment at whatever size it has attained. The capital-gains tax interferes with that right. But is it any more valid to allow us to judge our own taxable status on capital gains in terms of "undiminished capital" than it is to permit the wage earner to dictate the taxes on his wages in terms of "undiminished take-home pay?" Certainly, the investor feels put upon when a piece of his investment is snipped out by taxes when he shifts from one security into another. But from the vantage point of the small-income recipient who does not have access to this form of enrichment, a capital gain must look like a very capable form of taxpaying income. If each man were to be the judge of his own taxes, the tax take of the United States Treasury would be very small indeed. In taxation, as elsewhere, we should expect to be governed by value judgments made by a jury of our peers rather than by our own, often highly colored, judgment of what taxes we should pay.[22]

The second contention, that gains arising from inflation are illusory, has gained rather wide acceptance. Capital appreciation that merely keeps up with the rise in the price level is said to confer no increase in real economic power on the asset holder. Only the administrative impossibility of identifying and weeding out the capital gains and losses arising from inflation and deflation keeps the serious advocate of this argument from urging their exclusion from the tax base. The New York Stock Exchange group, contending that most gains have their origin in secular or cyclical inflation, uses the argument to support reduction or elimination of the gains tax.

To dispose of the last point first, one need perhaps do no more than point to the 50-percent increase in stock prices from September 1953 to January 1955, plus a further advance to September 1955. That is, in a period when the general price level was holding steady, upward of $75 billion was added to the market value of stocks. It has been said that this was merely the delayed impact of inflation expressing itself. But whether this means the post-World War II inflation or the post-Korean inflation (which came to a stop early in 1951), in either case, the delay was so long as to cast doubt on the strength and perhaps even the validity of the point. Most of the rise can be explained in terms of higher earnings and earnings prospects, strengthened financial position of corporations (especially through retained earnings), reductions of taxes on profits and income, and a reduction in the capitalization rate for earnings (expressed in a rising price-earnings ratio). There is nothing illusory about these gains.

But this does not meet the main question: Are capital gains illusory and unfit subjects for income taxation to the extent that they represent merely a keeping pace with the price level? If one concentrates

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[22] Heller, op. cit., p. 26.

on absolute economic position, the answer is likely to be affirmative. But the entire emphasis of modern income taxation is, quite properly, on relative economic positions. The taxpayer who protects himself from inflation by holding common stocks or real estate is certainly better off than the one who holds fixed-income securities or no securities at all. To exempt inflationary gains would be to ignore significant changes in the relative taxpaying capacity of individuals.[23] In this light the illusion argument loses much of its force. This is not to deny that the income tax would be fairer without inflation than with it. But it does suggest that an income tax with inflationary gains in its base is fairer than one without them.

Turning to the third count listed above, one may readily acknowledge that the practical necessity of restricting the tax to realized gains and losses complicates the equity problem. That is, within the confines of the gain-and-loss category, strictly equal treatment of equals cannot be achieved because those who realize gains pay a capital-diminishing tax while those who hold on to their accrued gains continue to enjoy the full fruits of their capital. But this argument, especially when offered on behalf of tax reduction, is incomplete and unconvincing.

Some inequity within the capital gains category can be tolerated as a small price to pay for avoiding the far greater inequity that would result if we were to exclude this entire class of income from the tax base. In fact, for this class as a whole, the option the taxpayer has of timing the tax to suit his needs or even avoiding the tax entirely would suggest greater rather than lesser ability to pay.

Moreover, the indicated remedy for the internal inequity is not to lower the tax but to close off the options of tax-free transfer by death and gift. If such transfers were treated as constructive realization, the accrual-versus-realization inequity would largely vanish except for the interest differential between earlier and later realizations. All property would go through the capital-gain-or-loss screen of the income tax at least once during the owner's lifetime. Only a timing discrepancy would remain.

An attempt to arrive at a fair tax treatment of gains and losses must go beyond questions of the internal equity of the tax and the most equitable relationship between the gains category and ordinary income. It must take account of the perversions of tax justice growing out of the great tax differential between ordinary and capital gains income. The wider that differential the greater is the temptation to give ordinary income the form and appearance of long-term gains shielded by the 25 percent ceiling rate.[24] The already intense pressures on Congress to add to the categories of "capital assets" eligible for these favored treatments would become even greater if the gains tax were reduced or eliminated. The dominant role already played by capital gains and losses among tax avoidance devices is indicated by the fact that between one-third and one-half of the Casey and Lasser volume, Tax Sheltered Investments, is devoted to the tax attractions of gain and loss situations.[25]

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[23] This position is persuasively illustrated in the Memorandum of Dissent in the recent Final Report of the British Royal Commission on the Taxation of Profits and Income, June 1955, p. 366.

[24] For a thorough discussion of 16 categories of tax avoidance via capital gains, see Seltzer, op. cit., ch. 9.

[25] Casey, William J., and Lasser, J. K., Tax Sheltered Investments, Business Reports, Inc., New York, 1951.

CONCLUSIONS

The foregoing analysis leads us to the following conclusions:

1. The extent, severity, and economic impact of the lock-in effect have been seriously overrated.

2. By the same token, the beneficial economic consequences of reducing the long-term capital gains tax rate and shortening the holding period have been substantially overstated; it is doubtful that this action would greatly increase capital mobility and, all things considered, it might well increase rather than decrease market instability.

3. Putting the capital gains issue in the full context of the economic and equity criteria that have to be satisfied to reach a defensible solution tends to dwarf the lock-in effect as a policy determinant.

4. In the economic sphere, the role of the tax-favored position of capital gains as an attraction to investment in general and venturesome investment in particular probably deserves more weight than questions of impact on market fluidity and stability.

5. In the sphere of equity one finds little in the generally accepted standards of fairness in taxation that supports, and much that militates against, the case for lighter taxes on capital gains.

6. Even after all the facts are brought forward and put in focus, conclusions as to the proper treatment of capital gains and losses cannot be reached until conflicts between equity dictates and economic objectives are resolved.

7. Given a desire to strike a proper balance between the promotion of investment and the maintenance of an equitable and progressive income tax, the following policy actions gain support from the points made in this paper:

(*a*) Constructive realization at gift or death would serve both equity and economic objectives.

(*b*) Lengthening rather than shortening the holding period is indicated by equity criteria and gains some support on economic grounds.

(*c*) A tightening of the capital gains structure to cut down avoidance possibilities would improve the fairness of the income tax without adverse repercussions on investment.

(*d*) Narrowing the gap between the capital gains tax and the tax on ordinary income would clearly serve the interests of equity and, if accomplished by lowering ordinary rates, would also serve to stimulate investment. Even accomplishing this end by raising the capital gains rate would not necessarily have the dire consequence on the flow of investment funds that is often assumed.

RELATION OF CAPITAL GAINS TAXATION TO TAX TREATMENT OF UNDISTRIBUTED PROFITS

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THE EXISTENCE OF UNDISTRIBUTED PROFITS, POSITIVE AND NEGATIVE

Most corporations in the United States retain, in prosperous years, a considerable fraction of the year's profit that is left after paying corporation income tax. Many of these corporations are small, closely

held concerns, but, in terms of the total amount of dollars involved, more importance attaches to those companies whose stock is held in considerable part by large numbers of the stockholders, most of them without any personal link at all with the men who direct the production policy of the corporation and its dividend policy. For the 10-year period 1945-54, undistributed profits of corporations in the United States aggregated $89 billion.[1]

The percentage of disposable profits that is retained in prosperous years varies widely from one concern to another. A few large, prosperous, and expanding companies whose stock is listed on organized exchanges, or is actively traded in over the counter, have for several years past been retaining from 90 to 100 percent of profits. At the other extreme can be found corporations paying out in dividends more than 100 percent of disposable earnings. Some, indeed, even continue to pay dividends while operating at a loss. These corporations show negative undistributed profits. This diversity of practice renders a solution of the problem of taxing undistributed profits more difficult, but it also makes the discovery of such a solution more important, to the end that discrimination among individual stockholders, and among individual taxpayers generally, may be minimized.

In deep depression, as in the 1930's, corporations in the aggregate show negative undistributed profits. For each of the years 1930 to 1938, inclusive, corporations in the aggregate, in the United States, paid out in dividends more than they were earning currently in profits (after corporation income tax); indeed, this excess of aggregate dividends over aggregate profits cumulated to $20 billion for the 9 years 1930-38.[2] Still, even in such a period of depression, many corporations will be paying out less in dividends than they are earning. Much of the aggregate of negative undistributed profits is attributable to companies that are showing a loss, but are still paying dividends.

High-Income Investors, and Undistributed Profits in Widely Held Corporations

The practice of retaining a fraction of corporation profits, or even the whole, during prosperous years, is no doubt traceable, in part, to a natural desire to minimize personal income tax. This motive may be quite strong with respect to closely held corporations. But this aspect of the problem of undistributed profits, which has been worked over so much in the flood of articles on the old section 102, has been given far more attention than it deserves, relative to the problem posed by retention of earnings by large corporations, much of whose stock is held by individuals who are in no position to influence dividend policy. Tax favoritism raises an ethical problem even when it is not actively promoted by the beneficiary. A wealthy investor buys some shares of a rapidly expanding corporation listed on the stock exchange (or over the counter), a corporation whose directors distribute only a small proportion of earnings each year, or even none at all, primarily because the opportunity for profitable expansion of

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[1] If inventory valuation adjustment is made, the figure is $69 billion. U. S. Department of Commerce, National Income, 1954 edition, pp. 164-165, and Survey of Current Business, July 1955, pp. 11-12.

[2] If inventory valuation adjustment is made, the $20 billion becomes $16 billion. U. S. Department of Commerce, National Income, 1954 edition, pp. 164-165. Carl S. Shoup, Principles of National Income Analysis, pp. 130-134.

the firm is so inviting. Such an investor benefits, taxwise, from the expansion policy, even though it has not been adopted with his interests in view. He competes with other wealthy investors, it is true, for the floating supply of the stock, but common observation suggests that he is often able to buy in at a price that leaves him well off, after all income taxes, compared with what the individual income-tax rate schedule in the law implies he should be, relative to low-income investors.

But while the investor who gets the benefits of undistributed profits is being considered, we must not lose sight of the investor who reaps on balance only a net undistributed loss, an investor whose holdings of corporate stocks, on balance, produce for him dividends that exceed the amount the corporation has earned during the period he has held the stocks. This investor pays more in personal income tax than the earnings of the corporation imply that he should. Perhaps this aspect of the problem will never again be as important as it was during the 1930's, for a good deal has been learned about how to avoid such economic catastrophes. But it will always exist to a degree, even in prosperity.

Taxing Capital Gains as a Method of Reaching Undistributed Profits

What methods are available for bringing undistributed profits of widely held corporations into personal income-tax returns? And how may the extra taxation that accompanies negative undistributed profits (dividends in excess of current earnings) be eliminated?

One approach is to include in the individual's taxable income the amount of capital gain he realizes when he sells his stock, and to allow him deduction for capital losses.

Insofar as retained profits have built up the market value of the shares, such profits are brought into the individual income tax net through the taxation of capital gains. They are brought in, along with all the other influences that make for capital gains—shrewdness in taking advantage of periods of market depression, and of boom psychology, changes in the value of money, changes in long-term interest rates, and so on. To the degree that tax policy does not want to take account of these other forces in fixing the amount of individual income tax, the capital-gains method of solving the undistributed profits problem is too much of a blunderbuss. However, it is possible to make adjustments in the capital-gains reckoning for some of these other forces, at least for changes in the value of money (changes in price level).

The inclusion, in individual taxable income, of capital gains, the method just mentioned for subjecting undistributed profits to personal income taxation, is not found in certain other countries, Great Britain, for instance. If one asks, how does Great Britain subject undistributed profits of widely held corporations to personal taxation,

the answer seems to be that Britain has not made a serious effort to do so, perhaps considering any such aim impracticable.[3]

Even in the United States, inclusion of capital gains is so restricted that the way is still open for the wealthy investor, if he is wise, and fortunate, to build up an estate and to pass it on to his heirs, quite free of individual income tax, by buying into widely held corporations that retain most of their earnings, and by keeping this investment position intact over a long period when the companies are expanding. He may similarly escape all personal taxation on the undistributed profits by giving his shares of stock to a religious, charitable, or educational institution after they have grown in market value, taking the market value as a deduction in his income-tax return, but paying nothing on the appreciation in value.[4]

If the investor does not succeed in avoiding entirely all personal taxation of the undistributed profits, he may yet come out with a low personal income-tax charge because of the relatively mild rate of taxation on capital gains (25 percent maximum rate, except for gains on property held for only 6 months or less).

The unsuccessful investor, on the other hand, is given only restricted tax relief, because of limitations on deductions for capital losses.

Finally, since capital gains are taken into account only in the year in which they are realized, by the sale of the stock, rather than piece by piece in the years in which the gain is accruing, there is a postponement of tax on the undistributed profits (transmuted into capital gains) that saves the taxpayer an interest charge or its equivalent, a saving that may be important over a long term of years. Correspondingly, the unsuccessful investor must part with his stock—and not buy it back at once, either (under the "wash sale" provision)—if he is to get a deduction for his capital loss. Thus, even if the present provisions that allow complete escape of capital gains, and enforce complete neglect of capital losses, at time of death or of transfer to charitable, etc., organizations were altered, the taxing of undistributed profits through the capital-gains route would be imperfect because of the long delay available.

Current Fallacies Respecting Relationship of Capital-Gains Taxation to Undistributed Profits

Before proceeding to suggest possible ways out of the present impasse, some widely accepted fallacies must be noted.

One fallacy is the assumption that the case for bringing capital gains to account as a method of reaching undistributed profits is dependent on there being an exact correspondence between the amount

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[3] The latter attitude seems to be that adopted by the recent Royal Commission on the Taxation of Profits and Income in Great Britain. See its Final Report, Cmd. 9474, June 1955, pp. 25–40 and compare the Memorandum of Dissent by three members of the Commission, ibid., pp. 358–360 and 365–382, especially pp. 370–371. In 1938, about one-third of profits after tax was retained, on the average, by British corporations, excluding closely held "private" companies. In each of the years 1952, 1953, and 1954, about two-thirds was retained, only one third being distributed in dividends. "Profits" here refers to profits as reported, plus or minus adjustments for inventory profits or losses and for depreciating fixed assets at replacement costs. Aggregate dividends paid net of tax (including minor plus items for change in dividend reserves), which totaled £315 million in 1938, had risen only to £405 million in 1954. These data exclude from both periods companies that have been nationalized. See table 4 in F. W. Paish, Company Profits and Their Distribution Since the War, District Bank Review, Spring Gardens, Manchester 2, England.

[4] "In extreme cases, the saving in the donor's taxes is larger than the amount he could realize, net of taxes, by selling the property" (Lawrence H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses, New York, 1951, p. 301).

of capital gain and the amount of retained earnings, in every case. No such sweeping, exact correspondence exists, of course. There are too many other forces playing on stock prices; and even if there were not, a dollar of profits retained might put the price of the stock up by less than or more than $1 [5] (compared to what it would have been ex-dividend if the dollar had been distributed), depending on what investors think of the vigor and astuteness of the management, and prospects for the industry and the economy.

Justification for reaching undistributed profits through capital gains depends, not on any such extreme and unrealistic assumption, but rather, on the postulates that (1) the other forces that operate, along with undistributed profits, to determine the amount of capital gain are proper factors to take into account in determining the individual's ability to support government through the income tax, or, if they are not, can be isolated and removed by adjustment of the amount of the capital gain (for example, change in value of the dollar), and (2) that the accumulation of retained profits is indeed a significant factor in creating capital gains in a considerable number of cases. The first part of this postulate remains beyond the scope of the present brief memorandum; as to the second part, no investor familiar with the stock market will doubt its validity.

The fact that there is no exact correspondence between the amount of undistributed profits and the amount of capital gain shown by the company's stock is a recommendation for the capital gains method rather than a count against it, in those cases where the common stock is preceded by so heavy a senior capitalization that it is exceedingly doubtful how much benefit, if any at all, the stockholders are going to get by the company's retaining profits. This point is especially important where there are large accumulated preferred dividends unpaid, or where income bonds are an important part of the capitalization, or where ordinary senior obligations are massive in amount and not very far off in maturity. In such cases, the market itself judges what the retained earnings are worth to the common stockholder—along with all the other factors playing on the price of the stock—and by taking the market's judgment, as expressed in capital gains or losses, the tax law gets a more accurate appraisal of the economic worth of the retained earnings to the shareholder than would, for example, the so-called partnership method, which would require the stockholder to include in his income-tax return his share of the corporation's earnings for the taxable year.

A second fallacy is that, so long as the amount of revenue involved is not very important, there is little point to making an effort to solve the problem of taxation to the individual of undistributed profits. The nature of this fallacy may be exposed by supposing that some responsible official of the Treasury (say) suggested that complete exemption from the personal income tax should be granted to all individuals with incomes of $1 million or more, on the grounds that the impact on the Federal revenue would be negligible, and that there would clearly be some saving in administration and compliance costs, not to mention the boost given to incentive to invest. The public

[5] See Oscar Harkavy, The Relation Between Retained Earnings and Common Stock Prices for Large, Listed Corporations, Journal of Finance, September 1953, passim, and references therein

would properly be outraged at such a proposal, even though no taxpayer could claim that his own tax burden would be perceptibly increased by the fiscal measures that would be needed to make up the minor loss in revenue. The issue at bottom is an ethical one, and it is so, indeed, largely just because so small a percentage of taxpayers are favored.

A third fallacy has to do with capital gains accrued at death. Under present Federal income tax law, capital gains that have accrued on stocks that the taxpayer is holding at the time of his death are not brought to account for the income tax, either then or later. If the heirs sell the stock they pay tax only on the further gain, if any, that accrues after the taxpayer's death. With reference to this point, it is sometimes argued that this gap in the income-tax structure is made good by the fact that the shares of stock are included in the estate of the taxpayer, and hence are subject to the death tax. But the estate tax applies equally to savings that have been accumulated from dividends or from salaries. Hence it does nothing to redress the balance in favor of undistributed profits (as compared with other forms of income) that has been created by the income tax, on stocks held by high income taxpayers.

Differences in Timing of Capital Gains and Accrual of Undistributed Profits

There is, then, a virtual certainty that a substantial capital gain will arise on the stock of a corporation that retains most of its earnings, especially if that corporation is favored by having able management and by being in a rapidly growing industry. In this sense, undistributed profits give rise to capital gains, and taxation of capital gains is a way of making undistributed profits subject to personal income tax. But now another question arises. Who gets the capital gain, and when?

Before the investing public realizes that the corporation in question is headed for a long period of rapid expansion, its stock will sell in the market at a modest price in terms of current earnings. As the years pass and the growth characteristics of the company become more widely appreciated, the market value of the stock is bid up faster than the earnings rise, faster than the undistributed profits accumulate or than the dividends increase. Ultimately, the corporation becomes accepted as a paragon of growth, and investors eager to participate in tax-free or tax-favored capital gains reach for the stock at lofty prices that fully discount, and in some cases overdiscount, any growth that can reasonably be assumed even by the most optimistic (but sane) investor. From then on, the price of the stock increases slowly, though the corporation grows rapidly, just as anticipated, through retention of profits.

Consider what happens to an investor who buys into the company at such a late point in time. He holds the stock faithfully, he sees the undistributed profits accumulate rapidly as predicted, yet the market value of the stock rises only gradually, even over a decade or two, from the price that he paid for it.[6] Undistributed profits have

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[6] See John C. Clendenin and Maurice Van Cleave, Growth and Common Stock Values, Journal of Finance, December 1954, pp. 365–376.

given rise to roughly corresponding capital gains, but the two have not materialized in the same time periods at the same rate; the capital gain has preceded, in large part, the earning of the undistributed profits. Hence the capital gains have accrued to those investors who were astute enough to buy into the corporation before its growth characteristics were fully appreciated. Thus the corporation may start in year 1, and grow rapidly for 50 years; the market value of its stock may rise only modestly during the first 10 years, say, roughly corresponding only with the growth of the undistributed profits during that period (or even by a lesser amount); in the second decade the price of the stock may be bid up far more rapidly than the undistributed profits accumulate, until by the 20th year the price discounts all the future undistributed profits—as well as dividends, of course—that are anticipated to accrue over the remaining 30 years. Anyone buying the stock in year 20 will find that he gets little capital gain the next 30 years, relative to the large amount of undistributed profits that will be earned in the same period. These anticipated undistributed profits have already been siphoned off, so to speak, by the stockholder who is now making his exit, after his 20-year speculation. The new purchaser, to be sure, has made a good investment in the sense that he gets a modest 5 percent return (if that is what he figures on), over the next 30 years, dividends and capital gain considered together, but the amount of capital gain will be very small compared with the amount of undistributed profit that is accumulated during those 30 years.

To put it another way: If everybody agrees that growth of the corporation is to occur at a certain rate, due to retention of earnings in a favorable climate, and if the growth does in fact take place at that rate, competition among investors will have developed before that growth occurs, so that the price of the stock will have been pushed up to a point where only a modest capital gain will be accrued to the current purchaser, even though the corporation's surplus grows at the rapid rate expected.

Of what significance is this discounting of future undistributed profits, in the formulation of income-tax policy?

One aspect is this: The astute investor who gets in early can transmute into capital gains for his personal use not only the undistributed profits of the years that he holds the stock, but also the undistributed profits of years to come. If capital gains are not taxed, or are taxed at favorable rates, such an investor gains an enormous economic advantage over his fellow investors who stay with corporations that pay out most of their earnings in dividends and hence either grow not at all or grow only by obtaining fresh capital through sale of securities.

Another aspect is that, once the bidding up of the price of the stock has taken place, and the astute early investors have given way to the later purchasers, it is too late to increase the personal income tax on a large part of the future undistributed profits. A Government that has, up to that point, not taxed capital gains or has given them favorable treatment, cannot reach most of the undistributed profits yet to come, by measures designed to tax capital gains accruing in the future. However, new-growth companies are continually being born, or are about to be recognized as such, and with respect to investors

in such companies, it is not too late to reach their future undistributed profits through taxation of capital gains yet to accrue. Moreover, wide swings in investors' sentiments occur; in periods of depressed markets even well recognized growth stocks fail to discount at a normal rate the undistributed profits to come.

Finally, even if the stock of the growth company has been fully recognized as such, there remains some capital gain to accrue in the years ahead, representing part of a normal return on the purchase price, and this gain will be the larger, the larger is the percentage of future earnings that is to be retained. If a corporation is to distribute no dividends at all for a substantial period ahead (but is sure to distribute correspondingly large dividends after that), its stock should be expected to show a capital gain of close to 5 percent, for instance, if 5 percent is the normal rate of return on an investment of that degree of risk. This 5-percent return will escape personal income taxation to the extent that capital gains are not fully taxed as ordinary income.

The Ordinary Corporation Tax as a Means of Taxing Undistributed Profits

It may be asked, does not the present corporation income tax go a long way toward solving the undistributed profits problem, since a corporation's entire profit, including the undistributed portion, pays the 52-percent tax (30 percent on the first $25,000)?

The difficulty is that any corporation tax is just a flat-rate, across-the-board levy, insofar as the various stockholders are concerned. Some stockholders have very modest incomes, even if we include, in computing their incomes, their shares in the undistributed profits of the corporations in which they own stock. Such stockholders are overtaxed, under the present system, even if the corporation retains all its profits and thus deflects from its stockholders the impact of the personal tax. The corporation tax is in effect a 52-percent levy on the investment income of such shareholders, unless the tax is thought to be shifted on to consumers in higher prices, or back to wage earners in lower wages.[7] Some of the corporation tax may be so shifted, forward or backward, but it seems unlikely that Congress believes that most of it is. Otherwise, Congress would have had to justify extracting nearly $20 billion annually, mostly from low and moderate income consumers or wage earners, by what would amount to a general excise tax imposed chiefly on the necessities of life, or a hidden payroll tax. (Moreover, would Congress under this view, have granted virtual exemption to intercorporate dividends?) In the name of consistency, and until economists come up with more definite indications that the corporation income tax is shifted, the 52-percent levy must be assumed to bear indirectly on the investor, at either high- or low-income levels. At low-income levels it is obviously excessive.

At high-income levels, however, the corporation tax, even at its present 52-percent rate, is a deficient substitute for the personal income tax, with respect to undistributed profits. The high-income investor who some time ago bought into a rapidly growing corporation that retains all its earnings is paying only 52 percent (indirectly) on

[7] See also the qualification made below, concerning stockholders who have bought into the corporation since the 52-percent tax became established.

his share of the undistributed profits, against 60, 70, 80, or even nearly 90 percent that a fellow investor is paying on dividends from another corporation.

No doubt the existence of the high corporation income tax lessens the tax favoritism granted one high-income investor as compared with another. But just because it is so high, it increases the discrimination between the low-income investor and the high-income investor.

Moreover, there is one more complication to consider. Investors who are buying into corporations now, as compared with those who bought into corporations a decade or so ago, are buying with full awareness that 52 percent of the corporate income will be taken in tax for an indefinite period in the future (and if not exactly 52 percent, then apparently something not far from that). For this current crop of investors, the proper tax comparison may well be on the basis of what happens to the remaining 48 percent of the profits, disregarding the initial 52 percent. The answer then is plain: if the 48 percent of the profits is retained in the business, it is taxed not at all; if it is distributed in dividends, it is taxed at the personal income-tax rates (minus the small abatement given to dividends in the Revenue Act of 1954).

In general, then, an ordinary corporation tax cannot be used to eliminate the tax differential in favor of investors who accrue capital gains through undistributed profits.[8]

Tax on Undistributed Profits

A special corporation tax levied on undistributed profits would not redress the balance as among individual investors with different amounts of income. Like the ordinary corporation income tax, an undistributed profits tax imposed on the corporation comes out as a tax at the same rate for all stockowners of the corporation, whatever their individual levels of income. The low-income stockholder is hit just as hard as the high-income stockholder, by any tax the corporation pays (and does not shift). Even an undistributed profits tax at rates graduated according to the percentage of the corporation's profits that are retained is nothing more than a flat-rate tax so far as the several stockholders of any one corporation are concerned. To be sure, if the undistributed profits tax is so heavy that it forces every corporation to pay out all current earnings in dividends, the immediate problem of equitable treatment among stockholders is solved; but so heavy a tax would give rise to other problems no less important. It is not implied here that those problems would necessarily be insoluble, but discussion of them lies outside the scope of this paper. The point is that a tax on undistributed profits, if it yields any revenue itself, directly, is by that very fact shown to be failing in the task of redressing the balance among the stockholders of any one corporation, and probably also between stockholders and other income recipients.

Evidently the undistributed profits tax, however useful it may be in dealing with closely held corporations, is no solution to the problem with respect to widely held corporations, unless it is so heavy as to

[8] See Carl S. Shoup, The Divided Exclusion and Credit in the Revenue Code of 1954, National Tax Journal, March 1955, pp. 136–147.

force out all profits in taxable dividends. As an imperfect solution it may still of course prove better than the existing system, or some more ineffective substitute.

THE "PARTNERSHIP METHOD"

Every stockholder might be required to include in his taxable income his share of the corporation's current earnings, distributed and undistributed. Actual dividend payments would then be disregarded in computing the stockholder's income. However, the amount of capital gain or loss realized upon disposition of his stock would have to be adjusted to allow for the excess of profits reported in his returns up to that time over the dividends received up to that time, if extra taxation was to be avoided.

In this manner the stockholder would be treated, with respect to current earnings of the corporation, as partners and sole proprietors are treated with respect to the current earnings of partnerships and sole proprietorships, no account being taken of the amount of such profits that is distributed or undistributed. The kind of adjustment for capital gains and losses noted immediately above has been used with respect to sale of partnership interests.

Application of the partnership technique to corporate stockholders has gained substantial support among tax students.[9] However, even aside from the difficulty alluded to above that emerges when heavy senior capitalization makes common share earnings mean little to common stockholders, there are troublesome technical difficulties in the partnership method.[10] And capital gain or loss, as just noted, would still have to be taken into account when stockholdings were disposed of.

SUMMARY

The analysis immediately above suggests that no matter where one searches for methods to meet the problem posed by undistributed corporate profits, taxation of capital gains and allowance of capital losses remain essential ingredients of the formula. Indeed, the two income-tax problems posed by capital gains and by the undistributed profits of widely held corporations are intertwined, inextricably.

To say that capital gains are to be taxed is to say also that capital losses must be allowed as deductions; otherwise, discrimination between high and low income investors is imply replaced by discrimination between successful and unsuccessful investors.

The particular techniques to be used in taxing capital gains and allowing capital losses cannot be compared here; the choice is wide, and has been analyzed in detail elsewhere.[11] The provisions of the present Federal tax law are far from the best, technically, that can be devised; they represent, in fact, not so much a logical development

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[9] See, for example, Report of Committee of National Tax Association on Federal Taxation of Corporations, Robert M. Haig, chairman, Proceedings of Thirty-second Tax Conference, 1939, pp. 534 ff.; and Report of Committee of National Tax Association on the Federal Corporate Income Tax, Harold M. Groves, chairman, Proceedings of Forty-third Conference on Taxation, Pittsburg, 1951, pp. 54 ff.

[10] See Vickrey, op. cit., pp. 161–162, and Henry C. Simons, Personal Income Taxation, Chicago, 1938, pp. 100–104.

[11] See Seltzer, op. cit., chs. 6, 7, 10, 11; Carl Shoup, Roy Blough, Mabel Newcomer, directors of research, Facing the Tax Problem, Twentieth Century Fund, New York, 1937 (see index, Capital gains and losses); William Vickrey, Agenda for Progressive Taxation, New York, 1947, chs. 5 and 6.

of capital gain-and-loss treatment designed for a given end as they do a simple compromise between two groups with quite opposing views on what are the proper ends—those who believe that capital gains and losses should be taken into account somehow in arriving at personal income for tax purposes, and those who believe they should be entirely excluded. The middle ground reached in a compromise of this sort is not likely to be one that is technically very suitable for anything at all.

In any event, something is gained, whatever one's ultimate views as to taxable ability, if it is kept in mind that capital gains cannot be intelligently discussed without some reference to undistributed profits, nor undistributed profits without reference to capital gains.

DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION

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The income-tax provisions of the 1954 Internal Revenue Code represent probably the most complex revenue law ever enacted in the fiscal history of any country. The subject singly responsible for the largest amount of complexity is the treatment of capital gains and losses, and the single factor in that treatment which is accountable for the resulting complexity is the definition of capital gain and of capital loss. The fact that our tax law is complex does not necessarily mean that it is a poor law. Instead, the complexity of the law may well be recognized for the most part as a testimonial to the achievement of the tax sophistication necessary to operate an income tax raising $50 billion and applying to about 75 million individual taxpayers and 700,000 corporate taxpayers. But if the complexity is to be kept within reasonable bounds, we must at all times have an awareness of the factors responsible for each particular complication and the values which that complication serves, so that the two may constantly be compared and weighed. So viewed, the complexities caused by the treatment of capital gains and losses far outweigh the values which it is asserted are served by that treatment. Moreover, the present congressional approach to the definition of capital gains and losses inevitably results in more and more complexity, so that the difficulties can only grow worse.

The treatment of capital gains and losses in itself is relatively simple. On the gain side that treatment for an individual is distinctly preferential: an individual taxpayer may deduct 50 percent of a long-term capital gain, so that only one-half of the gain is subject to tax. Further, if the rate of tax applicable to the remaining gain exceeds 50 percent (a point reached at $18,000 of income for a single person and $36,000 for a married person), no further tax is to be paid on the gain. Put differently, the entire capital gain is subject to a maximum rate of 25 percent. On the loss side, that treatment imposes limitations: capital losses in excess of capital gains are allowed to offset only up to $1,000 of ordinary income, and the losses not utilized in any one year may be carried forward for 5 years, offsetting, until exhausted, the capital gains in those years plus $1,000

of ordinary income. For a corporation, the preferential treatment consists of the 25-percent maximum rate for long-term capital gains; the deduction of capital losses is limited to the offsetting of capital gains. To be sure the above summary omits some of the nuances. But even when these are added the complete treatment, and the statutory provisions in which it is expressed, come to no more than a readily acceptable amount of detail. In fact, only four short sections are involved. It is only when attention is focused on one bit of detail—the fact that this treatment is applicable only to capital gains and capital losses—and the search begins for the definition of those capital gains and losses that we start to uncover the enormous complexity and confusion inherent in this treatment.

The term "capital gain" has been used in the tax law for so long a period of time and with such wide publicity that it has acquired a very familiar ring. We are led to believe that it has a readily ascertainable content and as respects its comprehension and application stands on no different footing from other items of income such as salary, interest, rent, and the like. But we must remember that a fully developed concept of "capital gain" has not been offered to the tax law by either the economist or the accountant, so that its content cannot readily be supplied by reference to those branches of discourse. Many economists see "income" as a "gain"—the result obtained by adding to the wealth on hand at the end of a period of time the consumption during that period and then subtracting the wealth existing at the beginning of the period. But once having defined income as "gain," they do not offer—nor have they really any occasion to offer—any workable concept of a "capital gain" as a component of that "gain." The accountant, in turn, knows of "net income" and while he has occasion sometimes to seek a capital-gain component so as to charge a profit on the sale of certain fixed assets to surplus rather than current operations, his concept of capital gain is a much narrower and essentially different concept from that sought in the tax law. And even the only definition of "income" seriously essayed by the Supreme Court before it abandoned the attempt—the *Eisner* v. *Macomber* definition of "income" as "the gain derived from capital, from labor, or from both combined"—spoke of "gain from capital" and not "capital gain." Consequently, when the Congress in the Revenue Act of 1921 introduced the term "capital gain" into our technical tax law and was therefore faced with the problem of defining that term, it was embarking upon a journey through areas previously unexplored in this country. When we turn from the beginning of that journey in 1921 and pass over 34 years to arrive at the present definition in the Revenue Code of 1954, we see that while the Congress has added many maps and charts and much elaborate equipment, it still has not uncovered a clear and useful trail.

The Definition of Capital Asset

The code (sec. 1222) defines "capital gain" in terms of "the sale or exchange of a capital asset," which for the most part merely passes us along to the question of what is a "capital asset." It is here, in the definition of "capital asset," that the code itself discloses the enormity of the problem. For it commences to define "capital asset"

as "property held by the taxpayer (whether or not connected with his trade or business)" (sec. 1221). Since in one sense everything that the taxpayer holds is "property" and hence will be a capital asset, at this point it would seem to follow that all income could well be "capital gain"—for any moneys received by a taxpayer could readily be regarded as the result of the surrender by him of "property" in the form of either tangible assets or intangible property such as claims to moneys. Hence unless the definition is to be useless, exclusions must be found. But in seeking to give content to the definition through the development of appropriate exclusions, it must be recognized that one facet, and perhaps the basic facet, of the present difficulty thereby emerges. For unless a particular item of income is covered by an exclusion it will become a capital gain by passing through the residual category of capital asset. Given a maximum capital gain rate of 25 percent when the regular starting rate is 20 percent and the top rate 91 percent, so that the taxpayer has a terrific stimulus to seek to classify his income as capital gain, this method of definition works directly to his advantage.

The generality of the definition of "capital asset," when placed in the chain of definitions involved in giving content to "capital gain," also involves another important decision. It is clear that an increase in the value of an asset can result from many causes. Thus, in the case of shares of stock an increase in their value may come from accumulated corporate earnings, from innovations or discoveries such as the development of a new product or market, from the seasoning of the business organization or the efforts of the shareholder-managers, from the weaknesses of competitors, from an improvement in the general level of economic activity, from inflation, and so on. An increase in the value of land may result from the discovery of new resources in the land, from the development of new uses for its resources, from the growth of population, from the growth of crops on the land, such as timber, over the passage of time. The value of a bond may increase through a change in general interest rates. And so it goes, through the effects of the expected and planned or the unexpected and erratic, through the effects of inflation, war, depression, invention, the vagaries of public taste. Are all of the resulting gains to be regarded as "capital gains"? The Congress answered in the affirmative when it commenced its definition of "capital asset" to mean all "property" and then did not embark on the search for exclusions essentially related to the causes of the increase in value. Consequently, the additional value imparted to a taxpayer's stock through factors within his control, as the accumulation of corporate earnings or his personal efforts as corporate president, was regarded in the definition used as no different from increases in value caused by forces beyond his control. Taxpayers were quick to perceive the enormous range of possibilities in planning for capital gain under such a definitional approach. Here again, the pattern of definition was all in their favor.

The Problem of Distinguishing Investment and Business

Let us turn to the all-important exclusions from "capital assets." The first (sec. 1221 (1)) is that of—

stock in trade of a taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of a taxable

year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

The main objective of this exclusion is reasonably clear, but the scope of the problem is not so evident. For in these deceptively few words the Congress is attempting to exclude from "capital gain" all of those profits which it regards as the everyday profits of the business and commercial world. Here is the first important concept to give content to capital gain - the division between "business" and "investment."

Property held for sale to customers

The intent of this exclusion and its application to the obvious situations are relatively clear—the daily receipts of the corner grocery store, of the big city department store, of the large manufacturing concern, are ordinary income even though they arise from the sale of "property." But a sale of stock on the stock exchange by the average investor, a sale of a parcel of undeveloped land purchased as an investment, or a sale of a residence are to give rise to capital gain.

But beyond the obvious are great areas of uncertainty. The investor to realize his increase in value must sell his investment and at that point he is engaging in an activity that will have many of the characteristics found in the activity of some of the everyday businessmen whose profits from sales are regarded as excluded from capital gains. John Jones has bought a tract of land many years ago as an investment and now he desires to sell. He must find buyers and to do so he may have to add improvements, advertise, hire an agent, subdivide, and so on. John Jones is a college professor of the classics and would be shocked to think of himself as a real-estate dealer. Yet John Jones may have more land or choicer land to sell than the everyday real-estate dealers in town, so that, for the moment, John Jones, classics professor, is, in reality, the biggest real-estate operator in the area. Is the land which John Jones bought years ago as an investment now "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"? The courts have struggled for years with this problem, and Congress, in 1954, added a section (sec. 1237), covering a page and a half, which only resolves a few situations, and in doing so manages to create a great many problems. Moreover, the section is essentially limited to unimproved land. What about Harold Smith, who decides to invest his money in rental housing and builds 200 houses? He had at first sought a return on his capital in the form of rent, but after several years he now desires to sell those houses and retire. Harold Smith now has more houses for sale than many a real-estate broker. Is Harold Smith now a businessman?

These issues are not restricted to land—the estate of Richard is disposing of an inventory of $1 million in furs left by the decedent in his fur shop; the estate of Robert is selling a large quantity of antiques collected by the decedent in his lifetime; the estate of Mary is selling a large amount of valuable jewelry which she had owned. Norman, a motion-picture director, has invested in a story which he desires to sell to a studio. He wishes then to direct the production of a picture based on that story; also, on the other side, consider the case of the businessman whose inventory greatly appreciates in value because of unforeseen conditions, such as war, shortages due to strikes

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or other factors, and the like. Has the inventory become an investment? In all of this, what is "investment" and what is "business" and how can we describe the differences with the precision desirable in tax law?

Real property and depreciable personal property used in business

The aspect of "investment" as distinguished from "business" has another important facet—what about those assets of an admitted business activity which are other than inventory, such as the building and land on which the business is conducted or the machinery used in the business operations? If these are sold, is the profit ordinary income because we are dealing with an admitted business, or may the businessman be regarded as "investing" in these business assets? The Congress on this question has been deluged with advice, but, unfortunately, the advice has been conflicting. Thus, farmers holding livestock for breeding or dairy purposes and then selling the livestock desired classification of the property as capital assets. This was only natural, after one considered that the sale of the livestock would produce a tax profit, since the expense of raising them had been previously deducted and their tax cost was zero. On the other hand, railroads and other users of machinery and equipment which were sold after their utility had declined desired classification of that property as noncapital assets. This was only natural, after one considered that the equipment was sold at a loss, which loss could have been deducted as an ordinary item through depreciation if the property had been retained until the end of its useful life or scrapped. But both livestock and machinery were "property"—and "property used in the trade or business." Faced with this dilemma, Congress resolved it in an intensely practical fashion—such property would in effect be a capital asset for gain purposes but not a capital asset for loss purposes (secs. 1221 (2), 1231). Farmers and railroads could both depart pleased, but one searching for a concept of capital gain was left only with an added appreciation of both the theoretical difficulty of the task and the congressional flexibility in escape from dilemmas.

There are other interesting ramifications of these congressional solutions in the business area: The value of standing timber before it is cut by a taxpayer in the timber business is a capital asset (sec. 1231 (b) (2)) and the value of unharvested crops sold with the land is also a capital asset (sec. 1231 (b) (4)), though in each case the distinction from everyday profits is debatable, and in treating livestock as a capital asset the Congress excluded "poultry" (sec. 1231 (b) (3); also, in another section, Congress has partially ventured into the area of exclusive dealing arrangements, sales agencies, profitable leases, favorable purchase contracts, and the like by in effect classifying the profits on the sale of certain but not all of these arrangements as capital gains (sec. 1241). The point here is that, lacking an adequate definition of "capital gain," the Congress is gradually moving to dealing with particular assets 1 by 1. In such an endeavor any possible concept is likely to be lost in the welter of lobbyists.

Further, the treatment of real property and depreciable personal property used in the business as a capital asset on the gain side leads into considerable difficulty when one considers the deduction provisions. If a taxpayer can recoup the cost of the asset at a rapid rate through 5-year amortization or accelerated depreciation or through

percentage depletion and intangible drilling expenses, thereby receiving ordinary deductions, and then sell at a tax profit receiving a capital gain, the combination is a most happy one. Congress sometimes worries about this, more often not—but the resulting statutory complications are apparent. And, from this, one is led to another interlocking problem—suppose the asset is acquired by merely buying the property subject to an indebtedness so the dollars of the deduction are dollars not yet spent by the taxpayer. Here the capital gain trail thus leads into the maze of assumptions of indebtedness taking property subject to an indebtedness and even cancellations of indebtedness, where most of the law is in the cases and not the statute. On the other hand, on the loss side the treatment of this property as an ordinary asset leads into the provisions involving the practice of purchasing corporations owning high basis-low value business real property so as to obtain the ordinary loss benefits from the sale or depreciation of that real property. The "devil and the deep blue sea" are thus usually present in these problems of capital asset classification, although the Congress may not always perceive the perils on both sides.

The Problem of Distinguishing Investment and Speculation

Congress, in the few words earlier quoted which form the first important exclusion from capital assets, is also concerned with another set of distinctions which it regards as important. These involve those groups who make their profits in the stock market. Here Congress apparently saw three main groups: the dealer in securities, the speculator, and the investor. The dealer in securities was regarded like the grocer except that his inventory consisted of securities and not groceries, and hence his assets, the securities, were not capital assets. The investor, who holds his securities for their annual return but whose securities appreciate in value, was the prime example for Congress of the capital gain taxpayer and his securities were capital assets so that their appreciation in value would be a capital gain. Even here a problem presented itself when a taxpayer was both a dealer and an investor, and a section was adopted to aid in classifying his securities (sec. 1236). But the profits of the speculator were not regarded as worthy of preferential treatment. However, the Congress could see no way to distinguish the speculator from the investor by reference to the nature of the assets held, for both simply held securities. So it resorted to another criterion and added a holding-period requirement under which a capital asset had to be held a certain length of time to obtain preferential treatment. That period is now 6 months.

But the double test—capital asset and holding period—leaves some strange results. In the nonpreferential area are left traders, those speculators who are seeking an eighth or a quarter of a point and whose turnover of securities generally involves a period of hours or days rather than months. But the other market participants are all grouped together—the professional speculator whose purchases and sales are substantial and frequent, the large investor who is constantly perfecting his portfolio through changes in its composition, the modest investor who occasionally changes his portfolio, and the amateur spec-

ulator who takes a chance now and then. The only differentiation possible under the statute is in the length of time that the securities have been held, and this factor cuts through these last four groups in indiscriminate fashion rather than between groups. In fact, it is much more likely to put all of these groups safely on the capital-gain side, in view of the short length of the holding period. In 1951 there were, in the tax returns showing net capital gains, $6.5 billion of net gains involving securities held more than 6 months and only $240 million of net gains on securities held less than 6 months.

We are thus left with a congressional feeling that speculation and investment are different matters, but with no statutory differentiation between the two except as respects the in-and-out daily traders. Also, we find that the person who makes his profits by sagacious buying and selling of securities is on the capital-gain side, but his counterpart in the real estate or other personal property area is on the noncapital side. Further, even this almost ineffective use of the holding-period requirement has brought with it considerable complexity, for Congress has found it necessary to adopt two pages of statutory provisions to protect that period from the manipulations possible through short sales, puts, and calls, and then to protect certain arbitrage operations from the effect of the first set of provisions (sec. 1233).

So much for the first exclusion from capital assets in the words earlier quoted and its ramifying statutory provisions. The Congress has in the most general way sought distinctions between "business" and "speculation" on the one hand and "investment" on the other. But its own concepts are unclear, and it is beginning to appreciate that these terms do not have the settled significance in the world of economics or commerce necessary to support statutory differentiation. Hence, a piecemeal approach is developing, and we are being led into a maze of complexity.[1]

The Problem of Distinguishing Investment Profits From the Rewards of Personal Efforts

The next principal exclusion of certain property from capital assets (sec. 1221 (3)) is that of:

> a copyright, a literary, musical, or artistic composition, or similar prosperity, held by * * * a taxpayer whose personal efforts created such property.

Here the Congress is pursuing another factor in its concept of capital gain. Apparently, profits attributable to "personal efforts" are not entitled to capital-gain treatment. This is, presumably, a result of the realization that salaries, wages, commissions, and professional fees are on the ordinary income side, along with the everyday profits of the businessman, and the feeling that profits coming from other per-

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[1] There are of course many other aspects that could be considered. For example: (1) If a businessman must deposit Government bonds in escrow as a guaranty under a sales contract and buys bonds solely for that purpose, is the purchase of the bonds an independent investment or an integral part of the sales contract? (2) An individual who buys a bond selling at a premium and callable at the corporation's option on 30 days' notice can deduct the amount of the premium against ordinary income thereby reducing his tax cost to par, hold the bond for 6 months and then sell it at a tax profit equal to the premium but taxable only at capital-gain rates—the net effect is an ordinary deduction of the premium against, say, a 91-percent rate, at the price of a 25-percent rate on the premium (sec. 171 (b) (2) left this practice largely undisturbed); (3) the sale of a stock just before it goes ex dividend will transform the dividend into capital gain; (4) on the loss side, there are differences in the classification of (a) stocks and bonds whether the taxpayer is an "investor" or "promoter," (b) debts represented by notes if he is an "investor" and (c) debts represented by notes if he is a "promoter" (secs. 165 (g); 166).

sonal efforts belong with these classes of income. One can understand such an attitude and accept the exclusion. Yet one becomes considerably nonplussed when he finds an entire section devoted to classifying the profits of an inventor as capital gain (sec. 1235). Moreover, this capital-gain treatment is extended even to one whose business is that of promoting inventions. And it applies whether the profits are received in a lump sum or through royalties. One's faith in the apparent conclusion regarding the congressional view of profits from personal efforts is further shaken when it is noted that 4 pages of the statute are devoted to classifying the rewards under executive stock option arrangements as capital gains and about 2 more pages to making the capital gain preferential status available to employees who on their retirement obtain lump-sum payments from pension plans (secs. 421, 402, 403). The latter provisions of course lead into the intricacies of pension plans and profit-sharing arrangements, especially in the case of closely held corporations, since they become the rainbow leading to the capital gain pot of gold. One can only conclude that the exclusion regarding authors and other creative artists does evidence the basic congressional concept that the rewards from personal efforts should be outside the capital-gain area, but that significant pressures can often turn aside the application of that concept.

These aberrations in the patent, stock option, and pension trust situations really involve a congressional tax bounty through the gift of a capital-gain status and should not obsecure the definitional problem. Since all "property" unless excluded is a "capital asset" and since personal efforts result in creating "property"—be it a book, a patent, goodwill for an individual business, a trade name, a contract not to compete, a profitable employment contract, an exclusive agent's contract to represent an actor or a writer, or a promoter's stock in a corporation whose value rises because of his business sagacity—the magnitude of the problem is apparent. Where does the emphasis on the personal efforts cease so that the resulting "property" may become a "capital asset?" The Congress has here given little guidance other than the ad hoc statutory decisions described above and these are conflicting. The problem of classification is largely left to the courts, who tend to find noncapital gain when the personal service element predominates or when the asset is of a character distinguishable from the traditional capital-gain area. Hence the sale of an employment contract would probably produce ordinary income while the promoter's stock would be a capital asset. But the fact that these problems are largely unanswered in the statute does not eliminate them. Again they illustrate that while Congress on the whole may be seeking to distinguish between "investment profits" and "the rewards of personal efforts," the world of affairs does not offer any neat division.

The Problem of Classifying Transactions Involving the Sale of Recurring Receipts

A consideration of the problems created by the all-inclusive scope of "property" in the statutory definition of "capital asset" leads to still another source of difficulty. The Congress as respects capital gains presumably had in mind a distinction between recurring receipts such as salaries, wages, interest, rents, dividends, royalties, and the

like on the one hand and the nonrecurrent realization of the appreciation in the value of property on the other. It is sometimes difficult to be clear about this, for here also there are aberrations, and the capital-gain status has been conferred by statute upon timber and coal royalties (sec. 631 (b) and (c)). But since Congress has so far refused to extend this treatment to oil and iron ore royalties, one may suppose the principle still stands though in the end it may turn out to have little application in the natural-resource area. But the right to a salary earned, or to interest accrued or a dividend due, is "property" in the legal sense. Does such a right when sold therefore transport the salary, interest, or dividend out of the ordinary income area and into the capital gain category via the term "property" in the definition of capital asset? Here again the Congress has dealt piecemeal with parts of the problem. A cryptic clause added in 1954 appears to exclude from capital assets the sale of claims for salary earned as well as claims for goods sold (sec. 1221 (4)), but there is nothing as to other items. There is over a page devoted to the allied problem of discount bonds, with the purpose of treating as ordinary income the interest element in the discount (sec. 1232). On the other hand, there is a section (sec. 1241) making the amounts received on the cancellation of a favorable business lease or a favorable distributor's agreement capital gain though the continuation of the lease or agreement would have been reflected in larger profits for the business. But aside from these stray pieces of legislation, the matter has been left to the courts with varying results. The decisions permit the future distributions to a life beneficiary of a trust to be converted into capital gain through the sale of his interest in the trust. The courts may be in the process of permitting a similar result in the case of oil payments. In the case of the sale of salary claims or of matured interest or dividend claims, the decisions require ordinary income treatment. Here again the absence of a statutory answer does not remove the problem. While we are clear as to the ordinary-income treatment of recurring receipts, what result should obtain if the right to the receipts is sold (*a*) along with the underlying asset, as in the case of the sale of a stock or bond; (*b*) apart from the underlying asset, as in the sale of only the right to dividends or interest but not the sale of the stock or bond; or (*c*) where there is only the right to the future receipts and that right is sold, as in the case of the claim to salary, the trust distribution to a beneficiary, or the right to oil payments? Can workable statutory concepts and provisions be devised to cover the myriad situations in this area?

The Transformation of Tangible Assets Into Intangible Property Rights to Those Assets

Collapsible corporations

The problems considered so far have dealt with the attempts to classify the myriad types of "property" between capital and noncapital assets. Difficult as these problems are, their resolution unfortunately does not represent a successful end to the question of definition. Instead, the answer to these problems projects the capital-gain definition into an entirely new set of problems which, in the structure of the income tax, raise difficulties even more complex than the previous issues. For when a particular piece of "property" has been neatly

cataloged as a noncapital asset, the taxpayer may with relative ease change the legal cloak which covers his relationship to that property and substitute a new relationship from which a different piece of "property" emerges. Thus, suppose that an individual in business owns appreciated inventory which represents the major value of the business. Since "inventory" is in the property group classified as a noncapital asset, its sale will produce ordinary income. The individual now incorporates his business, and then sells the stock of the corporation. Stock, we have seen, is in the property group classified as a "capital asset." The obvious question is whether the individual has transformed the profit on the sale from ordinary income to capital gain by changing his legal cloak from that of individual proprietor to sole shareholder. Since stock is an accepted type of property, the courts could hardly come to any general conclusion, except possibly in the crudest of arrangements, other than that the individual in selling the stock was selling "property"—the stock itself—and the "property" so sold was a "capital asset." But this result obviously makes unimportant for this situation the classification of inventory as a noncapital asset. Nor is this result limited to the particular case of inventory. Whenever an individual could interpose a corporation between himself and a noncapital asset and then sell the stock in the corporation, the individual could thereby deal in a capital asset rather than in a noncapital asset although it was the noncapital asset which imparted value to the capital asset.

A wide area of the problem of defining capital gain thus became a shell game, with the taxpayer in control because he could determine under which legal shell to place the asset. Individuals formed corporations to produce a single motion picture, to construct a housing project, to develop a tract of real estate—all transactions which would if handled by the individuals themselves result in ordinary income—and then disposed of the corporate stock when the venture was ready for sale. The tax bar early gave the colorful name of "collapsible corporations" to these single-shot corporate ventures. Congress in 1951 recognized that this procedure could make a shambles of the capital-gain definition, and in a complicated two-page section attempted to meet the difficulty (sec. 331). But the section, while highly intricate, is not generally regarded as an effective solution or even a theoretically proper solution. More effective and more comprehensive solutions, however, would be even more intricate in their structure and operation.

Collapsible partnerships

Congress, spurred on by the Treasury Department, in 1951 thus recognized the problem of the collapsible corporation and its threat to the capital asset definition. But both failed to comprehend how fluid and subtle was the capital gain shell game as conducted by resourceful tax practitioners. For soon the "property" was found under another shell, that of an "interest in a partnership." The individual simply adopted the partnership form of doing business and transferred his noncapital assets to the partnership. Then, when he was ready to sell, he was selling not the noncapital assets but a "partnership interest" and a partnership interest is "property" of the type classified as a capital asset. Again, the capital-asset classifications could be turned into a shambles by this substitution of legal cloaks.

The 1954 Revenue Code devotes a number of sections to this problem, and they represent the most complicated portion of the partnership area. Whether they will be effective as presently written is another matter. Moreover, the solution here adopted for the collapsible partnership differs from that chosen for the collapsible corporation, although the problems are similar.

In this general area of the sale of business assets the 1954 code presents three different solutions depending on whether the business assets are owned by the individual as a proprietorship, a partnership, or a corporation. This result concretely illustrates the tremendous difficulties inherent in the attempt to classify property between capital and noncapital assets under a complex legal structure which offers many patterns of property ownership. Such a legal structure by permitting a tangible piece of property in effect to proliferate itself into various types of intangible assets, each in itself a form of "property," dooms any tax classification under the present definitional approach, if possible at all, to extremely intricate and detailed solutions. Moreover, the fact that it has taken us over 30 years to perceive these structural problems underscores the difficulties of definition in the capital gain field.

The Transformation of Ordinary Income Into Stock Appreciation

The accumulation of corporate earnings

Complex and difficult of analysis as the above set of definitional problems may be, they are surpassed by even more formidable problems in the corporate area. As was pointed out at the outset, stock in a corporation is classified in the property group of capital assets. An increase in the value of that stock will thus on its sale become capital gain. This is so whether the increased value of the corporation is traceable to an increase in corporate earning power because of better management, product development, general business conditions, or any of the other factors affecting the fortunes of business enterprises or whether it is traceable to the retention and consequent accumulation of annual corporate earnings. In the latter situation, if the earnings had been distributed currently as dividends, they would have come to the shareholder as ordinary income. The accumulation of the earnings in the corporation therefore transforms that ordinary income into capital gain to the extent the accumulation is reflected in the value of the stock, for the stock is a capital asset and a profit on its sale is capital gain. To this extent the flexibility of the corporate form of organization in our legal system thus renders ineffective all of the effort spent in excluding the everyday profits of the business world from the definition of "capital asset." All of the difficulties earlier described in distinguishing "investment" profits from "business" profits must be surmounted if there is to be a proper definition of capital assets. Yet once they are surmounted the result to a considerable extent becomes pointless when the individual incorporates and accumulates the "business profits" in his corporation. As to those profits the individual substitutes the lower combination of the corporate rate plus the capital gain rate for his individual

rate—and if he retains the stock until death will eliminate the capital-gain rate.[2]

This dilemma was early perceived and provisions aimed at restraining the accumulation of profits in a corporation are a familiar part of the income tax. In their most severe aspect they comprise the personal-holding-company tax (secs. 541-547) and the foreign personal holding company provisions (secs. 551-557). In considerably less severe form they represent the special accumulated earnings tax on corporations improperly accumulating surplus (secs. 531-537). These measures take up 24 pages of the code. But while the dilemma was early perceived and has been dealt with at greater and greater length as the years pass by, there is general agreement that it by no means has been satisfactorily solved. On the contrary, it represents one of the basic issues in the complex relationship of corporate and individual income taxes. Moreover, it is constantly appearing in new forms, as is attested by the recent appearance of the Canadian investment trusts whose shares are quoted and publicly dealt in. Through these trusts an American investor may invest funds in Canadian stocks, see the dividends on those stocks go untaxed in Canada and the United States, have the dividends accumulate in the Canadian investment trust without hindrance from United States or Canadian tax law, and then with his investment thus appreciated through the unhampered accumulation of earnings realize his profit at capital-gain rates on the sale of that investment. As a consequence, the elaborate detail of the personal-holding-company provisions and the special accumulated earnings tax on corporations, adopted to prevent much of the capital-asset definition from becoming pointless, in turn itself is rendered pointless by the tax treatment accorded to these Canadian investment trusts and their shareholders. These tax savings are not limited to incorporation in Canada, and many a wealthy American is having his advisers survey the "tax havens" of the world to find the most suitable place in which to establish the foreign corporation which will hold his investments and those of his associates in the enterprise.

Corporate distributions

In recent years the maneuvers of taxpayers and intensive study of the technical tax problems of corporate distributions are combining to demonstrate that the problems just described growing out of the accumulation of corporate profits are unfortunately only one facet of the difficulties caused by that procedure. For more and more the shareholders of corporations with accumulated earnings are seeking to realize those earnings at capital-gain rates without, however, a complete sale of their stock which would end their relationship to the corporation. Consequently, they are devising corporate arrangements, short of a complete sale, which operate to draw down to the shareholders some of the accumulated earnings at capital gain rates but which still leave the shareholders in control of the corporation and its future operations. Since corporate laws are extremely flexible and since in a closely held corporation the shareholders can readily

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[2] Through his control over the choice of the form of business organization the taxpayer is able to achieve an "ordinary loss-capital gain" position. He can organize the business as a partnership, so that if it loses money the losses may be taken by him as ordinary losses. If the business is profitable he can under some circumstances then simply elect to be treated as a corporation (sec. 1361) or he can always actually incorporate, so that the profits may be accumulated and eventually realized as capital gain.

shape the corporate structure to suit their tax ends, the opportunities for maneuvering are rich and varied. Almost overnight, the Treasury Department has been forced to cope with the bewildering problems presented by this maneuvering. This is the area of the distribution of preferred stock dividends then sold by the shareholders and redeemed by the corporation; of corporate divisions under which some corporate assets are placed in a new corporation through spinoff, splitoff, or splitup, whose stock is then distributed to the shareholders to be sold by them; of corporate stock redemptions and partial liquidations under which the corporation distributes some of its assets for some of the shareholders' stock but leaves them through their remaining stock with their control unhampered; of complete liquidations followed by a reincorporation of part of the assets, leaving the shareholders with control of those assets and with the remaining assets in their hands; of mergers and reorganizations involving in more complex form the types of transactions described above. As a consequence, the most significant and probably the most complex of the corporate provisions adopted in the 1954 Revenue Code revolve about these capital gain-ordinary income classifications, such as those dealing with distributions or redemption of stock and stock dividends (secs. 302–307, 318); with partial liquidations (sec. 346); and with corporate divisions (secs. 355–356, 368). Many of the solutions adopted are new and untested, sometimes inconsistent, and certainly incomplete. In sum, the 1954 Revenue Code with all its detail and intricacy represents in this area, when judged against the problems known to exist today, in reality only a first draft of the possible answers. When judged against the fact that we have been working at refining the definition of "capital gain" for over 30 years and against the constantly growing ingenuity of tax practitioners spurred on by the relentless drive of their clients for capital gains, the technical level of solution reached in the 1954 code should not leave us optimistic as to the future.[3]

Conclusion

In sum, the difficulties inherent in the present approach to the definition of "capital gain" are formidable almost beyond belief. We have considered the necessity at the initial level of distinguishing "investment" both from "business" and from "speculation"; of differentiating the rewards for "personal efforts" from the rewards of "investment"; and of separating the disposition of those recurring receipts which are in the stream of ordinary income from the disposition of other assets. All of this must at present occur in the context of the classification of "property." We have seen how any success at this level in the classification of tangible property can be swiftly negated through the creation of intangible property rights to the tangible property by use of the corporate and partnership forms. We have also seen how the familiar but unsolved problems of using the corporate form to change ordinary income into capital gain through the accumulation of corporate earnings and the sale of

[3] The definition of "capital gain" and "capital loss" also involves the sale or exchange of a capital asset. This "sale or exchange" requirement in itself involves a host of problems, which add to the complexities of the capital gain definition. Some of the ramifications of this aspect of the definition are considered in Surrey & Warren, The Income Tax Project of the American Law Institute, 66 Harvard Law Review, pp. 761, 808 (1953).

stock have suddenly spread in far more intense and complex forms throughout the entire area of corporate distributions.

The result has been a snowballing accumulation of complex and intricate provisions in the tax law which, not solving our present difficulties, can only promise still greater complexity if the present approach is continued. Yet there is no escape from plunging deeper and deeper into this technical morass of the definition of capital gain as long as the following conditions exist:

(1) Preferential treatment is given to "capital gains," either through exemption, a preferential rate, or permission to average those gains while other items of income are not so averaged;

(2) The rate schedule with respect to non-capital-gain items is of such steepness as to make the preferential treatment of capital gains significantly advantageous;

(3) The definitional approach to the content of "capital gain" follows the refined and intricate character of the present code;

(4) The Congress follows the practice of granting relief from high rates of tax through the device of bestowing "capital gain" status on those taxpayers who are successful in pressing their claims for a tax reduction applicable in their situations.

At this point I wish to observe that the title of this paper refers to the definitional problems of capital gains—not to a definition of "capital gain." The task is to describe the present labyrinth in which we are wandering, and not to discover the path which takes us out of it. However, I venture the following suggestions as to that path:

(1) Reduce the present high rates of tax in the top brackets while *at the same time* (I emphasize this) eliminating the various devices by which favored groups now escape those high rates—tax-exempt securities, the various natural-resource tax shelters, the dividend credit, investment in life-insurance policies, and so on.

(2) Reduce the present large differential between the capital-gain treatment and the treatment of ordinary income by (*a*) eliminating the present exemption of one-half of the capital gain; (*b*) increasing the maximum capital-gain rate to the level of the middle bracket marginal rates. At the same time, increase the allowance for capital losses.

With respect to possible incentive effects, the lowering of the top bracket rates will permit an increase in the maximum capital-gain rate, since the greater attractiveness of income yield resulting from the first step serves to offset the lessening in the attractiveness of capital-gain realization that may be caused by the second step. Perhaps consideration should be given to maintaining some differential not through a maximum rate but through an exemption of part of the capital gain, such as one-quarter or one-third of the gain but not as much as the present one-half.

(3) Contract the definition of "capital asset" by—

(*a*) withdrawing the capital-gain label from such areas as employee stock options, pension-trust terminations, oil and timber royalties, patent dispositions, real property and depreciable property used in business, and the like;

(*b*) increasing the holding period to at least 3 years.

(4) Permit 3-year averaging of all capital gains, by spreading the capital gain pro rata over the current year and the 2 preceding years.

Extend this form of averaging to other classes of income as experience is gained and as administrative feasibility and fiscal appropriateness are demonstrated.

(5) Tighten the provisions relating to corporate distributions seeking to transform ordinary income into capital gain and the corporate and partnership provisions respecting the sale of a business. Undertake study and analysis of other aspects of the definition of "capital asset," as "investment" and "business" and the sale of recurring receipts, to see whether measures are available to surmount the present difficulties.

(6) Consider whether the above measures are adequate or whether it is necessary to go further and

(*a*) tax at death or gift unrealized capital gains;

(*b*) further increase the length of the holding period. If the holding period is lengthened, consider a combination of staggered periods with increasing differentials until the maximum differential suggested in (2) above is reached. Thus, for each 3-year period the maximum rate on capital gains could drop 10 percent until the maximum suggested in (2) above is reached.

These suggestions, I repeat, are ventured and not guaranteed as a solution to the present definitional problem. The capital-gain area involves significant and difficult fiscal, social, and technical issues. In this area the only statement one can make with conviction is that the present state of affairs is highly unsatisfactory, is steadily worsening, and therefore makes attempts at solution imperative. The above suggestions by no means will take us out of the woods. They do not eliminate all of the problems of the definition of "capital gain" which have been described. But they will considerably lessen the strain which is placed on that definition today and which it is incapable of bearing. While the suggestions therefore do not take us completely out of the woods, they will not lead us farther into the jungle.

IX. IMPACT OF FEDERAL TAXATION ON NATURAL RESOURCES DEVELOPMENT

DISTINCTIVE TAX TREATMENT OF INCOME FROM MINERAL EXTRACTION

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I. INTRODUCTORY

The distinctive problem in determining taxable income from mineral extraction is that the mineral sold is a part of the capital asset represented by the mineral deposit itself. This is a different problem from that of the merchant or manufacturer who purchases from others limited short-time supplies of goods or raw materials for sale or manufacture, pays for them only as he obtains them and finds them satisfactory and expects to replace what he has sold or used by similar purchases. In mining,[1] as the deposit is exhausted the mineral is not replaceable in any such manner. Other deposits may perhaps be found, with much uncertainty and risk of discovery and development: with expenditures made and effort given without knowing what may be obtained and with extended deferment of realization. (Replacement by purchase of a developed producing property would probably be at high cost, even if possible.) An exhausted mineral deposit is not to be replaced as the merchant or manufacturer may expect to replace his goods or materials.

Nor are expenditures for mines, with all their uncertainties, comparable with the capital expenditures normally made by others. Hopes for profitable mineral may fail. Even when mineral is found, there may be great variations in its character and quality, in costs of production and in market prices from year to year. Some good results may be offset by poor. Even ultimate realization is apt to be long deferred. If the mineral venture is not successful, expenditures for the deposit and its plant and equipment cannot readily be shifted to other uses.

Most mineral deposits found, even most of those developed to a production stage, never yield profits and never repay the expenditures for them. To furnish incentive for trying to find, develop, and bring into production mineral properties, there must be the hope of finding a successful property whose profits, after taxes, will be adequate to cover the costs for it and the losses on unsuccessful ventures, and yield a net overall gain, commensurate with the expenditures, effort, and risk involved. Taxation at high rates should take this into account if incentives for mineral production are to be maintained. This our income-tax laws have endeavored to do in their distinctive provisions.

[1] The terms "mine" and "mining" may here be used, as sometimes in the law, broadly to cover all mineral extraction, whether from what are technically mines or from wells or otherwise.

While mineral extraction in general has its common and distinctive problems, there are many differences in nature and location of mineral deposits, in methods and conditions of their discovery, development, and operation, and in the recovery, treatment, and sale of their products, and our law recognizes that depletion allowances are to be made "according to the peculiar conditions in each case," even though under common provisions of the law. (Particularly, for oil and gas, the problems in many ways differ so materially from those of the solid minerals that special rules are to be applied, as we later note.) Our law, regulations, and rulings have made many special rules to govern the application of the mineral provisions to various circumstances and conditions. A statement such as this can present only a general outline, which must be considered as subject to the many provisions of law, regulations, rulings, or decisions applicable thereto.

II. Historical Review of Depletion Allowances

1. *Depletion in general*

It was early recognized that the allowance of depletion for exhaustion of mineral deposits was distinctive and different from depreciation or other allowances and that it must be specifically dealt with in the law if a fair and equitable allowance was to be made.

The 1913 act authorized "a reasonable allowance for depletion * * * not to exceed 5 percent of the gross value at the mine of the output for the year." The 1916 act, abandoning the 5 percent limitation (which generally gave inadequate allowance), authorized (*a*) for oil and gas "a reasonable allowance for actual reduction in flow and production" and (*b*) for mines a reasonable allowance for depletion "not to exceed the market value in the mine of the product * * * mined and sold"; under regulations by the Secretary; not to aggregate more than cost or 1913 value.

In the 1918 act the general provision for depletion was—

> In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: (with provisions that 1913 value be used in lieu of cost, where applicable, and that deductions be equitably apportioned between lessor and lessee).

Discovery depletion, first provided under the 1918 act, is later referred to.

The early acts had stated "cost" (or 1913 value) as the basis for depletion and for gain or loss on sale of property, but this left many questions as to "cost" and adjustments to be made thereto. The 1924 and later acts have dealt more definitely with this question of basis for property (including cases of tax-free sales or exchanges), and adjustments to be made in different cases. Without following through the technicalities we may refer to "cost depletion" as depletion based on "cost (or other basis)" and subject to required adjustments.

The general basis and method for "cost depletion" thus adopted have been continued, although with some changes in detail from time to time in the law or in regulations, practices, and procedures.

2. *Discovery depletion*

In 1918 the low prewar rates of income tax had been greatly increased and a heavy excess-profits tax imposed. Such taxes at high

rates had become a serious block to exploration for and development of mineral resources and had a naturally deterrent effect upon desired increases in production. The discovery depletion provision was accordingly made—

> That in the case of mines, oil and gas wells, discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter.

The 1921 act provided this allowance should not exceed the net income from the property for the year. The 1924 act limited it to 50 percent of the net income from the property for the year.

The principle of discovery depletion was simple in recognizing that the mineral deposit was essentially capital, the realization of which, through extraction and sale of the mineral, should not be taxed as if it were income. However, the technicalities in determining what constituted a discovery, its value, and the allowances to be made, were very great, and amendments to the provision from time to time failed to avoid them. Percentage depletion was therefore substituted, first for oil and gas, later for other minerals, until today discovery depletion has been entirely superseded by percentage depletion. Accordingly discovery depletion need not be further discussed, but its principle should be recognized.

3. Percentage depletion

By 1926 the discovery depletion provision had been found not to be working satisfactorily in its administration and application, particularly for oil and gas. Accordingly the percentage depletion plan was adopted for oil and gas, which (to give on the average substantially the same allowances the industry had previously received), was to be at 27½ percent of the gross income from the property, not to exceed 50 percent of the net income from that property; but not less than the cost depletion allowable.

Cost depletion, if more than percentage depletion, was to be allowed because in many cases, even though some mineral might result, the amount realized would not be sufficient to repay the investment. These were merely liquidating operations from which no income resulted. Percentage depletion would not cover such cases.

After percentage depletion had first been allowed to oil and gas, its extension to other minerals was a subject of extended studies by the Treasury and by the staff of the Joint Congressional Committee on Internal Revenue Taxation, resulting in a staff report of 1929. This contained recommendation for allowance of percentage depletion for metals at 15 percent of the gross income, which was somewhat less than the average of prior depletion allowances based on cost, 1913 value or discovery. (It did not attempt to compute corresponding rates for all the other minerals.) The report contained alternative recommendation for percentage depletion at 33⅓ percent of the net income from the property as a reasonable allowance for all minerals; which was also urged in special hearings before the joint committee in 1930. However, Congress in 1932 decided to follow for mines the previously established pattern and allowed percentage depletion for metals 15 percent, sulfur 23 percent, and coal 5 percent of the gross

(the minerals for which it had satisfactory evidence of the average of previous allowances); in no case to exceed 50 percent of the net income from the property for the taxable year; but only if the taxpayer elected percentage depletion in lieu of cost depletion. (This elective requirement was eliminated in 1942, to permit for mines, as for oil and gas, allowance each year of cost or percentage depletion, whichever was greater.)

After passage of the 1932 act the interpretation and application of the new provisions to the many different methods of mining, treating, and selling the various minerals covered thereby was considered at length by the Treasury. The new enactment for mines in no way changed percentage depletion for oil and gas; for which the gross income from the property was to represent the price for which the oil and gas were sold or salable at or in the vicinity of the well, where posted or representative market prices were generally established. There was no such uniformity of cutoff point for the minerals falling under the new provision. It was recognized that the ordinary treatment processes normally applied by mineowners or operators to obtain the commercially marketable mineral product or products should be included in mining. For some mines there were representative market prices for the crude mineral as customarily shipped from the mine after ordinary processes to prepare the crude mineral for shipment. For others there were many different processes, varying at different mines, to obtain the customarily marketable products. For most of the metals there was no representative market or field price for the crude minerals; for these, the "net smelter return or its equivalent" seemed the intended general standard. After extended consideration, appropriate regulations, practices, and procedures were established by the Treasury, covering particularly determination of gross income and of net income from the property (not then defined in the law). Some features of these were later questioned and in 1943 Congress wrote into the law a definition of "gross income from the property" to accord with the original requirements; stating the general principle that the ordinary treatment processes were to be included as part of mining, with some listing of particular processes which, under stated classifications, were to be so included. Most of the minerals later included have not been specifically referred to in the definition in the law; to some extent Treasury regulations have indicated their treatment; but in general they have been left to fall under the gross-income definition as written into the law.

The later additions to the 1932 list were relatively few until 1951 when many others were added. The record is not clear how the percentages for these minerals were determined. This seems not too important, since the allowances to them do not constitute a relatively large aggregate in the total percentage depletion picture. It may be more important to establish reasonable, broad classifications than to dispute over an exact rate applicable to each. Finally, in 1954, there were some reclassifications as to percentages, and percentage depletion was extended to all minerals (except a few specific exclusions).

"Net income from the property,"—not defined in the law, but in the regulations—is determined, in brief, by deduction from "gross income from the property" of the cost of mining and various other required expenses.

From time to time there have been amendments in specifications of the law or regulations which we cannot attempt here to mention in detail.

III. Present Taxation of Income From Mineral Extraction

Our present Federal taxation of income, under the Internal Revenue Code of 1954, follows generally the system and method of taxation developed under prior law, and most of its provisions are substantially the same. Yet there are differences, sometimes major, sometimes quite minor, in nature, specifications and result. Except as these differences have their effect, we may presumably expect interpretative and administrative regulations, rulings, and precedents to be carried from prior law to the present, and shall so assume in this outline.

A. DEPLETION

Depletion, to take into account the exhaustion or diminution of the mineral asset as extracted and sold, is allowable to a taxpayer who owns a mineral deposit or has the required depletable economic interest in the mineral. If there is divided interest in the property, appropriate allocation of depletion is made; but, for simplicity, we outline the depletion provisions as applicable to a single owner and operator.

Depletion is allowable when mineral produced is sold or otherwise disposed of and income or loss is to be computed thereon. (If the mineral is not sold in customary form, and it is impracticable to trace it through to processed or manufactured products sold, depletion computations may be based on mineral production, under reasonable procedures.)

Depletion allowable for any year is either (1) "cost depletion" or (2) percentage depletion; whichever of the two is greater.

(1) Cost depletion

The cost depletion allowable under the general rule of sections 611 and 612 [2] will be determined, in brief, as follows:

The cost (or other basis) divided by the estimated mineral units recoverable from the property (the principal or customary units, such as tons of ore, pounds or ounces of recovered minerals, barrels of oil, cubic feet of natural gas, etc.) will give the allowable cost depletion per unit. This depletion per unit multiplied by the units of mineral sold during the year will be the cost depletion allowable for the year. Thus for a deposit having a basis of $100,000, estimated to contain 1 million tons of salable ore, the depletion per unit would be 10 cents. If 50,000 tons of ore were sold in the year, the cost depletion would be $5,000. (Further examples are presented in annex A.)

In general, the initial basis will be the cost of the property (or its 1913 value) except in case of tax-free transfers or other cases where the code prescribes a substituted basis to be used in lieu of cost to the taxpayer. In any case, the cost or other initial basis is subject, from year to year, to the adjustments prescribed in section 1016.

One of the most important of the adjustments is for depletion previously allowed (with tax benefit) but not less than the depletion previously allowable (whether or not with any tax benefit to the tax-

[2] Section references are to the Internal Revenue Code of 1954.

payer). Cost depletion (or percentage depletion if more) is deemed allowable and is applied to reduce the basis for subsequent cost depletion whether or not its deduction has served to reduce otherwise taxable income. Thus, the taxpayer's basis for his property (for computing future cost depletion or gain or loss on sale) may be reduced by depletion allowable from which he has derived no tax benefit. Accordingly, the remaining "adjusted basis" for the property may and often does have no relation to the amount of investment which has not yet been recovered out of profits or with tax benefit.

The mineral units applied in the initial computation of depletion per mineral unit will be the recoverable units as then estimated. Thereafter, any revised estimates of recoverable mineral still remaining, if substantially more or less than the prior estimate, will be divided into the remaining "adjusted basis" to determine the new amount for depletion per unit to be thereafter applied.

The depletion computations for cost depletion and for percentage depletion are to be made for each separate property. In general, "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land" is to be considered as a separate property, but the taxpayer is given an election to combine separate interests in an operating unit as provided in section 614.

(2) Percentage depletion, section 613

The percentage depletion for the year will be (*a*) the applicable percentage prescribed in the code applied to the prescribed "gross income from the property" with respect to the taxpayer's depletable economic interest therein; but not to exceed (*b*) 50 percent of the taxpayer's "taxable income from the property" (computed without allowance for depletion).

For example: 15 percent of $100,000 "gross income from the property" is $15,000 which would be the percentage depletion if the "taxable income from the property" were $30,000 or more. If such "taxable income" were $20,000, the percentage depletion would be $10,000. If there were no "taxable income," no percentage depletion would be allowable for that year. (For further examples of computations, see annex A.)

In all of this it is to be recognized that the terms "gross income from the property" and "taxable (formerly 'net') income from the property" carry their special technical meanings as defined in the law or regulations (as referred to in the preceding historical discussion).

Percentage depletion rates

The percentage depletion rates now applicable to all minerals (except for a few specific exclusions) are set forth in section 613 of the code, in a series of groupings; briefly as follows:

(1) 27½ percent for oil and gas wells.

(2) 23 percent for sulfur and uranium; and for certain listed minerals or ores (strategic or critical for defense) if from deposits in the United States.

(3) 15 percent for metal mines (if (2) does not apply) and for certain other named minerals.

(4) 10 percent for coal and a few other named minerals.

(5) 5 percent for certain named minerals, such as brick and tile clay, gravel, sand, shale, and so forth.

(6) 15 percent for all other minerals (some of which are specifically named, including dimension stone or ornamental stone, and with provision that a 5-percent rate would apply to such minerals for use as riprap, ballast, road material, and so forth).

B. EXPLORATION AND DEVELOPMENT

Expenditures for mineral prospecting, exploration, and development presented the basic question whether expenditures made with such great uncertainty of valuable results should be considered as capital expenditures or merely as expenses or losses. The general question is the same for all minerals but, under our law or regulations, is somewhat differently answered for oil and gas than for mines because of differences in nature of the work and conditions.

1. For oil and gas

The regulations—virtually from the beginning, with later sanction in the law—have made special provisions (with some changes from time to time in specifications) as to "intangible drilling and development costs" for oil and gas—being, in general, the costs for or incident to the drilling of wells and preparing them for production, including expenditures for labor, fuel, supplies, and so forth, which in themselves have no salvage value. The taxpayer is permitted election to charge these to expense, currently deductible from gross income, or to capitalize them, to be recovered by depletion or depreciation, as applicable, or to be written off when they prove worthless, as specified in the regulations.

2. For mines

Under earlier regulations, expenditures for exploration or development of mining property before it reached the production stage were to be capitalized, recoverable through depletion, or written off when proven valueless; but after the production stage, development expenditures were deductible as expense currently or, if extraordinary, were deductible ratably as ore benefited was produced. Development expense does not include plant and equipment whose cost is recoverable through depreciation.

Recognizing the doubtful nature of the expenditures, and because the requirement for their capitalization was a large deterrent to the search for and development of minerals, all development expenses after existence of commercial ore is established are now currently deductible, but with taxpayer election to defer extraordinary development to be deducted as mineral benefited is produced. Expenditures for exploration before existence of a commercial deposit is established are allowable as current deductions in limited amount (first $75,000, now $100,000 per year) for a limited period subject to certain specifications; otherwise, to be capitalized recoverable through depletion or charged off when valueless.

C. DEPRECIATION

Depreciation, although a deduction generally allowable, is of great importance to mining, particularly as very large expenditures for plant and equipment are necessary for modern mining of low-grade ores, from which most of our present production is derived. The

depreciation allowance is made under the general provisions for a reasonable allowance over the probable useful life of the depreciable property.

D. NET OPERATING LOSS

The net operating loss provision was adopted to allow the operating loss of a business in 1 year as a deduction from profits of another in computing income tax, but subject to definite limitations as to period of carryover and as to computation of the loss deduction. It has been amended from time to time and now permits a carryback for 2 years and carry forward for 5 years of the operating loss deductible from profits, and specifications for computation of the loss deduction have been broadened. While still quite technical, it avoids much of the injustice of high taxation of profits without allowance for losses and is of great importance for mining where profits are notably subject to fluctuation, frequently with years of loss interspersed with years of profit.

E. TAX ON CAPITAL GAINS

Most countries having an income tax do not consider capital gains to be income, but we apply our income tax to them. As our tax rates greatly increased, it was recognized as unfair and undesirable to tax as ordinary income the long-term gain derived from capital assets. This was blocking transactions economically desirable and it was defeating the revenues. Accordingly, in 1921 provision was made that taxation of capital gains as defined in the law should not exceed 12½ percent for individuals, which it was felt was the maximum rate which could be applied thereto without impairing the revenues and having undesirable economic consequences. (The provision was not then applied to corporations, since the corporate tax did not then exceed that rate.) The provision has been amended from time to time. At present the tax on long-term capital gains as defined in the code is limited to 25 percent for both individuals and corporations.

By special provision, the gain on cutting of timber may be taxed as capital gains (instead of as ordinary income subject to depletion); with somewhat similar provision for taxation of coal royalties received. Under section 632, the individual surtax on sale of oil or gas property, where its principal value has been demonstrated by prospecting, exploration, or discovery work done by the taxpayer, shall not exceed 30 percent of the selling price.

F. DIVIDENDS TO STOCKHOLDERS

Percentage depletion, allowable to a corporation in computing its taxable income, is not, under the law, taken into account in determining earnings and profits of the corporation for dividends. For such determination, only cost depletion is taken into account, computed on the cost (or other basis), but excluding percentage depletion as adjustment to the basis. Thus, in computing dividends any excess of percentage depletion over cost depletion is treated as distributable earnings or profits. Dividends are deemed payable first from earnings and profits as thus computed, and stockholders are taxable thereon without allowance for percentage depletion.

IV. Comments on Economic Effects

(*a*) If material change is made in depletion or other tax provisions, and consequently in incentives, we cannot reasonably assume that the extractive industries will continue the same in their output and income, the employment they give, and the purchases they make. The exact effect of any such changes may not be readily determinable, but we must assume that, if material, they will have their material results. The business incentive for investment and effort is the expected net return after taxes. If incentive is reduced, we must expect reduction in activity and resulting income. Assumption that with decreased depletion allowances the same activity will continue and greater taxes result is unwarranted.

(*b*) A timelag is to be expected before tax changes have their full effect. If incentives for new discoveries or developments were removed, now-operating properties might continue production until affected by lack of reserves; yet some immediate reduction is probable. But then, when lack of new discoveries and developments seriously affected current production, there would be similar, or even more serious, timelag before production could be realized from newly instituted search for and development of further mineral resources. The timelag would vary in different cases, circumstances, and conditions, but it cannot be disregarded.

(*c*) Expectation for the future may have an even more powerful effect on incentives than the actual present situation. Present taxation and allowances have their important effect on transactions to which present taxation will apply. However, the prospect of future taxation must be most considered in determining present outlays from which future income is expected.

(*d*) Taxes may impair, but do not create, the hope that future profits will be sufficient to warrant the uncertainties and risks of present outlays and effort.

Nor does the mere right to deduct present outlays or ultimate losses from other income give, in itself, incentive for expenditures which, except for tax effect, would not be warranted. At most, the right of deduction merely reduces the deterrent effect which taxes otherwise might have. If, when the deduction is allowable, there is no income or inadequate income from which the deduction may be made, the right to make the deduction is wholly or partly ineffective. But even if the expenditure or the loss is fully deductible from otherwise taxable income, the tax reduction will only be for the tax percentage of the deduction, leaving the taxpayer still out of pocket for the remainder of the expenditure or loss. If $1 million spent for development is deducted from income otherwise taxable at 50 percent, this still leaves the taxpayer with $500,000 unrecovered expenditure from his own resources. The deduction, even if effective, may reduce, but not eliminate, the taxpayer's expenditure at risk.

(*e*) Taxes derived from the activities of any taxpayer are not merely the taxes imposed against that taxpayer. Expenditures made by the taxpayer, whether for income or capital account, are sources of further taxes flowing to the Government. Payroll expenditures for operations, construction, or other purpose, are directly taxable to the employees who receive them; and, as spent by the employees, contribute to creating taxable income for the storekeepers and others, for their

employees and for those with whom they do business. (In the mining community, if the mines are shut down or their expenditures reduced, the entire community is affected.) Similarly, expenditures by the taxpayers for materials and supplies, machinery, transportation, etc., contribute to creating taxable incomes of others, in a long chain which may reach across the country. Thus, a reduction in expenditures by mineral companies may mean far more of a loss in taxes to the Government than the taxes on incomes of the companies themselves.

Dividends paid by mining companies in turn give rise to taxable incomes of their recipients, and as they flow through the ensuing stream of expenditures therefrom.

There is the possible assumption that if the mines decreased their payrolls and purchases others would increase theirs in equal amounts, thus maintaining the same employment and flow of funds and Government taxes therefrom. This is, however, a particularly difficult assumption to justify with respect to mining and metallurgical labor and expenditures, which do not readily shift to other lines and other locations.

(*f*) Minerals brought from the earth in continuing supply and made available for the use of mankind are basic to our industrial and economic life, as it exists and as we want it to be. Without the mineral products, much that we have and prize would be lost. Without the minerals, we should be striving desperately for food and bare subsistence. Only with the mineral products can human endeavor be applied most efficiently and productively to provide for the needs and aspirations of the people.

To some extent we may obtain minerals from abroad, but we should not be wholly dependent on foreign countries for our minerals, thus giving them power, in peace or war, to cut off or limit the mineral supplies needed for our industrial and national life and our defense. We wish we did not need to consider the possibility of war, but we must do so in the world of today. Although we may rightly acquire some minerals currently from abroad, we must maintain a vigorous, active, well-equipped and well-trained mineral industry which will be available for emergency needs. (We can hardly count on stockpiles alone to carry us through a great emergency.) But, even our peacetime industrial life should not be placed in foreign control, particularly when the foreign demands for minerals and mineral products are increasing, and must increase greatly if the people of the world are to raise their living standards to what they should be.

(*g*) Determination of taxable income from mineral extraction is a distinctive problem. For this our tax law has made its special provisions, as it has also provided special treatment for other groups or activities and for many special problems. A single general rule cannot be uniformly applied under variant circumstances and conditions without injustice unless the tax rates are so low that differences are not material.

Present provisions for taxation of mining income may not be perfect. Undoubtedly they are very technical and difficult and fail to do full justice in many cases. But in striving to improve them we should not make them less appropriate and fair, with undesirable economic effects on our mineral production and on the welfare of our people.

ANNEX A

Illustrative examples of depletion computations

[In outline without full detail required for actual computations and on assumptions indicated]

(A) COST DEPLETION [1]

	I	II
Basis for the property:		
Cost	$1,000,000	
Cost plus additions		$1,200,000
Depletion—previously allowable, whether or not with tax benefit (more than allowed with tax benefit)		750,000
Adjusted basis for the property	1,000,000	450,000
Estimated recoverable ... tons	2,000,000	
Estimated recoverable (plus new acquisitions and developments less extracted) ... tons		1,500,000
Cost depletion per unit ... cents	50	30
Cost depletion for year:		
200,000 tons sold	$100,000	
300,000 tons sold		$90,000

(B) PERCENTAGE DEPLETION

	A	B	C
Gross income from the property	$1,500,000	$1,000,000	$700,000
Costs of production, depreciation, taxes, and other applicable deductions	900,000	750,000	600,000
Taxable income from the property before depletion	600,000	250,000	100 000
Percentage depletion:			
15 percent of gross	225,000		
50 percent of taxable		125,000	50,000

(C) DEPLETION ALLOWABLE (ASSUMING COST DEPLETION AS IN II ABOVE)

Percentage depletion	$225,000	$125,000	
Cost depletion			$90,000

[1] When adjustments for cost or percentage depletion allowable, whether or not with tax benefit (or depletion allowed with tax benefit, if greater) equal basis, no further cost depletion will be allowable.

NOTES

(1) Other percentage rates on gross would change results 10 percent of gross in A and B would be less than 50 percent of taxable; 5 percent of gross in A, B, and C, would be less than the cost depletion stated. Different cost depletion (or difference in any other figure) might change relative amounts and amount allowable.

(2) If company produced ore concentrated at its mill and sold concentrates to smelter, "gross income from the property" would be "net smelter returns" computed somewhat as follows:

Payments for concentrates by smelter, representing the market prices for the estimated recoverable metals less charges for smelting, refining, transportation, etc	$1,600,000
Less freight on concentrates to smelter	100,000
Net smelter returns, being gross income from the property	1,500,000
Costs of production (mining and milling), depreciation, and other applicable deductions	900,000
Taxable income from the property before depletion	600,000

This being the same gross and taxable as in A, subsequent computations would be the same.

(3) If the mining company itself treated the concentrates in its own smelter and refinery and sold the refined metals, the selling price of the refined metals less deduction for smelting, refining, transportation, etc. (cost, plus a reasonable allowance for profit attributable to performing such processing or transportation if performed by the taxpayer), would be the equivalent of "net smelter returns" as "gross income from the property."

These examples only briefly outline the general nature of the required computations, which are subject to many variances for different minerals and the different circumstances and conditions of their mining, processing, and sale.

PERCENTAGE DEPLETION, CONSERVATION, AND ECONOMIC STRUCTURE

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INTRODUCTION

The depletion allowance, in its present form, dates from the Revenue Act of 1926, when Congress granted to oil and gas producers the privilege of charging against net income in the computation of income-tax liability an amount equal to 27½ percent of gross sales from crude production but not to exceed 50 percent of net income. This grant of privilege was justified on the ground that under the existing technological and economic conditions a stimulus was necessary to encourage the discovery and development of new oil and gas deposits. At the tax rates prevailing in 1926 a depletion allowance of 27½ percent did not appear to be an excessive price to pay for assurance of increased supplies and additional reserves. Furthermore, the tax savings and loss of Federal revenue, it was thought, would not be significantly greater than those resulting from the system of cost depletion then operative. (Fernald, pp. 3–8, for historical summary 1913–54. Note particularly act of 1918 which recognized "fair market value" of deposits as the basis for depletion. This established recovery of the capitalized value of deposits, rather than recovery of actual outlays for discovery and development, as the basis for income-tax computation, thus laying the foundations for the wasting asset and capital-gains arguments in defense of percentage depletion.)

During the subsequent 30 years, however, this restricted privilege, designed to serve the public interest, has been transmuted into a generalized tax immunity, or subsidy, which seriously depletes the public revenue, creates grave social injustices and produces serious distortions in the economy. In short, the depletion allowance has become primarily a private tax-escape device the approximate effect of which is to equate the corporate income tax with the capital-gains tax in the natural-resource industries. This lucrative privilege constitutes a powerful vested interest, the capitalized value of which amounts to billions of dollars. For the defense and justification of this vested interest a sophisticated rationalization has been evolved to demonstrate that percentage depletion is a necessary, indispensable, and beneficial feature of our economy. Ingenious arguments, which go far beyond the original purpose of stimulating exploration, are adduced to show that percentage depletion, as now authorized, is necessary to compensate for unusual risks, to facilitate capital formation, to protect small producers, to expand the extractive industries, to strengthen national defense, to sustain economic prosperity, to recover the capitalized value of wasting assets, and to equate income with capital-gains taxation. The grand design of this rationalization is to reconcile private privilege with the public interest.

This transformation was inevitable, for in our society all privilege tends to be capitalized and Government cannot for long grant special privilege to some and deny it to others. The pressure is always toward the generalization and equalization of privileges. In the present instance, no sooner had the oil and gas industries been accorded the privilege of percentage depletion than other extractive industries began to

clamor for equality of treatment. The 27½ percent depletion allowance became the goal to which all the rejected and excluded—even the lowly oyster-shell people—might aspire. With rising prices and higher income-tax rates the depletion allowance became increasingly lucrative and the capitalized value of its benefits (tax savings) correspondingly greater. Thus, the pressure to extend the privilege mounted until it became irresistible; Congress was forced to yield and gradually other extractive industries gained admission to the select company of the privileged, albeit at considerably lower rates. The Revenue Act of 1954 represented a crowning achievement in this long struggle, for the list of eligible minerals was extended to embrace almost the entire field and rates of depletion were increased substantially. The fact that these rates are still below the oil and gas rate is a source of continuing dissatisfaction and we find the President's Cabinet Committee on Minerals Policy, in its November 30, 1954, report, suggesting further tax concessions to eliminate deterrents to discovery and production (pp. 2 and 16).

These developments have brought us to a point where the depletion allowance imposes on the Federal Treasury a huge loss of potential revenue the exact amount of which is not known but which may run to as much as $1 billion per year, of which amount the oil and gas industries account for approximately three-fourths. This deficiency must either be made good by nonprivileged taxpayers, or borne by consumers through chronic inflation or by the general public in the form of desirable public services foregone. On the other hand, the public benefits derived from this tax concession to the owners of natural resources are indeterminate and extremely dubious. It may well be doubted that these public benefits are commensurate with the social costs involved, such as misallocation of resources, aggravation of economic concentration, inequities in taxation and impairment of the public finances. Whatever the balance of good versus evil inherent in the system, it seems clear that the time has come for Congress to ask some searching, critical questions about the depletion allowance and to explore carefully alternative means by which public purposes in the natural-resource area may be served without recourse to subsidization through tax immunity. In this inquiry the burden of proof should rest on the recipients and beneficiaries of special privilege to demonstrate that, on balance, percentage depletion actually serves the public welfare.

Some Basic Questions

Among the questions that should be asked are the following:

1. Is public subsidy, by percentage depletion or otherwise, actually necessary to call up sufficient supplies of mineral products? Why will not normal profit incentives and a free price system suffice to insure adequate supplies?

2. If subsidy is actually necessary on account of national-defense requirements would not some selective form of subsidy or direct public assistance, specific to given situations or needs, be superior to the generalized, nonspecific depletion allowance, achieving more certain results without the attendant disadvantages? For example, why not substitute for percentage depletion such direct aids as loans, purchase

contracts, sharing of exploration expenses, stockpiling, publicly financed research, and premium prices for additional production?

3. Taking into account modern scientific methods, industrial organization and institutional devices for spreading risks, are the risks of exploration and development in the natural-resource industries actually greater or more onerous than in business enterprise generally? If they are greater in some degree why will not a somewhat higher return on capital, as determined in a free market, compensate for these additional risks?

4. Why should the Federal Government forego needed revenue in order to provide new increments of capital for the natural resource industries? Why cannot these industries, like other businesses, finance expansion by internal savings and by resorting to the public capital market without reliance on tax savings through percentage depletion?

5. What assurance is there that tax savings achieved through a generalized depletion allowance, with no performance requirements, will actually be used for exploration and development, technical improvements, conservation of resources or other beneficial purposes? In the absence of public control as to their ultimate disposition, may not such funds be diverted to other purposes quite unrelated to the development of natural resources?

6. If, as alleged by its proponents, percentage depletion does stimulate an abnormal (i. e. non-market-determined) flow of capital into the natural resource industries, does not this constitute a misallocation of economic resources, which lowers the overall efficiency of the economy, encourages the waste of natural resources and reduces the level of general well-being?

7. Why should any attempt be made, through percentage depletion or otherwise, to place the natural-resource industries on a capital gains basis of taxation? Why should they not pay income taxes at regularly prescribed rates like other business? What is peculiar or unique, in an economic as distinct from a physical sense, about wasting assets that entitles them to preferential treatment approximating capital gains taxation?

8. Why, in the natural-resource industries, should the capitalized value of mineral deposits be treated as a wasting asset subject to depletion for income-tax purposes when in all other business only capital outlays, or actual investment, are depreciated against net income? In short, why use capitalized values in the first and capital investment in the second instance as the basis for computation of income-tax liability?

9. Do not the two privileges of charging intangible developmental costs against net income and averaging net income through the carryback and carryforward provisions adequately compensate for any unusual risks or hazards associated with exploration and development? Why is percentage depletion necessary as an additional incentive?

10. Given the existing degree of economic concentration in certain branches of the natural-resource industries, with its attendant consequences in respect to production and market controls and price and profit maximization, does not the major proportion of the subsidy represented by percentage depletion accrue to large firms, thereby aggravating the trend toward concentration of economic power and

jeopardizing further the viability of competition? Is not the Federal Government by this device actually promoting monopoly and destroying competition?

TAX POLICY IN RELATION TO THE CONSERVATION AND SCIENTIFIC UTILIZATION OF NATURAL RESOURCES

It is the special responsibility of the Federal Government, acting for the Nation as a whole and within its constitutional limitations, to preserve and expand the natural resource base, and to insure its most efficient utilization. Since, in our system, most natural resources are privately owned and immune from direct public control the Federal Government must for the most part operate indirectly to induce modes of private utilization consistent with the public interest. That is, it must, by the means at its disposal, seek to curb private acquisitiveness when it threatens to impair the resource base and stimulate individual self-interest to perform the public good. Tax policy is one of several institutional devices which may be used for this purpose. Although its influence on resource owners is marginal rather than determinative—other considerations of self-interest and institutional pressures being ordinarily more decisive—taxation, if properly applied, can play a significant role in stimulating scientific utilization of natural resources.

From the viewpoint of conservation, then, the central question in the evaluation of any tax policy is its ultimate effect on the resource base. Does it operate to encourage wastes in production, processing, and consumption, to accelerate exhaustion, to deter investment. technological innovations, and improved organizations? Or does it stimulate resource owners to undertake new discoveries, scientific research, investment and technological innovations designed to conserve natural resources and to utilize them more efficiently? Does it retard the exhaustion of scarce, nonrenewable resources by encouraging a shift of technology and investment toward the exploitation of more plentiful and renewable resources? Or, as the case may be, is tax policy a neutral factor in respect to the conservation and scientific utilization of natural resources, failing to influence the economic decisions of private resource owners either toward or away from the goals of conservation? Let us examine briefly the tax immunity device of percentage depletion by reference to these criteria.

First, and most fundamental, it should be noted that the pecuniary advantage of percentage depletion (tax saving) is completely disassociated from resource-conserving action by the beneficiary. The Federal Government grants this lucrative privilege to a certain class of taxpayers but exacts no quid pro quo in return. The beneficiary is under no obligation or compulsion whatever to serve the public interest by conserving natural resources as a condition precedent to receiving the subsidy. It accrues to him by virtue of profitable exploitation, not by virtue of any required conservation measures on his part. Thus, under favorable economic conditions, one might reduce one's income tax by 50 percent while using the most wasteful and inefficient methods of exploiting a natural resource. In this case, the depletion allowance is a functionless subsidy—a grant of privilege without public benefit in the form of conservation results. Resource owners may, for other reasons of self-interest, find it to their advantage to institute conserva-

tion measures and to raise the technical level of production, but there is no necessary or causal connection between such efforts and percentage depletion. If the depletion allowance is to become an effective tool of conservation policy a direct and specific relationship must be established between performance and benefit, whereby tax savings on account of percentage depletion accrue only to resource owners who meet prescribed performance standards in respect to utilization of the natural resources under their control.

Second, and on the negative side, there is good reason to believe that percentage depletion, as now operative, actually accelerates the exhaustion of natural resources and militates against the institution of comprehensive conservation measures. The prospect of tax savings up to 50 percent of net income tends to divert economic resources from other employments, where higher taxation applies, into the extractive industries, thus intensifying the rate of exploitation. Since net income after taxes depends so largely on percentage depletion, resource owners are under pressure to liquidate resources quickly and in quantity at the lowest short-run cost, and to sell them at the highest prices obtainable, under monopolistic or publicly subsidized conditions if possible, in order to maximize the advantages from percentage depletion. This pressure is especially severe when both profits and tax rates are high; under such conditions, tax saving may become a more immediate and urgent goal of business policy than efficiency in the use of natural resources.

The depletion allowance may serve to divert economic resources into the extractive industries but it provides no assurance that any considerable portion of the economic resources thus diverted will go into resource-conserving techniques or investment. Here again, there is no legally prescribed functional relationship between public subsidy and private performance. In the absence of any such public requirement the diverted economic resources may only hasten exploitation by the techniques currently in vogue, however wasteful and inefficient, and contribute nothing to raising the technical level of natural resource utilization. Whatever the ultimate allocation of these new economic resources over the entire field, as between resource-destroying and resource-conserving techniques, the significant point is that the decisions are made by private recipients of special privilege, each according to his immediate self-interest, and not by the Government which grants the privilege, ostensibly for public purposes. It would seem elementary that if the Federal Government is to divert economic resources into the extractive industries by means of public subsidy—in this case tax immunity through percentage depletion—it should have control over the disposition and use of those resources, and that it should exercise this control to protect and expand the natural resource base on which our whole economy depends.

Third, the depletion allowance diverts economic resources into the domestic extractive industries when in the interests of conservation, reducing costs, and overall economic efficiency such resources might better be employed in expanding overseas production. One of the easiest, simplest, and most effective conservation measures is to draw from the rest of the world by means of trade those natural resources in scarce supply at home. This policy not only preserves the domestic resource base but has the added advantage of reducing costs and stimulating international trade generally. Why should our Government

subsidize domestic producers to expand production of scarce and irreplaceable natural resources, thereby hastening their ultimate exhaustion, when these same natural resources can be had from overseas much cheaper, and without subsidy, by the normal processes of international trade? Such a policy is quite irrational from the conservation point of view. Neither does it make good sense in terms of long-range national security, for preservation of the resource base, particularly in respect to scarce, irreplaceable natural resources, is vital for national defense. To the extent percentage depletion contributes to the artificial overexpansion of domestic production while discouraging the development of overseas supplies it violates one of the accepted principles of conservation policy and, in the long run, weakens our national security.

Effect on the Economic Structure

Taxation is a powerful institutional device by means of which government can shape the structure of the economy according to the prevailing conception of the public interest. This is particularly true when tax rates are high and when taxation absorbs a large proportion of the national income. Under such conditions neutrality is out of the question; the very magnitude of the operation guarantees structural consequences of significant import. What these consequences may be depends in the last analysis on the social purposes sought to be accomplished. Hence, it is always necessary to evaluate the structural effects of tax policy by reference to some standard of social desirability. What kind of an economy do we want? What type of economic organization will best serve those aspirations and ideals to which we profess allegiance? Does a given tax or tax policy have structural consequences consistent with, or contrary to, our ideal of a good economy? Obviously, these are difficult questions because they take us beyond the relatively safe waters of scientific measurement and verifiable objectivity into the uncharted sea of social values, public purposes, and conflicting human aspirations, where there are neither landmarks, nor agreed destinations, nor accurate means for determination of course and position. All social policy in the last analysis must rely on dead reckoning and steer as best it can by the flickering star of its own ideals. There is no other way.

In our individualistic, democratic society we traditionally assign the highest priority to the freedom, welfare, and personal development of individuals. We affirm that the State and all the institutions of society exist to promote the welfare of individuals; and we limit the exercise of individual freedom only when it impinges adversely on the freedom of others. In the economic sphere this philosophy manifests itself in our predilection for a free, competitive economy in which neither private nor public coercion obstructs the operation of the free market, and by our traditional aversion to private monopoly and the excessive concentration of private economic power. This preference for competition and hostility toward monopoly has been especially acute in the area of natural resources because our experience has taught us that there is a direct, intimate relationship between individual freedom and access to the natural resources on which economic activity is based. Hence, our conception of a good (i. e., a free) society involves widespread, decentralized ownership of natural re-

sources, equality of access to them, and maximum freedom in their utilization. Because monopolization and undue concentration of control do such violence to these basic ideals they have been vigorously opposed throughout our history.

How, then, does percentage depletion, as now operative, square with these ideals, with this tradition? Does it make our economy freer and more competitive, or does it modify the economic structure in the direction of centralizing control over and limiting access to natural resources? In short, does the Federal Government by this particular tax policy promote competition or monopoly?

In attempting to answer this question it must be recognized that numerous institutional factors, other than the depletion allowance, affect the balance between competition and monopoly, and influence the evolving structure of the economy. Since it is impossible to isolate any one of these factors from associated influences and determine its independent effect, it can never be said that percentage depletion, or any other factor, alone causes some particular shift in the balance of institutional forces as between competition and monopoly. An observed trend in either direction is ordinarily caused by a combination of forces which taken together are sufficiently powerful to overcome those forces working in the opposite direction. Thus, all that can properly be said of percentage depletion is that it operates in conjunction with other institutional forces to produce structural changes in a given direction. To ascertain the direction of its influence one must examine its functional relation to the total organizational complex.

In practice the beneficiaries of percentage depletion start their income-tax computation by charging against income, as a cost of doing business, outlays for research, exploration, and development, thus artificially reducing their apparent net income and shifting to the Federal Treasury a large proportion of their developmental costs. Against the net income, as thus artificially reduced, they then apply percentage depletion at the rate permissible for their category of business, up to 50 percent of net income. Tax liability is then computed by applying the normal corporate tax rate against the residual "net income after all charges and percentage depletion." The effect of this two-pronged reduction of net income is to reduce their tax liability very substantially. The depletion allowance alone, under the most favorable circumstances, can cut it in half, nullifying any excess-profits tax and lowering the effective corporate tax rate from 52 to 26 percent. Generous deductions for "exploration and development" yield further substantial tax savings.

The benefits of this system accrue to favorably situated individuals and corporations in the form of tax savings, or liquid funds withheld from the Treasury under tax immunity; the corresponding losses accrue to the Treasury in the form of potential revenue foregone. Thus, the Treasury is poorer by exactly the amount by which the beneficiaries of this special privilege are richer. Other taxpayers who must make good the resulting deficiency in the Federal revenue ultimately sustain this loss in the form of tax rates higher than otherwise would be necessary.

The beneficiaries obviously enjoy a strategic economic advantage over other business enterprises. They can expand their ownership and control of natural resources and charge it to the Treasury as a

cost of doing business; they are in possession of tax-free liquid funds, withheld from the Treasury under percentage depletion, which can be used for further expansion of their economic power. These funds are available, at the discretion of management, to acquire natural resources, invest in improved capital facilities, buy out competitors, strengthen market positions, expand into collateral lines of production, or otherwise increase the size and power of existing organizations. If this process of capital formation at public expense continues year after year, as had been the case since 1926, the progressive concentration of economic power is a certainty, for competitive forces are too weak to overcome the disadvantage posed by this special privilege. The concentration movement in the oil and gas industries during the last 30 years, and the more recent concentration in other mineral industries, although not caused solely by the depletion allowance, has been powerfully abetted by its cumulative influence. Without the large sums of liquid capital that have accrued over the years from percentage depletion these firms would scarcely have been able to attain the position of economic dominance they now occupy.

As the situation now stands, with economic concentration far advanced, the overwhelming proportion of the total benefits from percentage depletion accrue to a few giant corporations. Every study of this question in recent years confirms this conclusion. (Revenue revision of 1950, hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2d sess., Feb. 3, 1950, pp. 1-60, particularly pp. 52 and 58-59, and Graham testimony, pp. 177-219. It is stated by the Treasury, p. 52, that three-fourths of the total benefit from percentage depletion accrues to large corporations with assets of $100 million or more.) It cannot well be otherwise, for these giant companies account for the major share of production, on which percentage depletion is based; they exercise considerable, if not dominant, influence in the determination of crude or field prices—an important ingredient in the depletion formula; and their net profits before depletion are high, thus enabling them to take full advantage of the privilege and achieve maximum tax savings. These same strategic advantages are not generally available to small, independent producers. Their small volume of production and frequently narrow margin of profit nullify in large part the tax-saving benefits of percentage depletion and render the privilege of little value to them. The depletion allowance, by its very nature, can attain maximum value only when high production, high prices, high profits, and high tax rates are in conjunction. This conjuncture of favorable circumstances obtains frequently among large firms but only rarely among small ones. Some small firms and individual producers, to be sure, benefit from percentage depletion but these are the exceptions, not the general rule. Where economic power is already concentrated, special privileges in the form of tax concessions or immunity invariably operate to the advantage of large firms and return only a pittance to the small and economically weak firms. The depletion allowance is no exception to this general principle.

If Congress were so disposed the depletion allowance might be transformed from a promonopolistic into a procompetitive device by the simple expedient of restricting the privilege to firms below a certain size or volume of production. By thus granting a tax subsidy to small

firms and denying it to large ones the Federal Government could partially redress the balance in favor of competition and against further economic concentration. Another less extreme measure would be to differentiate depletion rates, granting higher rates to small firms and progressively lower rates to large ones. (See Congressional Record, June 30, 1954, pp. 8861-8865, for an attempt to differentiate depletion rates.) Either of these changes would constitute an improvement over the present system and, if we are to retain percentage depletion as a permanent policy, should be given serious consideration. But manipulation and differentiation of tax subsidies is no cure for the monopoly problem; at best one evil is used as a minor offset to another. If the extractive industries are plagued by monopoly, that evil should be eradicated by direct governmental action, not ameliorated by tax subsidies.

CONCLUSION

During the past 30 years the depletion allowance has undergone a profound functional metamorphosis. It began, at a time when alternative institutional means were not available, as a modest, restricted form of privilege designed to promote the public interest in an area of immediate urgency. It has degenerated into a lucrative, generalized, and largely functionless subsidy the benefits of which accrue primarily to a few large corporations. These benefits have in the course of time been capitalized until today they constitute a powerful vested interest the capitalized value of which amounts to billions of dollars. This transformation—or institutional deterioration—is productive of many demonstrable evils but few, if any, public benefits. If percentage depletion ever served the public interest to an extent commensurate with its costs, it has long ceased to do so. Under modern conditions the known evils so far outweigh the indeterminate and illusive benefits claimed for it that percentage depletion can no longer be defended on grounds of public, as distinct from private, interest. There is no necessary or urgent public interest at stake in the extractive industries which cannot be served better, more cheaply, and with fewer attendant evils by alternative means. If a free competitive price system will not call up adequate supplies of these minerals, and if a free capital market will not provide sufficient increments of new capital, then these deficiencies can be met by direct, specific, governmental action without resort to a generalized tax subsidy divorced from performance.

Any plan of institutional readjustment that involves the elimination or reduction of percentage depletion will meet powerful opposition. That is to be expected, for such a long standing and lucrative privilege, involving large capitalized values and the economic expectations of many people, will be defended vigorously and tenaciously despite its functional obsolescence. Its defenders will portray with alarm the dire economic consequences predicted to ensue from its elimination or reduction, such as destruction of incentives, cessation of exploration and development, scarcities, increased prices, foreign imports, retardation of investment, technological stagnation, shutdown of marginal properties, and impairment of national defense. Equally strenuous objections will be raised against proposed alternatives. These efforts to identify private privilege with the public interest and to make it appear that the public welfare is dependent on continuation

of percentage depletion are persuasive only if it be assumed that no alternatives are available or practicable. This assumption, however, is untenable; a free price system, a free capital market, international trade, and normal profit incentives, supplemented by direct governmental action in special situations, provide a readily available and socially desirable alternative.

THE TAXATION OF MINERAL INDUSTRIES

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In this paper I propose to outline the incentives given by our tax laws to mineral industries. It will be shown that these incentives lead to a situation in which it takes $2 million of capital invested in mineral exploration to produce as much product as $1 million of capital invested in other industries. Our tax laws also foster the uneconomic expansion of mineral production and give mineral holdings artificially high values.

These effects can be avoided through the gradual elimination of percentage-depletion provisions in favor of cost depletion and through the gradual merging of the rate of tax on capital gains with that on ordinary incomes. In the concluding sections of the paper, arguments for special treatment of mineral industries on grounds of their special riskiness and on grounds of their special contribution to our defense potential are examined.

NEUTRAL TAX TREATMENT

The corporation income tax operates chiefly as a tax on the return to invested capital. Such a tax would clearly not be neutral if the return to capital in some uses were free of tax. For example, if the tax rate were 50 percent, and if investment in the untaxed industries were carried to a point where the return was, say, 10 percent, then in the taxed industries investment would be carried only to a point where the return before tax was 20 percent. Investors would in each case be getting a 10-percent return after tax, but the economy as a whole would suffer as a result of the differential treatment of different uses. Projects yielding only 10 percent would be willingly undertaken in the untaxed industries, while projects yielding 19, 18, and 17 percent would be rejected as potential investments in the taxed industries. A lower tax rate, striking all industries equally, would yield the same amount of revenue, yet would not lead to a situation in which high-return uses of capital were foregone and low-return uses undertaken as a result of the tax laws. So long as we intend to retain the corporation income tax as a part of our fiscal structure, we should therefore strive to design its provisions in such a way that the return to capital is taxed equally in all uses and industries.

NONNEUTRAL TREATMENT OF CAPITAL GAINS

Practically everybody is familiar with the effects of the special provisions for capital-gains taxation, because they are present, also, in the individual income tax. The purchase of growth stocks increas-

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ing in value at 6 percent per year is preferable to the purchase of stocks paying dividends at 6 percent per year but which do not increase in value. Particularly for taxpayers in the higher brackets, it is worth while to incur substantial costs in order to find ways of transmuting income into capital gains. Actually, only the most arbitrary distinctions can be made between income and capital gains. If at the beginning of a year 2 taxpayers have $20,000 of net assets, and at the end of the year they both have $23,000 of net assets, and if during the year they both spend $7,000 for consumption, by what rationale can we justify separate tax treatment of the two, even though one might have had $10,000 in "income," and the other an accrual of $10,000 in capital gains? In this context it is sometimes argued that capital gains do not come in a steady flow, but for many taxpayers neither does income flow in steadily. Such arguments really favor the extension of the provisions in our tax laws that permit taxpayers to average their incomes over time, not the special treatment of capital gains.

For many industries the possibilities of treating the returns to their capital as capital gains are inconsequential, but for some industries, including mineral exploration, they are extremely important. Successful oil wells and other mineral finds can be sold, and the difference between their sale price and their cost treated as a capital gain. If this procedure were followed in the mineral exploring industry, and if all costs were considered in computing the capital gain, the return to capital in mineral exploration would be taxed at only 25 percent as compared with the 52-percent tax applying to ordinary corporate income. This would give a substantial incentive to mineral exploration. If in the economy as a whole the return to capital after tax were 10 percent, investment in mineral exploration (taxed at 25 percent) would be carried to the point where it yielded around 13⅓ percent before tax, while in industries unable to take advantage of the special rate on capital gains, investment would be carried only to the point where it yielded around 20 percent before tax. Projects yielding 19, 18, 17 percent would be foregone in most industries, while activities yielding only 13⅓ percent would be willingly undertaken by mineral explorers.

Capital Gains and the Expensing of Costs

The above example far understates the incentive which our tax laws offer to mineral explorers who sell their finds as capital gains. It assumes that the capital-gains tax of 25 percent applies to the difference between the value of successful finds and all the costs incurred. That is, it assumes that the Government takes 25 percent of the gross return to the explorer, and shares in his costs to the tune of 25 percent. Actually our present laws provide for the Government's sharing to the tune of 52 percent in most of the costs of mineral exploration, because most exploration costs are deductible from ordinary income in the computation of income subject to tax.

Consider first the costs of unsuccessful explorations. From the standpoint of economy as a whole, the costs of unsuccessful searches are part of the cost of finding new deposits, but individual searches are treated separately for tax purposes. Hence the costs of unsuccessful searches become losses, to be written off against ordinary income before computing taxes. The riskier is the type of exploration in ques-

tion, the larger will be the fraction of the total costs of unsuccessful exploration which finds a 52-percent tax offset in this way.

Some of the costs of successful explorations can also be written off as expenses against ordinary income. These writeoff possibilities are the result of special provisions of the tax laws. In the case of petroleum, a substantial fraction of the costs of successful wells are written off as expenses under the heading "Intangible Development Costs." In the case of mineral deposits, all development expenses after the existence of commercial ore is established are deductible. Such expenses do not, however, include the costs of plant and equipment.

The unequal tax treatment of revenues and expenses leads to the paradox that companies can make a substantial amount of money on exploration even if their revenues from exploration (before taxes) are just barely equal to their costs of exploration (before tax offsets). If $1 million in exploration expenditures carries with it $500,000 of tax offsets, and leads to finds worth $1 million in the marketplace, with corresponding capital gains taxes of $250,000, what would be a marginal investment under neutral tax treatment becomes an extremely profitable one.

Such extremely profitable outlets for capital will not last for long in a free market economy. Capital will flow into profitable uses until their rate of return after taxes is brought into accord with the rate of return to investors of capital in the economy generally.

If the rate of return on capital in the economy is 10 percent, investments will tend to be made in any line of activity up to the point where the returns from those investments after taxes, discounted at 10 percent, are equal to their costs after tax offsets.

Let us now compare 2 possible ways of producing capital assets worth $1 million: one by means of mineral exploration and the other by producing machines. Machine producers will be willing to spend up to $1 million to make machines whose discounted value is $1 million. But mineral explorers will be willing to spend, on the average, up to $1.5 million in order to provide discovered reserves worth $1 million. The explorers would obtain a tax offset of about $0.75 million on their costs, leaving costs net of taxes at $0.75 million. On their revenues, the explorers would pay $0.25 million in capital gains taxes, leaving revenues net of taxes also at $0.75 million.

Thus capital-gains treatment plus the expensing of exploration costs would lead to a situation in which $1.5 million worth of capital would be willingly spent in order to find $1 million worth of reserves. Alternatively put, if $1 million of capital were transferred out of mineral exploration into other uses, such as manufacturing, the economy would give up $0.67 million of reserves and gain in its place $1 million worth of manufactured goods, both evaluated at the normal rate of return. Looked at either way, the combination of capital-gains treatment and expensing of exploration costs leads to a shocking waste of the Nation's capital resources.

Discovery Depletion

Although, as we have seen, the available option of capital gains treatment for mineral discoveries gives extremely strong incentives to exploration, we do not in fact observe frequent sales of mineral discoveries as capital gains. The reason for this is that still stronger

incentives to exploration are available under the label of "percentage depletion," and when percentage depletion is used the discoverers have a strong incentive to retain and operate their properties.

It is convenient to begin the discussion of percentage depletion with an analysis of its historical forbear, known as discovery depletion. The earliest provisions for the depletion of mineral properties provided for a deduction from income for tax purposes, analogous to depreciation, of a certain fraction of the cost of the property in question. Where the property was in existence in 1913, provision was made (in the 1916 act) for the use of the market value of the property in 1913 in lieu of cost as the basis for depletion allowances. Since, because of the riskiness of mineral exploration, the value of successful finds usually greatly exceeds the costs of the successful finds alone, this provision was welcomed by the owners of properties which had been discovered before 1913.

Properties discovered after 1913 were not treated in this way; their depletion allowances had to be based upon cost. The apparent disparity of treatment of properties discovered before and after 1913 led to the adoption in 1918 of a provision allowing depletion based on the fair market value of the property at the date of discovery or within 30 days thereafter, in lieu of depletion based on cost. This was called discovery depletion.

Discovery depletion can best be viewed as a means of avoiding the capital-gains tax altogether. If the 1918 provisions applied today, and a discoverer spent $1 million on exploration in order to find deposits worth $1 million in the market, he would obtain tax offsets of about $500,000 on his costs, but would have to pay no tax at all on the value of his discoveries, so long as he retained and operated them himself.

If we compare discovery depletion with capital-gains treatment and with neutral tax treatment for the case where $1 million is spent to find $1 million in reserves, we find that in all 3 cases tax offsets of some $500,000 are obtained on the basis of the costs incurred. But while gross revenues would in effect be taxed at $500,000 under neutral tax treatment, they would be taxed at $250,000 under capital-gains treatment, and they would not be taxed at all under discovery depletion.

With discovery depletion, as with any other provisions, investment in exploration would tend to be pressed to the point where the discounted value of discoveries, net of tax, equaled the cost of discoveries, net of tax offsets. $1 million of capital investment would represent only about $500,000 of costs after tax offsets, and investment in mineral exploration would accordingly be pressed to the point where $1 million of investment resulted in the discovery of only $500,000 worth of reserves. Yet the investors would be making the ordinary rate of return on their capital, and would have no cause to regret this outcome.

Percentage Depletion

Percentage depletion grew out of discovery depletion when it was found difficult to obtain good estimates of the market values of all discovered properties as of the date of discovery. To overcome the administrative burden of estimating the value of each individual property, provision was made for allowing as depletion a certain per-

centage of the gross value of the output of the property, value being taken at the mine or wellhead. The percentage was different for different minerals, and was chosen so as to accord roughly with the actual experience under discovery depletion. Thus the percentage depletion provisions of the 1926 and 1932 acts attempted to allow roughly the same amounts of depletion as would have been allowed under the earlier discovery depletion provisions; the main purpose of the acts was to make the computation of depletion easier and less subject to controversy. The percentage of gross income allowed in the case of oil was 27½; in sulfur, 23; in metals, 15; and in coal, 5. Provision was also made that the amount of depletion should in no case exceed 50 percent of the net income from the property.

Since percentage depletion was the direct outgrowth of discovery depletion, and attempted to approximate its effects, it should be no surprise that an analysis of percentage depletion yields much the same results as the above analysis of discovery depletion. Because the computations are rather complicated, I have placed them in an appendix, but the results for typical minerals are summarized here:

Whereas under discovery depletion it would be worthwhile for an explorer to spend $2 million to find $1 million worth of reserves, under percentage depletion it appears that to find $1 million worth of reserves an explorer would be willing to spend $1.95 million for oil, $2.11 million for sulfur, $2.13 million for iron, $1.96 million for copper, $2.27 for lead and zinc, and $2.30 million for coal. These estimates are based on data provided by the Treasury for 1946 and 1947, and on approximations of the average length of life of wells and mines in the various minerals. They are accordingly not precise, but can be taken to confirm the conclusion that the effects of percentage depletion on exploration are not substantially different from those of discovery depletion.

Effect of Our Tax Incentives

There can be no doubt that our present tax laws give strong incentives to mineral exploration, but this does not mean that we have a great deal more exploring activity than would take place under neutral tax treatment. In the case of some minerals, such as petroleum, the annual volume of exploring activity is great, and here there is good reason to suppose that our tax incentives have rather substantially affected the amount of exploration. With other minerals, such as coal, reserves already known are ample to fill the needs of our economy for hundreds of years, and accordingly there is very little exploration for new deposits. Obviously the tax incentives under discussion here cannot have had a very substantial effect on the amount of exploration for coal. What is true of coal is probably equally true of sand and gravel and a number of the minor minerals that have recently (1951) been granted percentage depletion. Minerals like copper, lead, and zinc probably occupy an intermediate position, exploration for them having responded less than in the case of petroleum but more than in the case of coal as a result of our tax incentives.

Our analysis has indicated that to the extent that exploration is increased in response to current tax provisions, it involves a very substantial waste of resources, with capital devoted to exploration producing only about one-half as much value of product as the same capital would if devoted to ordinary industrial investment. But what hap-

pens if little or no additional exploration takes place in response to the special tax provisions? Here the predominant effect is either to increase the value of mineral holdings or to increase the rate of extraction. To the extent that the value of mineral holdings is increased, their owners have received, as a result of the special tax provisions, a "gift" from the Treasury. To the extent that the rate of extraction is increased beyond the point which would be dictated by neutral tax treatment, a waste of resources is involved which is closely analogous to that discussed above in the case of exploration.

These two effects are alternatives. If on the one hand, as may be true in the case of coal, our national output can be greatly expanded without any increase in unit costs, then tax concessions like percentage depletion operate to increase production and drive down prices. Mine owners end up with little more profit than they had before, and consumers get coal more cheaply, say for $9 per ton instead of $10. What looks here like a benefit to consumers really is not, however, for the economy is paying, in terms of the resources used to extract the coal, $10 per ton while consumers use coal to the point where it is only worth $9 a ton to them. But consumers in their role as taxpayers will be paying extra taxes to cover the concession of $1 per ton.

If on the other hand national output cannot readily be expanded, as may be the case with lead, prices will not fall significantly as a result of the tax concession, and the concession will accordingly lead to increased profits and hence to increases in the value of mineral holdings.

Thus if the waste of resources involved in increasing production beyond the level it would attain under neutral taxation is great, then the "gift" to mine owners in the form of enhanced capital values will be small. But if the increase of production beyond its level under neutral taxation is small, the "gift" to mine owners will be large, and indeed will be the predominant result of the tax concession.

Policy Recommendations

Our present tax laws thus have three possible effects on the minerals industries: To increase the profits and capital values of the owners of mineral deposits; to increase the production of minerals to a point where, but for tax concessions, cost would exceed the value produced; and to increase exploration for minerals to the point where, but for tax concessions, the value of discoveries would be only about half the cost of exploration. The relative importance of these three effects varies from mineral to mineral, but regardless of which effect is dominant, our present policy is unwise. It cannot have been the intent of Congress to make owners of mineral deposits richer at the expense of the rest of the community, and it is clearly unwise to foster the use of resources in either mineral production or mineral exploration when those resources would be much more productive elsewhere in our economy.

I accordingly strongly recommend and urge that every effort be made to place the tax treatment of mineral industries on a par with that of other industries. This should be accomplished:

(1) By the gradual reduction and eventual elimination of percentage depletion provisions, leaving strict cost depletion as the sole basis for recovery of capital values in mineral extraction.

(2) By the gradual reduction and eventual elimination of the differences that now exist between the tax treatment accorded to capital gains and that given to ordinary income. I envisage here the gradual raising of the maximum rate of tax on capital gains from its present level of 25 percent to the rate applying to ordinary corporate income.

Although a considerable improvement over our present position could be made simply by eliminating the percentage depletion options which are now available, there would still remain the strong incentives to mineral exploration that stem from the special treatment of capital gains, and which were outlined in the early sections of this paper. Thus a rather significant overhaul of our tax structure is necessary before the taxation of mineral industries can be thoroughly rationalized.

Risk and Small Enterprise

It will be recalled that most of the incentive to mineral exploration outlined above came from the fact that the costs of exploration were deductible against ordinary income, while the fruits of exploration received tax treatment which was more favorable than that accorded to ordinary income. A small firm with little or no income against which to offset its exploration costs is thus placed at a severe disadvantage as compared with a large firm having substantial income, either from mineral extraction or from some other source. This disadvantage would still remain if the policy recommendations outlined above were put into effect. However, it could be substantially mitigated by allowing firms to carry forward the losses made on unsuccessful explorations against the income to be obtained from future successes. Then small firms would be at a disadvantage only if their explorations over a long period of time did not yield discoveries equal in value to the costs incurred. A certain share of the costs of such firms would be without tax offsets, while all the costs of the corresponding large firms would be offset against income subject to tax.

Special Incentives to Risk-Taking

It is sometimes argued that our present tax provisions for mineral industries are desirable because of the special risks that such industries are alleged to face. Especially risky enterprises, like specially risky securities, are said to require a rate of return somewhat higher than that prevailing on investments of moderate risk. If the required rate of return were 15 percent after taxes in petroleum exploration, but only 10 percent after taxes in most other industries, then the search for oil would stop at a point where the capital invested yielded 15 percent. By transferring capital from other uses, where it was earning 10 percent, to oil exploration, the economy would gain until the point was reached where capital yielded only 10 percent in the oil business.

The difficulty here is that a yield of 10 percent after taxes in the oil industry cannot be achieved if the required rate of return is 15 percent. More oil can indeed be obtained by tax concessions, which operate as a gift from the rest of the economy to the oil explorers of, say, 5 percent per annum on the capital invested in oil exploration. But such a gift is merely a hidden price paid for the extra oil. If the rest of the

economy wants more oil, it should be willing to pay for it by way of a higher market price.

In our present world, in which most minerals are available in the world market, it would indeed be unnecessary for extra oil to be obtained through the payment of price premia to domestic explorers as incentives to risk taking. It would be much cheaper for the rest of the economy simply to buy whatever extra oil it desired in the world market. If in the process market prices would be bid up, more domestic oil would also be forthcoming, but oil users would have the knowledge that they were paying no greater price than was necessary to provide them with the amount of oil they wanted. Hence there is no justification for the use of tax concessions as a device for overcoming the reluctance of domestic mineral enterprises to incur risk, at least not in a peacetime economy.

In point of fact, there are good reasons to believe that the riskiness of mineral exploration has been exaggerated. In petroleum, which is often cited as an extremely risky industry for exploration, there have developed a wide range of contractual devices by which the risks of exploration can be shared. Exploring companies can sell off 90 percent or more of the interest in the wells which they themselves drill, and with the proceeds buy fractional interests in wells drilled by others. In the light of these possibilities, the fact that 9 out of 10 exploratory wells are dry seems less of a deterrent to exploration than it might at first glance appear. Additional evidence is provided by the fact that bankruptcies are not widespread among even moderate-sized petroleum companies. And the rate of return on capital, for the petroleum industry as a whole, appears to accord closely with that applying in other segments of the American economy. So even if the risks are substantial, it appears that investors demand no special premium of significant size for taking "long shot" rather than "sure shot" gambles. And in a way it would be surprising if they did require a special premium, for worldwide experience with gambling and lotteries suggests that many people are willing to risk their capital at long odds even when the aggregate winnings fall far short of the aggregate of wagers.

Thus even if mineral exploration is especially risky, in the sense that the risks cannot be pooled to leave the individual investor in a position of only moderate risk, and even if investors demand special premia for special risks, there is no justification for special tax concessions to mineral enterprises on this account. But our scattered evidence suggests that even if individual explorations are risky there is no reason to presume on that account that special risk premia are required; indeed it suggests that the possibilities of risk pooling are sufficiently great to cast doubt on the assumption that exploration need be especially risky to the investor or investing company.

Special Incentives for National Defense

Our national defense is such a primary objective that citizens are willing to incur great costs on its account. But especially with a defense budget as large as ours is today, we should be strongly interested in seeing to it that we are getting the maximum amount of defense potential for our money, or to put it another way, that we are not paying more than is necessary for the amount of defense potential

that we are getting. True economy, in this area as in others, requires scrutinizing each individual action to make sure that we are getting the most for our money.

It is my conviction that our present tax treatment of mineral industries has no justification in a peacetime economy. Hence it can be justified, if at all, only in terms of its contribution to national defense. But it would indeed be surprising if percentage depletion were the best way to provide for our defense needs of coal and sand and gravel as well as oil and copper and lead. Some minerals are domestically available in great abundance and can be extracted easily. These should need no special treatment on defense grounds. Other minerals are abundantly available, but their rate of extraction can be expanded only slowly. Here the maintenance of stockpiles or of standby capacity might be warranted. Still other minerals are increasingly hard to find in the United States, and we are relying increasingly on foreign sources of supply for them. These minerals, of which petroleum, copper, lead, and zinc are examples, pose the hardest problems for national defense. Should we create incentives to extract our waning supplies more rapidly, so as to have a high output available for an immediate emergency, but at the risk of failing supplies for a more distant conflict? Should we restrict current production and maintain stockpiles of known reserves in the ground, and incur the costs of recruiting and training a labor force to mine them in the event an emergency should strike? Should we rely exclusively on stockpiles above ground, incurring what in some cases might be substantial storage costs? Or should we attempt, in our defense preparations, to assure the comparatively safe transportation of the minerals from nearby foreign sources, such as Canada, Mexico, and Venezuela?

It is not within my competence to answer the above questions. They are questions of great importance to our Nation, yet they have not been given adequate study. Such study is necessary before the best minerals policy for national defense will be found. One may reasonably wonder, however, whether a tax policy such as we have at present would have a place in any rational scheme of providing for our defense needs. Certainly it is not in our defense interests to enhance the capital values of those who happen to own mineral deposits. It is dubious at best whether we should provide incentives to increase the production and use of our waning supplies of scarce minerals. And it is almost certainly wrong for us to foster the use of $200 worth of our resources to find $100 worth of mineral deposits, which then will more than likely be extracted and consumed before a national emergency strikes. Yet these are the effects of our present tax laws. I accordingly do not believe that the present provisions can be supported even on national-defense grounds.

Appendix

Computation of Effects of Percentage Depletion on the Use of Capital in Exploration

Consider two capital assets, one a machine and one a mineral deposit. Let them be equivalent in the sense that the streams of income expected to stem from them, net of other costs but before provision for depreciation or depletion, are identical. Let the discounted value of these expected income streams be Y. No purchaser would pay Y for the

assets, however, since taxes must be paid out of the income streams. In the case of the machine, with a tax rate of 50 percent, the taxes paid will be .5 (Y−dR), where R is the price paid for the machine and d is a discount factor. The discount factor depends both on the rate of interest and on the length of life of the machine. If the machine costs $100 and lasts 10 years, depreciation charges will be $10 per year for 10 years. The present value of this stream of charges, discounted at 10 percent, will be about $65. In this case d will equal .65. If the machine lasts 20 years the depreciation charges will be $5 per year for 20 years, and their discounted value, at 10 percent, will be $43. In this case d will equal .43.

The amount a purchaser will pay for the machine (R) will be the discounted value of its expected income stream after taxes. Thus **R=Y−.5(Y−dR)=.5Y/(1−.5D)**. Under competition, production **of this type machine** will be carried to the point where the cost to the producers, net of tax offsets, equals the discounted value of their receipts, net of taxes. Thus if C is used to represent the value of costs accumulated at 10 percent, we have C=R. This equality applies whether the machine is sold to a purchaser or is retained in the possession of the producing company, so long as the rate of tax offset applying to costs equals to rate of tax applying to receipts. We accordingly conclude that production of the machine will be carried to the point where C=.5Y/(1−.5d).

In the case of the mineral deposit subject to percentage depletion, the taxes paid will be .5Y(1−p), where p is the percentage which the depletion allowance bears to net income before depletion. Accordingly, the present value of the mineral deposit will be R=Y−.5Y(1−p)=.5Y(1+p). Explorers will be willing to spend up to this amount, net of tax offsets, in order to find a mineral deposit with the yield in question. Since under our present laws the costs of exploration carry tax offsets at the corporate income-tax rate (here assumed to be .5), exploration will under competition be carried to the point where .5C=.5Y(1+p), or where C=Y(1+p).

Thus to obtain streams of income identical in value, mineral explorers, under percentage depletion, will be willing to incur costs of Y(1+p) while producers of capital equipment would be willing to incur costs of only .5Y/(1−.5d). Costs in exploring thus are (1+p) (1−.5d)/(.5)=(1+p)(2−d) times as high as the cost of producing streams elsewhere in the economy.

To estimate the actual effects of percentage depletion it is necessary to estimate the actual average life of a typical deposit of each mineral, to assume a reasonable rate of return (in order to obtain d), and to estimate the fraction (p) which depletion allowances bear to net income before depletion for each mineral. In the following computations I have assumed that the average life of an oil well is 10 years, of deposits of sulfur, copper, lead, and zinc 20 years, of iron deposits 25 years, and of coal deposits 30 years. These estimates are conservative in the sense that they are probably too low. Higher estimates of the length of life would tend to reduce the estimated value of d, and hence increase the estimated excess costs of mineral exploration.

Estimates of p were obtained from data presented by the Treasury Department in testimony before the Committee on Ways and Means on February 3, 1950. They were based on a sample of corporations

in each type of mining, and showed the rates of allowable depletion to net income for 1946 and 1947. These rates averaged about 45 percent for oil, lead, and zinc, about 35 percent for sulfur and coal, about 30 percent for iron, and about 25 percent for copper.

To obtain estimates of d I assumed the rate of return on capital (after taxes) to be 10 percent. The estimates of d were .65 for oil, .43 for sulfur, copper, lead, and zinc, .36 for iron, and .30 for coal. These estimates lead to the conclusion that our percentage depletion provisions provide incentives to use 1.95 times as much capital to produce a given income stream in oil exploration as in the rest of the economy. The corresponding figure for sulfur is 2.12, for iron 2.13, for copper 1.96, for lead and zinc 2.27, and for coal 2.30.

PERCENTAGE DEPLETION AND THE NATIONAL INTEREST

SCOTT C. LAMBERT, Standard Oil Company of California

The Subcommittee on Tax Policy is engaged in a wide-range study of the impact of the Federal tax system on the Nation's economic growth and progress. In connection with this study, special consideration is to be given to the question of—

> The appropriate treatment of capital recovery allowances in the extractive industries to assure a development in these industries consonant with both military and civil resources requirements.

It is altogether fitting that this inquiry should be made as part of a comprehensive examination of our entire taxing system and policy to diagnose their effects upon the Nation's economy. But a scrutiny of the tax provisions of the United States law which affect the extractive industries is nothing new. Perhaps no area in our whole taxing system has received more attention or interest than the percentage depletion allowance. In every revenue act since 1926 the percentage depletion provisions have been reenacted without substantial change except for including therein many minerals and other natural deposits not originally covered. These provisions were reenacted only after a careful examination of the taxing provisions applicable to the extractive industries and an evaluation of their necessity and contribution in the fabric of our economy.

In responding to the question put by the subcommittee this paper will deal mainly with taxation of the oil industry but the remarks will apply with equal force to natural gas and generally to the other extractive industries.

TREATMENT OF CAPITAL RECOVERY ALLOWANCES

The profound significance of the extractive industries to the growth and stability of our Nation hardly needs mentioning—but the importance of the taxing provisions which bear upon the preservation of capital so vitally needed by the industries in their continuing and ever-growing search for new minerals to replace our exhausting supplies are so critical that every citizen should be informed of their purpose and effects.

It is sobering to consider that some of our most vital minerals are in relatively short supply—that the whole national economy depends upon explorers finding adequate replacement reserves of minerals which are now hidden by nature. In petroleum presently known reserves are only 12 times the current annual consumption, which means that continued availability of adequate supplies depends on a constant vigorous search to find reserves still undiscovered. One thing stands out from the rest in this fabric of continuing exploration and that is the necessity of an appropriate measure of capital recovery that should not be taxed as income.

It is fundamental in our tax law that the income-tax levy is upon income and not on capital which is the source of income. Thus, a taxpayer is assured the recovery of his capital if he realizes a profit and it is only the profit after capital recovery that is taxed under the 16th amendment. By reason of a special provision of our law, realized appreciation of capital assets is taxed as income but at capital gain rates.

Early in the history of the income tax, Congress recognized the special problem of the discoverer of a wasting natural resource. In all probability he had spent large amounts of capital in fruitless prospecting before making the discovery. The cost to him of the specific discovery would have borne no relation to its value which may have been greater or less than the cost directly attributable to it. Yet the value of the mineral deposit represented his capital. If he was to stay in business he had to recover sufficient capital to permit him to replace his wasting capital.

In recognition of this need, Congress in 1918 adopted the principle of discovery depletion. Under this provision the discoverer of an oil and gas deposit was allowed to deplete the value of the reserve if it was discovered by him and not acquired as the result of the purchase of a proven tract or lease and if such value were materially in excess of cost. In other words, if he purchased it or acquired it prior to March 1, 1913, he would have had a capital base for depletion commensurate with its value. If he discovered it after March 1, 1913, Congress felt he should also have a capital base for depletion commensurate with its value. In brief, the discovery depletion provisions of the 1918 act were an attempt to estimate and value the underground reserves of an oil discovery and to set up a value which the taxpayer could deduct in determining income subject to tax.

By 1926 this method, although unchallenged in principle, had become shackled in a maze of administrative difficulties and inequities. Endless controversy over value of an oil deposit upon the date of a discovery swamped the Bureau of Internal Revenue. Congress then sought a simpler, more easily administered device which would yield to the taxpayer the equivalent of discovery depletion. After several years' study, they adopted, in the 1926 act, the identical provision in effect today.

In brief, the depletion allowance is a deduction from taxable income equal to 27½ percent of gross income but not to exceed 50 percent of net income attributable to production of oil and gas. In any case, however, depletion shall be based on cost if greater than that computed on gross or net income.

What Congress was attempting to do was stated at the time by Senator Reed:

> * * * We provide that the owner of an oil well or a mine who is exhausting his capital when he takes out the mineral can chalk off an allowance for depletion of his property. That sounds simple; but when we come to apply that the application is so complicated that it causes a large part of the disagreement between the taxpayers and the Bureau. If Senators will think for a moment about the application of that rule to an oil well, it will be realized that the owner of the well is exhausting his capital every time he draws a barrel of oil out of the well, so part of the value of that oil is in there and part of it is a mere return of his capital. In order to calculate what part of it he can charge off to depletion the Bureau has been estimating the quantity of oil in the property, which is just about as hard as estimating the quantity of air over the property. Then, on top of that estimate, they try to estimate what that oil will be worth in the market in future years, which multiplies the first uncertainty by a second uncertainty, and, of course, no two people ever agree on that. * * * We have taken a big step forward in this bill, in our committee amendment, which provides that an arbitrary percentage of the gross selling value of that oil shall be deducted to allow for depletion. The owners of some of the oil wells say that we have not allowed enough, and some of the experts of the Bureau say they think perhaps we have allowed a little too much. Probably we have been reasonably fair. But the whole thing is in the line of simplification, getting rid of this everlasting accounting.[1]

In examining the appropriateness of capital recovery allowances there has never been any issue over the right or propriety of depletion. Depletion is an inexorable process and its recognition through write-off is as proper and legitimate as depreciation, to which it is so closely allied. The capital recovery allowance to which our critical examination is directed is the depletion allowance based on a percentage of income. This allowance relates only to income generated by the production and sale of crude oil and natural gas. The increment in value created by transportation, refining, and marketing is not included in the basis for computing percentage depletion.

In the depletion allowance Congress has acted in a particular manner to deal with a particular problem. It is a rather fundamental characteristic of our income-tax law to deal with a problem on its merits if it thereby serves the national interest. Thus, appreciation of capital is not taxed as ordinary income; special tax treatment is accorded to life insurance companies, cooperative associations, partnerships, Western Hemisphere trade corporations, and income from trade or business in United States possessions. Other examples will occur to the reader.

What then is there about the extractive industries in general, or the oil industry in particular, that justifies a recovery of the capital value of a mineral deposit on a basis unrelated to its cost?

1. The essential difference between the extractive industries and all other industries is the peculiar nature of the wasting asset character of the extractive industry. In reality, the miner or oil and gas producer is in the inexorable process of liquidating his capital in minerals. In one sense, of course, so is any manufacturer because his plant and machinery are gradually exhausted in the production of the article or service that he sells, but there is a great difference between the two types of capital being exhausted. In the case of the manufacturer, capital represented by plant and machinery is replaceable by the expenditure of funds with relative certainty as to capacity, time of acquisition, and cost. The oil producer, however, if he is able to

[1] Congressional Record, vol. 67, pp. 3018–3019.

replace his exhausted mineral reserve at all, has no control over the size of the reserves found, the time when they can be discovered, their finding cost, or their value. This uncertainty of capital replacement is peculiar to the extractive industry.

2. The finding cost of an oil and gas deposit bears no relationship to its value. In most industries a capital outlay of X dollars will bring to the investor plant of approximately X value with a known life of utility and productive capacity. In the petroleum industry a capital outlay of X dollars may bring to the explorer nothing (8 times out of 9) or a million-barrel oil reserve (1 time out of 44) or as much as a 10-million-barrel oil reserve (1 time out of 200).

In considering the value of mineral reserves, it is essential to have an understanding of the various operations and risks which enter into exploration. First, geological and geophysical surveys are made over large areas to determine whether drilling operations would be warranted. These studies are often on a continuing basis and it is not infrequent that after several years' work in an area no possible oil-bearing structures are evidenced. If, as a result of this work, an area does appear promising and the explorer wishes to venture further capital in what is still a venture of unknown success, he will acquire leases on properties. These leases convey mineral rights from the landowner to the explorer and also permit the explorer to drill. Large areas must be leased at substantial cost in bonus and rental payments to the landowners with the likelihood, as experience has shown, that not over 5 to 10 percent of the acreage will be productive.

Considerable time may pass and much money may be spent in looking for promising oil structures before any actual drilling occurs. It is well known that even finding a structure is no assurance of discovering oil by drilling. If the explorer finds oil in commercial amounts, it usually takes 3 or 4 years to develop the field and bring it to full production.

The foregoing refers to the average efforts and results for the industry. The experience for any given operator may vary widely from the average. By the same token the quantity or quality of reserves found from venture to venture by the successful explorer will differ widely as will the experience between different explorers even though identical efforts and monetary expenditures are made.

3. When an explorer makes a discovery, he creates or at least finds a capital asset that has a definite and realizable market value. This value has been shown to be independent of finding costs. The discoverer can realize this value by sale of his rights in the oil reserves at the fair market price. In so doing, he pays a capital-gains tax limited to 25 percent on his profit. This alternative to producing his own discovery is available to every discoverer and is one which is often exercised.

If the depletion allowance were limited to the capital costs of finding the oil, it would have a tendency to force the sale of oil properties after discovery in order to realize the advantage of the more favorable capital-gains tax. The obvious result of forced sales would be to promote the divorcement of exploration and production in oil and natural gas. It would also likely lead to concentration of ownership in producing activities because of the large amounts of capital required to effect the purchases. From a national interest viewpoint it does not appear to be a move to encourage. The discoverer should not be dis-

couraged from producing his find by this adverse tax situation. Rather he should be encouraged to develop his discovery in furtherance of our national policy of fostering competitive independent business entities large and small.

To replace his depleting reserves, any individual operator must either search for new discoveries himself or purchase from other discoverers. If he purchases reserves, his depletion base would be related to the capital value of the discovery. It appears realistic to treat the two alternatives from the same tax standpoint. This would not be the case if depletion allowances to the discoverer were limited to finding costs.

Any evaluation of the capital recovery allowances of the extractive industries must also take into consideration certain outstanding characteristics of the petroleum industry which have developed from the very nature of its activity:

The Petroleum Industry Faces Increasing Demands for Crude

The petroleum industry is a dynamic and growing industry. Over the past 25 years the total demand for petroleum products has increased from 3 million barrels per day to 8.1 million barrels per day, almost a threefold increase or about 4 percent per year. The growth during the postwar period, 1946 to 1954, was even greater, averaging some 5.4 percent per year. There are indications that this rate of growth will increase in the future. This increase in demand has required the petroleum industry not only to replace the reserves produced during the year, but also to provide additional reserves to meet growing requirements. The latter need has placed a requirement upon the industry considerably in excess of the volume represented by the growth in new demand.

It should be recognized that underground reserves cannot be produced at any desired rate. If the rate exceeds a given level, the total ultimate recovery from a field will be significantly less than if a more moderate production rate were used. Over the past years, experience has shown that an average production rate of 9 percent of reserves can be safely maintained. Thus, in order to produce an additional barrel of oil to satisfy 1 barrel of new incremental demand and stay within the safe range of producibility, the petroleum industry must discover 11 barrels of reserves.

A portion of this increasing demand for oil will be met from imports of foreign oil. This is desirable because the United States has been consuming its reserves at a much faster rate than other important producing countries (the Middle East is currently producing at less than 2 percent of reserves each year, while the United States is taking out 8.1 percent of its underground petroleum wealth). Thus while a part of the increased demand will be supplied from foreign sources, which will husband our own irreplaceable reserves, our national security demands that we maintain a dynamic domestic industry and assure a vigorous exploration program to unlock the still hidden reserves to replace the present discoveries as they are exhausted.

REPLACEMENT COSTS ARE HIGH IN PROPORTION TO TOTAL INCOME

The petroleum industry's expenditures for replacing crude reserves represent an unusually high proportion of total income. Faced with the need to discover an increasing volume of reserves year after year at higher costs, the petroleum industry must reinvest extraordinarily large sums in its operations. Over the past 9 years, expenditures for exploration and development in the United States averaged close to 50 percent of gross income after payment of royalties. Similar information on total manufacturing indicates that the corresponding ratio of investment to income would be a maximum of only 10 percent.

Because of the high ratio of capital expenditures made by the petroleum industry, it is extremely important that taxpayers have a proper measure of the value of wasting capital assets to be recovered free from tax. If the return of capital is taxed to any extent over a period of time the overall incentive to invest in the industry will decline and the source of funds for necessary expansion will not be available.

If anything, the burden of high replacement costs is likely to increase because the cost of finding new crude reserves is increasing. The higher finding costs result from the greater difficulty experienced in finding oil, higher labor and material costs, and the fact that the average depth of exploratory wells drilled is increasing. Within the last 15 years the average depth of all new oil wells drilled has increased 38 percent. Moreover, the cost of drilling a well increases rapidly with increasing depth. To illustrate, the average cost per foot of drilling a well increases according to depth as follows:

At 4,000 feet the cost per foot is approximately	$12.50
At 8,000 feet the cost per foot is approximately	17.00
At 12,000 feet the cost per foot is approximately	26.50
At 16,000 feet the cost per foot is approximately	[1] 53.00

[1] Testimony before Ways and Means Committee, August 14, 1953, pp. 28 and 29.

Chart 1 shows the total cost of finding and developing oil per barrel of crude produced and the average wellhead price of crude oil over the past 9 years. Over the 9 years the rise in finding and development costs have slightly exceeded the increase in the average wellhead price. But since 1948 the increase in these costs has greatly outdistanced the increase in the crude price.

This trend has been encountered despite great technological advances in the science and methods of locating promising oil structures and drilling to test the structures. Technology can help counter the rising costs but cannot be counted on to overcome them entirely.

LOSSES ARE UNUSUALLY HIGH IN EXPLORATION AND DEVELOPMENT

The magnitude of losses encountered in the petroleum industry exceed those of most other businesses. Eight out of 9 exploratory wells are dry and 1 out of 4 development wells are dry. In no other

industry of which we are aware is the loss ratio measured in these proportions. It is true that the producer with sufficient income can deduct his losses from taxable income. But this has the effect of recovering only a part of his loss. The loss is still very heavy to the oil and gas operator.

The magnitude of the loss ratio experienced by the oil industry may be seen from the following:

In 1953 the industry risked $3.3 billion on petroleum exploration and development and $0.5 billion to equip wells and leases, or a total of $3.8 billion. This compares to about $8 billion spent for new plant and equipment by all manufacturing. Of the $3.3 billion risked by the petroleum industry, about $1.8 billion proved to be successful investments and approximately $1.5 billion was lost. This $1.5 billion lost represented about 25 percent of the gross income realized by operators after payment of royalties. Such odds, even with a tax offset, assuming income to cover them, become a critical factor.

It will be recalled that the ratio of investment to income for manufacturing was a maximum of only 10 percent. Even if all of this were lost, which it is not, the comparative risks of the petroleum industry are much greater.

Is Percentage Depletion Equitable in Its Application?

An evaluation of the capital recovery allowances of the extractive industries would be incomplete if it did not involve a critical study of the equity of such allowances in the whole of our taxing structure.

It is not a test of the fairness of a taxing provision to find that its qualities are unique in the tax framework of a nation—or that its application is perhaps restricted to a particular industry. It is basic that taxation must be equitable as between individual members of society—that is, the exaction of Government must not oppress or favor individual members or groups to the exclusion or detriment of others. To this end Congress in developing tax laws has taken into account the unlike aspects of differing enterprises. To meet the unlike aspects of the wasting asset nature of the extractive industries, Congress enacted the depletion laws. These laws have been in effect for some 37 years. If Congress has been overly generous in its tax treatment of the oil industry the effects should show in high profits of the industry, overdiscovery and development of reserves, and possibly overproduction since it is evident that in our economy anyone with necessary capital can enter upon the exploration for mineral deposits.

With these points in mind, let us now examine the profits of the petroleum industry. A comparison of the profits expressed as percentages of net worth for the petroleum industry, all manufacturing excluding petroleum, and all trade for the period 1946–54 is shown below. These data reported by the National City Bank of New York

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cover a large number of companies and are representative of the classification shown:

Net income after tax as a percent of net worth

Year	Petroleum	Total manufacturing, excluding petroleum	Total trade
Average number companies	90	1,600	190
1946	10 8	12 5	21.9
1947	16.0	17.4	18 3
1948	21 6	17.2	18.2
1949	13.4	14.0	13.2
1950	15 2	17.7	15.0
1951	16.6	13 7	11.5
1952	14.5	11.6	10.1
1953	14 7	12.1	9.9
1954	13.9	12.0	10.0
Average	15 2	14 2	14.2

It will be noted that the profits of the petroleum industry were equaled or slightly exceeded by those of manufacturing, excluding petroleum, in 4 of the 9 years and by trade in 2 of the 9 years. For the 9-year average, however, the profits as a percent of net worth of the petroleum companies exceeded both the manufacturing, excluding petroleum, and trade by but 1 percentage point. In view of the high risks in petroleum production, it is not unreasonable to expect that the rate of return on the cost of successful properties should be somewhat greater than on investments involving less risk.

Although the petroleum-industry earnings have not been out of line with earnings in other industries, the requirement for heavy reinvestment has prevented the distribution of earnings to shareholders in the same proportions as that shown by other industries. Thus the Department of Commerce reported that for the 5 years 1944–48 industrial corporations paid out in dividends approximately 41 percent of their net income while the larger oil companies paid out slightly more than 35 percent for the same period. For the year 1954 the corresponding figures were 52.9 percent for manufacturing companies and 42.7 percent for oil companies.

A review of the amount of crude reserves discovered in relation to the demand for crude will serve as a final measure of the actual equity in the present percentage depletion provisions. If percentage depletion has provided the oil industry an incentive inequitable in relation to its purpose, there would have been an inordinate allocation of resources to exploration for oil and the results of this effort would have led to an increased ratio of crude reserves to requirements. This has not occurred as is shown in chart 2.

Chart 2 shows the end-of-the-year proved reserves and the total demand for crude oil in the United States for the past 19 years. It is significant to note that over this extended period of time the amount of crude reserves in relation to the demand for crudes has not increased at all. Therefore, any incentives available to the petroleum industry have been no more than sufficient to encourage the activity necessary to meet requirements.

Operating under laws which recognize percentage depletion has enabled the industry to develop some excess producibility. National-defense interests dictate that a substantial margin of crude producibility above peacetime demand be maintained. If foreign crude oil imports into the United States were cut off, the margin of excess producibility would be reduced, possibly to the point where domestic production would have to exceed rates which would assure the maximum ultimate recovery of the reserves.

The President's Materials Policy Commission recognized this danger and suggested, as a measure for national security, the possibility of maintaining—

> instead of the usual ratio of 1 to 12 or 13, reserves of 16 to 18 times production, with the surplus left unsterilized but available for stepped-up withdrawal should the need arise.[2]

In fact, any change in tax provisions which would reduce the flow of cash funds for exploratory activity would prove to be undesirable from the point of view of the national interest.

The foregoing material has viewed percentage depletion from the standpoint of its appropriateness as a capital recovery allowance and its equity in our tax picture and provides the reasons why percentage depletion has withstood every critical examination made during the last 30 years. However, it may prove helpful to consider briefly specific alternatives to percentage depletion and to evaluate their overall effect on the national interest.

Alternatives to Percentage Depletion

The most frequently mentioned alternative is to eliminate percentage depletion, to limit depletion to finding costs and let an increase in price provide the necessary capital requirements of the industry. The extent to which United States crude prices would have to rise to compensate for the loss is not known, but is estimated to be substantial.

It is hardly necessary to mention that oil is an international commodity and that United States crudes are competing more and more with foreign crudes. Foreign crude reserves are of greater magnitude and unit operating costs are lower than in the United States. It is unlikely that a price increase in domestic crudes would be followed by a compensating worldwide increase in crude prices because (1) changes in United States tax provisions would not affect foreign corporations; and (2) the strong tendency of the abundant lower cost crudes to seek a market would nullify such a possibility. Under such conditions, and in the absence of import restrictions, the higher price in the United States could not be maintained since foreign crudes would flood the domestic market. The overall result of the failure to maintain the higher crude price would be to curtail exploratory effort and the discovery of reserves in the United States. The effect of such an alternative upon the national interest is obvious.

It may be possible, however, to maintain for a period of time the higher crude prices through import restrictions or increased tariffs. This latter action does not appear to be sound approach on the basis of economics or international relations. It is doubtful that anything

[2] A Report to the President by the President's Materials Policy Commission, vol. III, p. 11.

could be gained and in all probability serious damage would result from substituting an increase in crude price for percentage depletion.

It may also be noted that an increase in the price of crude would correspondingly increase the market value of discovered reserves. If capitalized finding costs were the only basis for depletion, the discoverer would have an even greater incentive to sell his reserves and pay a capital-gains tax.

Another alternative to percentage depletion sometimes mentioned is the use of a subsidy by the Government to provide for needed exploration and development. This seems particularly undesirable in terms of our basic economic philosophy. Subsidies should be applied as support to industries only when no other alternative is feasible. Generally, deviation from just and proved taxation principles for a vital industry engaged in a basic economic activity endangers the national interest. Specifically, a subsidy would reduce the overall efficiency of the petroleum industry by encouraging wasteful expenditures in activities which would be too risky or offer too small a return for private capital to undertake.

National Interest Aspects

In the preceding pages we have examined the treatment of capital recovery allowances from the viewpoint of their appropriateness to assure development of the extractive industries. Let us now turn to the larger question of the effect upon the Nation's economic growth and progress, of the taxing provisions affecting the extractive industries. The President's Materials Policy Commission was definite in its view:

> First, the device of percentage depletion is a powerful inducement to capital to enter the relatively risky business of searching for mineral deposits of uncertain location, quality, and extent. Where the national need is great, there is justification for using a higher percentage depletion rate than might be appropriate if recovery of capital investment were the sole objective. This implies a need for being highly selective in the application of percentage depletion to various minerals.
>
> Second, the privilege of expensing exploration and development costs for minerals is a further inducement to risk capital to enter fields where a broadening of national reserves is needed. The expensing privilege in conjunction with percentage depletion makes a strong incentive combination.[3]

The background and purpose of Congress in enacting the percentage depletion allowance has been briefly treated above (considering the space limits on this paper), but a word is pertinent on the expensing of intangible development costs by oil explorers and producers.

Intangible developments costs

Since 1918 the tax regulations have given taxpayers the election to expense or capitalize, as depletable property, all intangible drilling and development costs. This term refers to amounts paid for labor, fuel, repairs, hauling, or supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for production. The cost of assets which have a salvage value, such as the drilling apparatus itself, pipe, tanks, etc., is not included and must be capitalized and depreciated. Intangible drilling and development costs incurred on a producing property are required to be deducted from the gross in-

[3] A Report to the President by the President's Materials Policy Commission, vol I, Recommendations on Tax Policy.

come of the property for purposes of the net income limitation on the depletion allowance for the property. Hence some of the benefit of the deduction of expenses is lost as a reduction of the depletion allowance.

The 79th Congress reviewed the regulation providing for the expensing of intangibles and by a House concurrent resolution confirmed the continuation of this treatment. Some of the reasons for the expensing of intangibles are as follows:

(*a*) Most of the expenditures for intangibles are for wells required to maintain productive capacity, and are similar to maintenance costs required to continue in business.

(*b*) The option simplifies administration by avoiding controversy over the classification of expenditures as depletable or depreciable capital, to the possible productive life of the well, etc.

(*c*) It is an incentive for the industry to develop discovered reserves immediately and thus insure maximum producibility to meet unforeseen contingencies.

(*d*) It facilitates the financing of development by providing a current writeoff of these expenditures for tax purposes.

The right to expense these costs has proved a sound tax policy and the combination of this deduction and the percentage depletion allowance have made and will continue to make a great contribution to the Nation's economic welfare.

Exploration costs

In view of the subcommittee's avowed search for ways "to improve the tax system in the interest of assuring for the long run the most rapid rate of economic growth consistent with short-run stability" it would be in order to mention briefly exploration costs. These costs in the case of oil and gas consist generally of geological and geophysical exploration programs and related exploratory activity. Such costs may be deducted only when the activity does not result in the acquisition or retention of potentially productive properties. Otherwise the cost must be capitalized. Since most of such costs are incurred on areas acquired or retained for further examination large sums are tied up in unamortizable capital for extended periods until the further examination proves fruitless and the areas are abandoned. In the end, generally years later, between 90 and 95 percent of such costs are written off as losses.

The President's Materials Policy Commission observed the incongruity of enforced capitalization of these costs in the minerals taxing scheme and the deterrent effect on exploration and suggested that—

> exploration and development costs for minerals should be fully expensible for tax purposes because of the direct incentive this arrangement gives for capital to take risks in highly uncertain fields. Such expensing would be likely to be particularly important for the petroleum industry whose annual exploration and development costs are measured in billions of dollars.[4]

The industry has for many years contended that exploration costs should be allowed as current expenses rather than be capitalized and later recovered through abandonment losses. This would be consistent with the treatment of research and development expenses which are deductible under the 1954 Internal Revenue Code.

In the final analysis the best measure of the value of percentage depletion and expensing of intangible costs to our economy is how

[4] Report to the President by the President's Materials Policy Commission, vol. III, p. 12.

they have worked for the country in the 30 years since the adoption of the percentage depletion allowance and 37 years since expensing of intangible development costs were recognized:

In Peace

1. They have aided immeasurably in building the standard of living of the American people by providing a cheap and plentiful supply of energy. The difference between the standard of living in the United States and the rest of the world is due, in large measure, to the difference in the per capita energy utilization between the United States and other countries. Per capita consumption of petroleum in the United States is 20 times as much as in the rest of the world, and 67 percent of the total energy requirements of the United States are now supplied from petroleum. In part this is due to the plentiful supplies developed by an aggressive industry. In part, also, it is due to making this highly versatile form of energy available at low cost.

2. They have helped to provide a steady flow of capital into the hazardous, high-cost business of exploring for and developing oil reserves to replace the millions of barrels consumed daily in this country.

3. Despite a tremendous consumption of over 41 billions of barrels since 1926 the known reserves are higher today than at any point in United States history.

4. Percentage depletion in particular has been a direct aid to the production of marginal reserves which would otherwise be abandoned because of their comparatively high cost of operation. There are approximately 293,000 of these so-called stripper wells and they represent a significant part of the total developed reserves of our country. All wells, regardless of their initial production, finally become marginal. When they do so, large sums of money must then be spent on secondary recovery methods in order to keep them producing in paying quantities. If it were not for the depletion allowance, the industry would be forced to plug many of these marginal wells. Waste would result since the oil left in the ground would never be recovered. Secondary recovery methods are improving through new scientific devices and engineering which will salvage millions of barrels of oil that would be otherwise lost. This is a direct benefit to our economy flowing from percentage depletion. These operations are as expensive and as hazardous as new drilling and would be discouraged if it were not for the depletion allowance.

In War

1. World War II was waged and won on petroleum from our exhaustible and irreplaceable reserves.

2. Eighty percent of all the petroleum consumed in World War II came from United States wells. The consumption of petroleum by modern war machines is almost unbelievable. One of our latest planes burns in 1 hour as much fuel as the typical family auto in 3 years.

3. Next to manpower and along with steel, it was the most important weapon on our side. The brilliant mobilization of our petroleum resources by the PAW during the war was a decisive factor in the Allied victory.

4. Our great advantage in petroleum resources and refining facilities was matched by the enemy's weakness in the same materiel. It was the greatest single shortage of both Germany and Japan.

5. The many years of sound taxing provisions relating to petroleum helped build a strong peacetime industry which was able to provide the sinews of war when needed. This experience has pointed the way to protect our security in the future by assuring a strong industry and adequate available mineral resources.

Conclusion

In peace and in war the Federal taxing provisions relating to minerals have rendered a service that is a testimony to the wisdom and vision of the Congress that adopted the provisions in 1926 and has repeatedly fought down ill-advised attacks upon them ever since. These provisions have become integrated into the fabric of our financial structure with such valued results that the President's Materials Policy Commission, after a thorough study of the depletion question in 1952 said of it:

> The prospects for future production of crude oil in the United States depend primarily on the rate of exploration and its success. In the past the rate of exploration has been responsive to market conditions. Furthermore, discoveries have largely been proportional to the rate of exploration with such year-to-year variability as is to be expected from the uncertainties inherent in wildcatting.
>
> The principal influence of public policy to date upon the rate of exploration for crude oil, beyond the provision of the general legal and social framework in which the free enterprise of the wildcatter can flourish, is to be found in the tax system. In particular, the provisions permitting the expensing of the intangible costs of drilling and the charging of depletion as a percentage of the value of oil produced and sold have acted as powerful stimulants to exploration.
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> * * * * * * *
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> In short, the device of percentage depletion as an incentive to minerals exploration is not without its limitations. But no alternative method of taxation has come to the Commission's attention or could be devised by the Commission which, in its judgment, promises to overcome these limitations and still achieve the desired results, particularly not without seriously dislocating well-established capital values and other arrangements in the industries concerned, with highly adverse effects on supply. Taking the practical situation as it finds it, the Commission believes that any radical alteration of the existing tax arrangements would be undesirable.[6]

The impact of these provisions on our continued economic growth could not be better appraised than by this impartial Presidential Study Group.

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[6] Report to the President by the President's Materials Policy Commission, vol. III, pp. 12 and 14.

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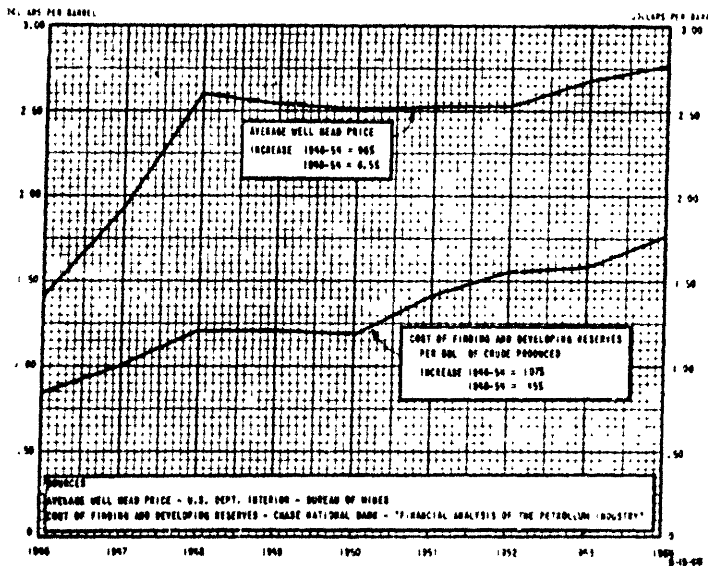
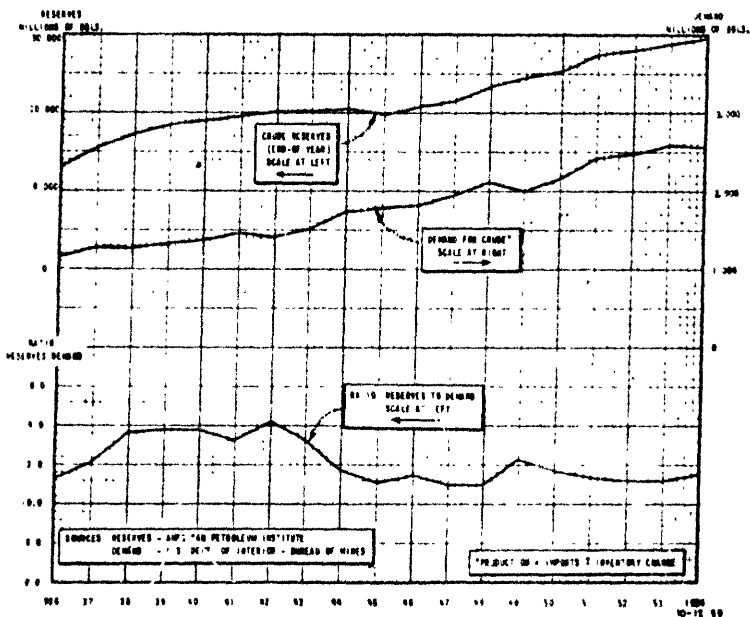
[5] Report to the President by the President's Materials Policy Commission, vol. III, pp. 12 and 14.


COST OF FINDING AND DEVELOPING CRUDE OIL RESERVES
AND THE AVERAGE WELL HEAD PRICE OF CRUDE OIL
UNITED STATES - 1946 - 1954
CHART 1
3.00
2.50
2.00
1.50
1.00
.50
0
AVERAGE WELL HEAD PRICE
COST OF FINDING AND DEVELOPING RESERVES
PER BBL. OF CRUDE PRODUCED
SOURCES
AVERAGE WELL HEAD PRICE - U.S. DEPT. INTERIOR - BUREAU OF MINES
COST OF FINDING AND DEVELOPING RESERVES - CHASE NATIONAL BANK
1946
1947
1950
1952


RELATIONSHIP BETWEEN CRUDE OIL RESERVES AND DEMAND FOR CRUDE OIL
UNITED STATES - 1936 - 1954
CHART 2
CRUDE RESERVES
(END-OF YEAR)
SCALE AT LEFT
DEMAND FOR CRUDE*
SCALE AT RIGHT
RATIO RESERVES TO DEMAND
SCALE AT LEFT

PERCENTAGE DEPLETION AND NATIONAL SECURITY

JAMES R. NELSON, Amherst College

This discussion will begin with disclaimers: No attempt will be made to forecast the exact effect on the American economy of an atomic war involving the United States, or of the security implications of international difficulties in one or another part of the world. No exhaustive analysis of statistical data will be attempted. No arguments will be advanced with respect to the vexed question of whether percentage depletion and other Federal income tax provisions relating to the extractive industries constitute loopholes in the tax system.

On the positive side, attention will first be centered on Adam Smith's dictum that defense is better than opulence.

THE RELATIONSHIP OF SECURITY TO PROSPERITY

A remarkable, and in some ways disconcerting, feature of World War II was its combination of the greatest amount of defense in American history with considerable if lopsided opulence. The dangers of dividing wartime gains in money income by cost-of-living indexes are obvious, but it is common knowledge that the civilian economy was better off with respect to the supply of some goods than it had been during much of the previous decade. This improvement, however, was a byproduct of two grave weaknesses in the prewar economy: we certainly had not had enough prosperity, and in the light of later events we also had not had enough security.

In the economically more desirable environment of the past decade, security and prosperity have been competitors. The effect of national-defense expenditures in creating incomes has been much less obvious, and probably much less important, than its effect in raising taxes. This tug-of-war-and-peace is not directly at issue here, although it is important indirectly because it enhances the importance of any special tax arrangements. An industry which still pays quite heavy taxes may attract resources which would have shunned it in the days when there was no income tax at all.

Beneath the obvious struggle between civilian and military claimants for resources there also lurks a broad fundamental identity of interest. Unless the United States is to be reorganized along the lines of ancient Sparta, security cannot be construed to mean a perpetual austerity which releases most of the able-bodied population to guard the frontiers and the rest of the population. Given the assumption that national security cannot be defined in terms of ability to achieve maximum military strength on an hour's notice, the obvious definition must be that security means excess capacity. This can take the economically and socially unpalatable form of unemployment of all factors of production, as it did during many years of the 1930's or it can be achieved along with full employment by obtaining the highest possible output from all available factors of production. This is the economist's familiar "optimum allocation of resources." Over a period of time, part of this highest possible output may be diverted into capital accumulation, thereby raising output still further and providing an additional store on which the economy may draw in case of an emergency, part may be used to expand the supply of durable or

dispensable consumer goods, or part may be used to decrease hours voluntarily worked. The great emergency strength of the American economy is precisely in its combination of a large store of capital on which to draw, a large potential labor pool even in periods of full employment (possibility of longer hours, return from retirement, housewives drawn from the home, juveniles working after school and on Saturdays, etc.), and a high ratio of dispensable to total consumption. Once direct military claims have been granted their share of the peacetime economic effort, the burden of proof must rest on indirect demands on the economy made in the name of security: it must be established that a system which provides the best potential security because it produces high levels of output and high peacetime living standards is not adapted to the peculiarities of certain segments of the economy.

Specifically, the necessary conditions for this proof are: (1) That dispensable uses of a commodity, or durable-goods sources of a service, are unusually small, or emergency demand increases unusually great, or (2) that important reductions in supply are particularly likely before or during an emergency. The sufficient condition, without which neither of the preceding two is conclusive, is that restoration or increase in the amount of the commodity produced takes an abnormally long time.

The Extractive Industries and National Security

Adam Smith had just such peculiarities in mind when he qualified his enthusiasm for the wealth of nations. In his time and place, a national merchant marine met all of the specific conditions listed in greater or lesser degree; hence his support of special measures for its protection. Hence also the policy of the United States Government with respect to both the shipbuilding industry and the merchant marine. But percentage depletion is used solely in calculating the Federal income-tax returns of a long list of extractive industries in the United States, of which only oil wells have so far gone to sea. What peculiarities do they have which prevent their normal contribution to a peacetime economy from measuring their importance in an emergency?

The term "extractive" is not just a descriptive term for industries whose economic role is to remove commodities from beneath the surface of the earth; it is practically the only term which fits them all. The essential feature of these industries is that they are engaged in the recovery of nonrenewable products. This is not completely satisfactory; mining the soil is possible in agriculture, and the classification of peat depends on the rate of extraction. But, in general, the nonrenewable resources were formed over eons and are being removed in years.

Thus these industries provide an exception to the general rule that high output is an aid to security as well as living standards. As their representatives are the first to stress, their operations involve depletion of natural resources.

As a first approximation, then, the normal peacetime operation of the price system may yield too much output of this one group of products even though this is assumed to be impossible for goods in general. This is a special case under the general heading of impor-

tant reductions of supply before or during an emergency. Present supply reduces total future availability; therefore the obvious way to insure adequate emergency supplies would seem to be to restrict consumption by special excise taxes, and so forth, in peacetime, or to rely on imports to conserve domestic resources.

This conclusion is precisely the opposite of that reached in most discussions of appropriate national policy for the extractive industries. Before it can be accepted, its application to important groups of natural resources must be examined.

In 1950, at the beginning of the last national emergency, mineral fuels provided $8.7 billion of the total value of mineral production of $11.9 billion: crude petroleum alone amounted to $5 billion, and natural gas and natural-gas liquids to a further $700 million, for a combined total of almost half the total minerals production. Bituminous-coal production was valued at $2.5 billion, and anthracite at $400 million. Other nonmetallic minerals had a value of $1.8 billion, with values over $100 million only for cement, stone, sand and gravel, and sulfur. Metals contributed $1.4 billion, led by iron ore at $500 million, copper at $400 million, and zinc and lead over $100 million each.[1] These statistics tend to exaggerate the importance of nonmetallic minerals because cement is at a higher stage of fabrication than the ores and crude products listed elsewhere.

Coal is in second place on this list, with a value almost equal to the combined total for all of the nonfuel products combined. The long-run problem of exhaustion of the resource is so far down on the list of the problems facing the industry, and the economy with respect to the industry, that it can be practically disregarded. The United States now appears to be on the verge of a revolution in energy resources comparable to that which accompanied the spread in the use of coal which began a century or more ago or of oil 50 years ago. Although atomic energy's final role can scarcely be guessed, its first contributions are likely to be made in replacement of some of the more important uses of coal. Even before the appearance of atomic energy, the emergency coal supply problem had nothing to do with the adequacy of reserves. Thus it must be assumed that the exhaustion of coal in a physical sense has very limited significance either for the economy or for national security.

The same comment applies to the major nonmetallic minerals, with the possible exception of sulfur. The tonnages produced are very great, uses are diversified, and substitutes usually unlikely because of the very low unit prices of most of the important nonmetallics. But, again except for sulfur, deposits are widespread and known reserves are generally high relative to current production. Further, unlike the basic fuels, a considerable fraction of the normal peacetime deman for these products is dispensable in an emergency. Even if widespread devastation of American cities should occur, it is questionable whether the resultant demand for building materials would be allowed to express itself immediately. This would require the cooperation of too many other scarce factors of production. And use in construction accounts for most cement, sand and gravel, and stone except certain grades of lime and limestone.

[1] Statistical Abstract of the United States, 1958, pp. 720–722.

This leaves the petroleum group and metallic minerals. In terms of this analysis, such nonmetallics as borax, potash, phosphate, and mica could appropriately be added, along with sulfur, because of similarities in the emergency supply-demand problem.

First for the differences among individual products in this group which are relevant for this discussion: (1) Petroleum products are not recoverable after use either directly or indirectly through their contribution to increased output; fertilizers are not directly recoverable, but they may continue to contribute their services indirectly for some time; metallics are recoverable from most uses, and contribute to satisfying demand during an emergency without the diversion of new production because of their durability. So petroleum, sulfur, and lead used in gasoline provide straightforward examples of economic exhaustion: present use does cut total future availability. The supply of most metallics suffers from attrition of various forms once the metal is embodied in a final product, and a large part of the supply is locked into the economy and therefore unavailable for new emergency demands although continuing to satisfy original requirements. But for most uses of metallics, new production not only reduces the reserves below ground but also partly counterbalances this reduction by increasing the supply of potential scrap. This may be economically a better source of supply for most emergency needs than new output, since it may make fewer demands on scarce productive factors.

(2) The durability of most metallics in use applies in still greater degree, with the possible exception of iron and steel, to their suitability for stockpiling. This has been recognized since World War II, with the result that present stockpiles of some minerals would probably satisfy an important fraction of emergency demand. Stockpiling is not only a means of converting national underground resources into more immediately usable forms; it also permits acquisition of foreign resources which might not otherwise be available at all. Finally, stockpiling of some minerals from some sources may amount to advance preclusive buying, by simultaneously providing an additional supply for the United States and denying it to a potential enemy. This should not be exaggerated, since the stockpile purchases may be matched, or more than matched, by increased production, but with respect to supplies from doubtful areas it may have some importance. Many metallics can also be stockpiled relatively cheaply because of their high value per unit of weight and especially of volume. Petroleum is not a good stockpile candidate, although it is questionable whether the possibilities here have been fully investigated in view of the trend toward stockpiling natural gas in advance of winter consumption peaks in caves, exhausted gas and oil formations, etc. The problem of physical loss and deterioration is greater, the value per unit of weight or volume is less, and the sheer quantity of consumption is enormous.

(3) For minerals, the problem of waste of resources in actual production is minor. Laws as to the maximum size of initial mining claims may produce considerable duplication of effort while a new ore body is being opened up, but the prevalence of words like "consolidated" and "amalgamated" in the corporate titles of mining companies is evidence that this problem is likely to be temporary. In petroleum and natural gas, if surface property rights are in different

hands, the temptation to get there first with the most is very strong. Hence the familiar pictures of a forest of oil derricks in Long Beach, Calif., and in general the problem of minimizing the number of wells required for effective recovery of the underground resource. The possibilities of waste extend beyond loss of oil through lowered pressure or poor location of wells. Too many wells use too much labor, too much steel, too much transportation, and too much of everything else required for well drilling. In terms of the basic contribution of a peacetime economy to national security, duplication of investment is undesirable even if it wastes no oil at all.

(4) In an emergency, petroleum output can be expanded at less additional cost per unit of additional value than minerals output, unless wells are already producing at maximum capacity. This level of production, in turn, will normally waste oil, or require secondary recovery which could have been avoided with lower original rates of production. So a policy of maximizing the total recovery from an oil pool automatically creates some excess capacity for use in an emergency at very little extra cost in money or resources, although at some long-run cost in total oil recovered. Expansion of mining output is normally expensive in money, which means for emergency purposes in man-hours and materials. Conversely, there is no direct connection between current rate of production and total ultimate recovery, as long as the property is not abandoned.

It is clear, then, that petroleum and metals present very different security problems in a number of important respects. Therefore the security aspects of the Federal taxation applied to them cannot be examined for both together. But this examination must be preceded by a return to the basic question: Why are not both products, or their producers, obvious candidates for unusually high taxes? In particular, since there is an obvious and recognized relationship between gasoline taxes and highway costs, why are they not both candidates for higher taxes levied for the specific purpose of restricting domestic production and consumption of irreplaceable resources?

One answer is that these products are peculiar because normal peacetime uses are practically indispensable:

> * * * I think it would be well if we had enough [domestic oil capacity] so that we would not even have to ration in time of emergency, because rationing is a nuisance.[3]

But to recommend that plans be made to provide normal peacetime supplies of all products to civilian buyers would be to favor dissipation of many of the security advantages of the American economy. For some products, including a few basic foods, by far the greater part of normal demand is really indispensable. For others, including petroleum and most metal products, the margin of dispensability is far higher.

For some specialized products, usually military end items, it can be argued that normal peacetime supplies are very small or even nonexistent. This may also be true of certain particularly strategic metals and nonmetallic minerals, but it is not true of the major products of the extractive industry. That is why they are major products. At various times in recent years, the country has suffered tungsten

[3] Testimony of Gen. Ernest O. Thompson, chairman, Texas Railroad Commission, General Revenue Revision, hearings before the Committee on Ways and Means, House of Representatives, 83d Cong., 1st sess., pt. 3, p. 2026.

shortages, cobalt shortages, and various others involving products whose markets are normally quite limited. But these problems have often arisen because of exceptional demand increases. They would not always have been alleviated if all dispensable supplies had been shifted to military uses. In these instances, something might be accomplished by efforts to expand normal peacetime supplies by special incentives, but in general the best solution would seem to be to forecast military demands as far ahead as possible and order accordingly. Great output stimulation of one minor but essential mineral will from time to time be desirable, but great output stimulation for all of them could easily represent a very expensive form of insurance.

The problem of abnormal emergency demand is relative not only to the amount of possible cutback in civilian demand but also to the availability of supplies. If these actually decline immediately before or during an emergency, and cannot be rapidly increased, then the industry constitutes a special security problem. Variations on this theme are in fact basic to the case of these industries for special tax treatment:

1. All extractive industries must continuously seek new deposits if they are to maintain output and reserves. For coal and most of the important nonmetallics, this search is almost certain to be successful with minor expense and effort except perhaps for special grades, and substitutes can often be found even for them. For oil and some metals, there is a definite risk of nondiscovery, or of discovery only of very inferior resources. From this point, the argument has two variants which are often confused: (*a*) The risk for the entire industry is large; or (*b*) the risk for any individual member of the industry is large, and he will not undertake exploration unless he is given incentives which encourage him to cope with his particular risk. The first variant represents essentially uninsurable risk; the second describes a risk which is possibly insurable, but for one reason or another not insured by the simple device of consolidating the financing of development in relatively few hands. The first problem may be of genuine significance for national security. The second may only be of significance if it is agreed that the emergency strength of the country is increased by a large pre-emergency supply of small independent oil wildcatters.

2. The problems of specialization of productive factors, and time consumed to bring new resources into production, are in part related to the question of risk. If the risk of nondiscovery is great, and part of the labor force is specialized, a lean period in discoveries may start the industry on a downward trend which will be hard to reverse. In crude-oil production, with small direct labor and special equipment requirements once a well has begun producing, the question of risk is at the heart of the problem of expansion.

3. Imports may be either nonobtainable, or unreliable, especially during an emergency. The recent Swiss watch controversy provides an example of the use of this argument in another area of the economy. With respect to petroleum and minerals, it is claimed that United States reliance on foreign sources increases our vulnerability because of possible transportation difficulties, direct enemy seizure, or simple foreign refusal to maintain sales to the United States market.

In its extreme form, the import problem may be illustrated by the following:

> * * * It seems that Texas crude is being supplanted by foreign crude by some companies. This works a hardship on Texas producers. The average Texas oil well produces 20 barrels per day. The average Persian Gulf area well produces 5,000 barrels of oil per day.
>
> * * * * * * *
>
> How can a Texas 20-barrel allowable compete with a 5,000-barrel well?
>
> We have built up a reserve daily producing ability in Texas of 600,000 barrels of oil per day for defense. Now we are confronted with the threat of being supplanted with foreign crude. It does not seem fair.[3]

The addition of this reserve supply to current Texas output would have raised the average to only about 25 barrels per day. So the only way to combine security with economic considerations would be to stockpile petroleum, if this were possible. The direct comparison is unfair to the current productivity of the United States oil industry in a number of respects, and does not consider transportation costs from the Persian Gulf. But it would be hard to add enough cost differences to the Persian Gulf figure, including the 10½ cents per barrel import duty cited by General Thompson, to obtain a figure even approaching probable United States costs.

In general, the import problem is not a separate issue for products that can be stockpiled. If the foreign price is enough less than the cost of domestic output to permit the payment of full carrying charges on the maximum desirable reserve supply, domestic sources should not be encouraged. If the foreign price is lower, but not that much lower, then the problem cannot be solved along strictly price lines. Questions must be raised as to the availability of the imports under specified conditions, the minimum domestic industry which has to be kept in being in order to permit expansion during an emergency, etc.

For oil, the import problem is a separate issue. Which leads directly to the relevance of the percentage depletion allowance to oil production.

Percentage Depletion and Petroleum

The problem of reconciling security and efficiency in petroleum supply would appear to be hopeless. Our output per well is only four-tenths percent as high as the level reached in the Persian Gulf area, we encounter immense risks in finding more, import sources are unreliable and likely to be cut off, and stockpiling appears to be impracticable.

Fortunately, the situation may not be this serious. The State of Texas alone accounts for almost half of United States production and over half of proved reserves. And Texas has controlled drilling and output since 1934. By 1950—

> * * * we have wells at east Texas that can produce 30,000 barrels of oil today, if opened wide open, but they are only allowed to produce 12½ barrels per day because the market demand is such that we can only make room for 12½ barrels from a 30,000-barrel well * * *.[4]

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[3] Exhibit submitted by Gen. Ernest O. Thompson, press release of February 14, 1953, Petroleum Study, hearings before the Committee on Interstate and Foreign Commerce, House of Representatives, 83d Cong., 1st sess., p. 690.

[4] Testimony of Gen. Ernest O. Thompson, Petroleum Study, hearings before the Committee on Interstate and Foreign Commerce, House of Representatives, 83d Cong., 1st sess., p. 626.

Evidently, then, the domestic industry is already on a partial standby basis, which affects the efficiency comparisons already made. It also affects the security aspects of oil taxation. Restriction of production to demand at a constant or rising price can make larger income-tax deductions effective in spurring producers to discover more oil, because market price does not decline in response to greater supply. But the price structure alone will not make the tax incentive fully effective if there is inadequate control over the total investment in wells.

Here again the Texas experience is instructive:

> * * * in the 21 years under conservation, we have increased the number of wells in Texas from 47,000 * * * to 142,000 * * * and the production is 20.1 barrels per well as against 15.7 in 1932 * * *.[5]

Overdrilling in Texas was notorious before the introduction of controls. So this small increase in barrels produced per well is surprising, especially in view of minimum spacing requirements.[6] At least a partial answer is provided by the legal limitations on action by the Texas Railroad Commission:

> * * * we are bound by law to protect correlative rights as well as prevent physical waste.[7]

As long as royalties are payable only when producing wells are located on the property, the pressure for overdrilling must continue except in very sparsely settled areas. A higher price will simply increase this pressure, as will percentage depletion—the latter by reducing the margin between income before and after tax.

The original discovered value method of calculating oil depletion rewarded genuine wildcatting. The reward went to the original discoverer. As long as no controls existed on further drilling in a field, this benefit was of rather speculative value, but at least it tied the reward for risk to the assumption of it. This the present percentage depletion system, available to all owners of producing wells and to all royalty owners, does not do.

In practice, original producers and latecomers must receive the same field price for their crude. But percentage depletion may differentiate between them: This allowance may be restricted to the encouragement of wildcatting, which is cited by practically every industry spokesman as its true function. In order to prevent the benefit from being frittered away by a decline in gross for the original discoverer as competitors follow after or he, himself, must overdrill to satisfy every royalty owner, percentage depletion should be restricted to unitized fields.

Finally, the problem of risk in oil discovery deserves more careful examination than it usually receives. The insurance principle should not be neglected; nor should businesses without discovery risk be viewed as necessarily more secure.

With the increasing effectiveness of State output controls and their correlative influence on crude-oil prices, the sales-price risk is now much less in oil than in the economy generally. The crude product does not require advertising or sales promotion, so the commercial risk of not being able to impress consumers with the special qualities of the

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[5] Ibid., p. 610.
[6] Ibid., p. 616.
[7] Ibid., p. 626.

article is nonexistent. Outlays are low relative to income from the start of production to the stripper stage, so the purchase-price risk is slight. Even the income-tax risk—the danger of increased future rates—is reduced by expensing and percentage depletion. It would be hard to maintain that a large concern exploring for crude oil incurs a total risk, in all dimensions, greater than that of a filling-station operator in northern New Jersey or southern New England.

These general statements can be tested against three bits of evidence:

1. Comparisons of rates of return on net worth of 24 oil companies and of an unspecified but large number of manufacturing corporations show oil returns lower in every single year from 1934 through 1948.[8] Crude-oil reserves increased in every peacetime year and declined only in 1943 (slightly) and 1945. Production increased in every year but 1938 and 1942. Over the entire period production increased by over 133 percent and reserves by not quite 100 percent, in spite of wartime restrictions on drilling. These comparisons are open to criticism because they relate crude production performance to the entire financial record of integrated companies, but they were originally used and have since frequently been quoted in connection with crude production. Taken at face value, the statistics indicate either subnormal risk or abnormal willingness to bear risk, particulary for an industry which must constantly make new investment even to maintain reserves. Changes in net worth over the period support the profit and discovery statistics: The lower petroleum rates of return were accompanied by the same percentage increase of net worth as in manufacturing, which again indicates equal absolute and greater relative willingness to plow back profits even with smaller profit ratios.

2. Common stocks of important crude surplus producers normally sell at higher price-earnings ratios than stocks of companies with large crude deficits or no crude production at all. In the immediate postwar period, this may have been due in part to higher crude prices, rising earnings of crude producers, and fear of inflation. Although these factors have practically disappeared, crude surplus companies, such as Humble and Continental, are still selling at twice the price-earnings ratio, and not much over half the dividend yield, of large crude deficit companies, such as Sinclair and the Standard Oil Companies of Ohio and Kentucky. Crude production is apparently thought by investors to be less risky than refining and distribution.

3. The effect of the insurance principle on pure risk may be judged from the continuous annual dividend records of 58 insurance companies (other than life insurance).[9]

	Companies
Continuous dividends since 1875 or earlier	22
Continuous dividends since 1876-1925	11
Continuous dividends since 1926-40	17
Continuous dividends since 1941 or later	5
No dividends (organized in 1949)	1

The median year for commencement of dividends on a continuous basis was 1908. A sample of 96 companies whose corporate title begins with the word "American," excluding insurance companies and investment trusts, shows that the median for continuous dividend

[8] Testimony of Roland V. Rodman, president, Anderson-Prichard Oil Corp., Revenue Revision of 1950, vol. I, p. 270.

[9] Fitch Stock Record, June 1, 1955, issue. Group of companies includes all those listed.

payments fell between 1939 and 1940, which was later than that reported for all but six of the insurance companies. Insurance companies outside the life insurance field normally have considerable investments in common stocks, so they are assuming an investment risk as well as a pure insurance risk. Yet their record of stability is remarkable.

It would appear, then, that percentage depletion is not a reward for the special risks assumed by large oil companies, because there are no such risks. The entire argument seems to be based on the assumption that risks are nonexistent in other businesses.

Percentage depletion doubtless stimulates exploration, as well as drilling in known fields, by raising the ratio of retained net earnings to earnings before taxes. It combines with the expensing of intangible development costs to provide a larger immediate cash flow available for any corporate use. But neither of these functions can possibly assist in the harmonization of economy and security through elimination of overdrilling, or provide any incentive to shift the emphasis from immediate production to accumulation of reserves.

Percentage Depletion and Metals

The percentage depletion rate for metals is only 15 percent, as compared with 27½ percent for oil. The danger of duplicating investment is slight. Risks of price and cost fluctuations are much greater than for oil. The industry discovery risk of finding nothing really worthwhile after an expenditure in prospecting which is important relative to the size of current receipts may be much greater for some minor metals. In these respects, the security case for continuing percentage depletion in its present form is better for metals than for oil, especially since the product is usually not lost forever in its first use.

Conversely, since stockpiling is easier, the case for excess production capacity is not as strong as in petroleum. Since prices of some metals are much freer to respond to supply changes than is the price of oil, the chances of stimulating consumption instead of creating excess capacity or additional reserves are greater. The import problem is important for most metals, but in view of the importance of Canadian production often different in character from the Persian Gulf security danger in the oil industry.

For many metals, the output problem is at least as much dependent on keeping a labor force and other facilities on the site once production has started as on finding new resources. Government assistance in placing floors under metals prices may be more effective in maintaining domestic capacity by preventing premature abandonment and loss of specialized skills than depletion allowances which may or may not be used for exploration in search of new deposits that may or may not exist.

Percentage Depletion and Sulfur

Sulfur is a special case, with a special depletion rate above that granted for any depletable product but petroleum. This strategic and versatile mineral has already passed through probably the outstanding emergency procurement crisis of the last decade. Sulfur has been granted percentage depletion at the rate of 23 percent since 1932.

During the 19 years 1930 through 1948 average net income was $13 million per year; average dividend payments, $11 million; and average annual exploration expense, $369,603. In 1946 allowable depletion was $11.2 million, and in 1947, $13.8 million. Total exploration expense was $7 million in the entire period 1930–48.[10]

This discrepancy between depletion allowance and exploration expenditure occurred in the face of rapid demand expansion, and in spite of the risk involved in exploration:

> In its physical aspects the search for sulfur is like the search for oil, but the chances of success are substantially less * * *.[11]

Exploration expenses will never match percentage depletion allowances except by coincidence. This equivalence would even be economically inappropriate in a declining industry, or in an industry with small discovery problems. But sulfur is neither. In view of the disparity between source and use of funds for exploration, the depletion allowance should either be drastically reduced or tied to actual expenditures for exploration. The latter, in conjunction with the expensing privilege, might permit subtraction of $2 from the income-tax return for every dollar spent for some purposes, but the advantages of avoiding future shortages might make even this worth while.

Conclusions

1. Extractive industries exhaust resources. Therefore, special tax stimuli inducing them to expand output are, in general, particularly undesirable on security grounds.

2. If new sources of the product are easily found and imports are unimportant or from nearby sources, percentage depletion has no relationship to national security. The coal industry, for example, has very great economic problems and a very important defense significance, but percentage depletion has practically no relevance to either attribute.

3. Industrywide risk may be low relative to the rest of the economy even if discovery risk is high in individual cases. In petroleum the insurance principle and the relative unimportance of risks other than that of discovery offset the familiar odds against the success of any one wildcat well.

4. For petroleum the security problem involves balancing support of a relatively high-cost domestic industry which may become even higher-cost as it exhausts reserves against the difficulty of storing imports and the geographically unfortunate location of some major import sources. This problem will be enhanced unless every governmental measure, tax and other, is designed to force the domestic industry to be as efficient as possible. Percentage depletion is not helpful in this respect because it does nothing to discourage wasteful investment in drilling, and even encourages it.

5. Adverse effects of percentage depletion are much less important for most metals. In view of the possibility of stockpiling, and the problem of internal demand fluctuation, other types of Government action may still be more relevant to national security.

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[10] Data submitted by U. S. Treasury Department, Revenue Revision of 1950, vol. II, p. 3021.

[11] Testimony of Langbourne M. Williams, Jr., president, Freeport Sulphur Co., op. cit., vol. I, p. 410.

6. For sulfur, and possibly for other minerals, the evidence indicates that percentage depletion has not furnished the incentive to exploration that it is supposed to provide. In such cases it should either be eliminated or tied to exploration expense.

THE INDEPENDENT PRODUCER'S POSITION

LOWELL STANLEY, Monterey Oil Co.

Production and development of natural resources—minerals and metals, fuels, and timber—are recognized as essential to the welfare and security of the Nation. With 6 percent of the world's land area and 7 percent of its population, the United States produces about 38 percent of world energy resources, 48 percent of world oil, 30 percent of the copper, 91 percent of the sulfur, 21 percent of forest products, 49 percent of free world iron ore, and has had a leading role in development of most natural resources.

Such production has resulted from the existence and development of substantial reserves of these natural resources, and has come under conditions of private ownership or operation; a capable, energetic, and resourceful people; and tax laws which have permitted, and in some cases encouraged, such development.

THE IMPACT OF TAXATION

All taxation, Federal and local, has a profound effect on economic activity. Natural resources industries are particularly sensitive to the effects of taxation, because, in a way different from industries which provide form, time, and place utility (manufacturing, merchandising, transportation), capital is consumed in the process of extracting and producing minerals, oil and gas, coal, other natural deposits, and timber. There is also the risk and hazard inherent in the exploration for and development of certain natural resources.

In a statement before the Committee on Ways and Means of the House of Representatives, the late Senator T. P. Gore said:

> Any effort at scientific taxation must take into account the nature of the business to be taxed; its character and its characteristics. And it is always as unscientific and sometimes as unjust to tax things which are unalike as if they were alike as it would be to tax things which are alike as if they were unalike.[1]

Since the early years of the income-tax laws, and through an evolutionary process, these fundamentals which differentiate the natural resources industries have been reflected in the law, with particular provision for:

(*a*) The exhaustion or depletion of the individual properties from which resources are removed;

(*b*) The cost of development of properties; and

(*c*) Exploration costs for certain designated resources.

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[1] Hearings before the Committee on Ways and Means, House of Representatives, Revenue Revisions of 1942, vol. I, p. 1015.

The Allowance for Depletion

The depletion deduction is a recognition of the gradual exhaustion of a depletable asset. A deduction for this purpose has been allowed under the Federal income-tax law since 1913, although the formulas which could be used in computing the allowable deduction have varied from time to time.[2]

The law now allows for the depletion of all minerals[3] and timber. Oil and gas accounts for a major portion of the resource industries' gross value of product, net income, taxes paid, and depletion allowed. Coal is allowed depletion, with special provision for owners of coal royalties. Minerals include the metals such as copper, iron, lead, and others of growing importance—antimony, magnesium, uranium, and lithium. There is a wide list of nonmetallic minerals, the salines, potash, borax, and raw materials for cement. Other minerals range from humble but very vital sand and gravel to elements like sulfur.

When the income-tax law became effective in 1913, and with 1916 amendments, all property was given a tax "base" not less than fair market value on March 1, 1913. For mineral and oil and gas properties such value compared with what later was written into the law as "discovery value." Depletion on, or recovery of, such value was then allowed.

Operators who subsequently discovered or developed properties were left in an unequal position. For a short time, with corporate rates at 1 percent of net income, and individual rates graduated from 1 to 7 percent, the effect was minor. But with increasing tax rates imminent with World War I, the operator who has discovered or developed his property after 1913 found he was being discriminated against by having his depletion based not on value, but on an accounting concept of cost of the individual property involved. The disposition through production of his mineral resources was taxed as income, while his neighbor or competitor, holding a property since March 1913, had a realistic tax allowance for the exhaustion of his capital values.

Congress found that this situation tended seriously to retard oil and mineral development, and therefore the Revenue Act of 1918 provided—

> that in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter.[4]

Both 1913 valuation and discovery value provided for the integrity of the operators' capital, its recognition and deduction spread over the life of the property, and the taxation of the remaining income after taking into account the economic values depleted in the process of extraction from the individual properties.

Administration of the 1918 act required that a "fair market value" be determined after discovery. In practice this provision proved very difficult to administer. There were so many leases and such wide

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[2] Report, the President's Materials Policy Commission, June 1952, vol. V, p. 10.

[3] Sec. 613 excludes from the definition of "all other minerals" such substances as the soil and minerals taken from sea water and the air.

[4] Sec. 214, Revenue Act 1918.

differences of opinion as to fair market value of oil properties, that the Bureau of Internal Revenue was swamped with endless detail and controversy. After several years of such difficulty, a Senate select committee was created to investigate the administration of the tax laws. The work of that committee led to adoption in 1926 of the formula for depletion still in effect today.

The percentage method now is substituted for all discovery values heretofore allowed, and depletion on a percentage basis is provided for "all minerals" in section 613 of the Internal Revenue Code of 1954.

Percentage depletion

The allowances are the lesser of certain specified percentages of gross income, or 50 percent of the net income, from each separate property. The rates have been carefully studied by Congress, and in the case of oil and gas and the metals, the percentage allowances were fixed at the time slightly less than the amounts allowed under prior discovery value.

While the courts have defined different aspects of the subject of depletion, perhaps the most direct and concise reference is by the United States Circuit Court of Appeals, Fifth Circuit, which stated:

> The depletion allowance was intended to encourage production, and may be regarded as a substitute for the capital-gains allowance where the taxpayer, instead of selling, leases or operates his own mineral holdings.[5]

The United States Supreme Court stated:

> The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance.[6]

Income of individuals on sales of property defined as capital assets and held for more than 6 months are recognized to the extent of only 50 percent, and limitations are placed on the rate of tax on such income in the hands of both individuals and corporations. Congress has determined that such tax differentiation between ordinary income and capital transactions is appropriate and necessary to prevent an adverse and stifling effect on the economy. Great Britain and Canada, among other nations, do not levy an income tax on capital gains.

An important and universal feature of depletion allowances for the various minerals and oil and gas is the limitation of the allowance to 50 percent of net income from the property—in other words, like capital gains, at least 50 percent of the income or gain is recognized.

This concept was clearly applied by Congress when in 1943 it provided capital-gains treatment for cutting of timber in adopting section 117 (k) (1), now section 631 of the 1954 law. Like the depletion allowance it provides for the recognition of 50 percent of net income from the property, but unlike the allowance for minerals it provides no further percentage limitation based on gross income.

In adopting this provision, the Senate Finance Committee stated:

> Your committee is of the opinion that various timber owners are seriously handicapped under the Federal income and excess-profits tax laws. The law discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess-profits tax rates and not at capital-gain rates. In short, if the taxpayer cuts his own

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[5] *West v. Commissioner of Internal Revenue* (150 F. 2d 723).
[6] *Anderson v. Helvering* (310 U. S. 404).

timber, he loses the benefit of the capital gain rate which applies when he sells the same timber outright to another. Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are, therefore, not accorded under present law capital-gains treatment of any increase in value realized over the depletion basis.

In order to remedy this situation, it is proposed to amend the existing law as follows:

"If the taxpayer so elects upon his return, the cutting of timber during the year by the taxpayer who owns or has a contract right to cut such timber is treated as a sale or exchange of the timber cut during the year * * *."[7]

Without the depletion provisions in the law, the same conditions would quickly arise in the mineral and petroleum industries, and the same statement would apply. Since the extensive congressional studies of 1942 and 1943, and with the 1951 and 1954 amendments, the principle of the depletion allowance and the capital-value recovery principle implicit therein has been extended to all minerals.

Depletion rates

With the uniform limitation on percentage depletion of 50 percent of net income from each property, and the various percentages of gross income, the overall effective rate is thus less than under the formula. Congress has set various limiting rates, after taking into account the characteristics and production cost ratios of the respective resources, at 5, 10, 15, 23, or 27½ percent. The allowance is calculated on gross and net income from the property, taking the value of crude oil and gas at the well, and as nearly as practicable the value of the raw material at the mine or deposit.

In no industry classification does depletion allowable amount to the gross income percentages provided in the law, and furthermore, such percentages, serving to limit the higher grade mining properties and better oil and gas properties, result in the aggregate in depletion allowances considerably below the 50 percent of net from the properties.

Persons entitled to depletion

Depletion is allowed to persons having an economic interest in the property. This includes:

(*a*) Operators (corporations, principals, partners, or coadventurers) who may own the property outright, or may be lessees

(*b*) Royalty owners, who may be lessors, or subsequent purchasers of royalty interests.

(*c*) Owners of various other kinds of economic interests in the property.

On the other hand, depletion is not available, or allowed, to stockholders.

Alternatives of the producer

Most operators, especially the independent or medium-sized or smaller operator, whether operating as an individual, partnership, or corporation, would, without laws which recognize such extraction or sale of property, ton by ton or barrel by barrel, be forced by the tax laws to sell their properties outright, take their capital gains at the lower rate, and leave the operations to new purchasers who would then be entitled to a new "cost" depletion which would approximate, or exceed, the amount of percentage depletion now available to the original holder.

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[7] Senate reports, 78th Cong., 1st sess., miscellaneous, vol. 3, Rept. No. 627, p. 25.

Such a program, which would tend to force through taxation the sellout of smaller mineral and oil producers, is presumably against present public policy. Nor would the public interest be served by a system of taxation which would tend to make all producers, including the largest, better off by disposing of their producing properties, even though in turn they purchased and applied new cost depletion to other properties.

As long as the present treatment of capital gains remains in the law, the owner of mineral property and timber, or an economic interest therein, has available the effect of percentage depletion through the avenue of capital gains.

If an operator has purchased developed or proven property, he may be expected to have cost depletion in excess of the amount allowed under percentage depletion. This tends to assure the integrity of his capital, his continuance in business, and his ability to replace his depleting property.

On the other hand, if another operator has acquired his property through discovery and development, his depletion based on cost may often be disproportionately low compared with the economic value of the property. By preserving the integrity of his capital values, through an adequate percentage depletion allowance, he can, as can the purchaser of properties using cost depletion, remain in business by using the cash flow covered by such depletion allowance for the acquisition of, or exploration and discovery of, replacing properties.

Depletion allowable to royalty owners, and for economic interests of other nonoperators

Sometimes it is assumed that a royalty owner has little right to the recognition of the depletion of his property, since minerals may have been discovered on his lands without a material effort or contribution on his part. But owners of some other kinds of nonoperator economic interests may have contributed and risked substantial resources or efforts in such discovery.

Depletion of 27½, 23, 15, or other applicable percentage of gross income in such cases makes the allowance often substantially less than the value of his royalty interest. This has had its effect as shown by the great number of royalty owners who have sold all or a portion of their mineral interests, taking the capital-gains treatment. Only when properties have inherent enormous risks, or a large portion of the income may be expected to be deferred over a very long time, would the value of a royalty interest be as low as the percentage depletion expected to be allowed.

So obvious did this become with respect to coal royalties, for which percentage depletion before 1951 was 5 percent of income, that Congress provided in lieu thereof, like for timber, the equivalent of depletion of 50 percent of the net, through taxing coal royalties as capital gains.[8]

About 80 percent of depletion allowed does not apply to the income received by the ultimate owner

In 1950 the Secretary of the Treasury presented a report to the Committee on Ways and Means, House of Representatives, which included a survey of depletion. In that report he stated:

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[8] Enacted in 1951 as sec. 325 (b), now sec. 631 of Revenue Act of 1954.

While the survey covers corporations only, it is estimated that corporations account for more than 80 percent and individuals for less than 20 percent of all depletion deductions.[9]

A substantial portion of the depletion allowed to individuals covers their royalty interests, for farmowners and others who have leased their lands. It might be reasonably estimated, then, that more than 90 percent of depletion of operators is that allowed to corporations. When earnings of these corporations are in turn distributed to their shareholders, such payments are taxed again, this time as ordinary income, without recognition of the depletable nature of the underlying properties. The American Mining Congress in a declaration of policy in 1954 states:

> While a start has been made in an allowance to stockholders on dividends with respect to taxes paid by the corporation, the principle should be further extended, and depletion allowed to a mining corporation should be carried through to the stockholder on some equitable basis.[10]

The allowance permits replacement of depleted properties

The percentage basis for depletion, limited by both net and gross income from the properties, adjusts to changes in value, both upward and downward, during periods of inflation and deflation in prices and property values.

Its operation actually has, on a broad scale, much of the effect of the last-in first-out (LIFO) method of handling inventory values. There, under section 472 of the code, it is provided, in effect, that a taxpayer may deduct as a charge against operations his current cost of replacing inventories sold in lieu of the original cost. Natural resources are seldom replaceable today at anywhere near the amounts allowed as percentage depletion.[11]

The LIFO principle of recognizing replacements costs is available to all taxpayers having inventories.

Of utmost importance to national welfare is equitable treatment of resources development and production on which most economic activity depends as a source. A literal application of LIFO methods to production of resources would involve problems even more complex than the old discovery value formulas. The percentage depletion allowance accomplishes directly and with far greater simplicity at least a significant portion of what LIFO is intended to do for other taxpayers.

The independent producers' position

We come then to a present situation where, even with the depletion allowance, which, however, does not carry through to amounts received by the stockholder, many if not most properties are actually worth more in anyone else's hands than the original owner, discoverer, and developer. Corporate managers in the resources industries realize that their companies may be worth more liquidated than as going concerns. Any adverse change in the depletion allowance would undoubtedly precipitate liquidations and sales on a much greater scale

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[9] Hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2d sess., vol. I, p. 51.

[10] Adopted at San Francisco, Calif., September 20–24, 1954.

[11] In the case of oil, with prices at the well ranging from $2.95 per barrel at gulf coast to $2.30, Signal Hill, Calif., for 21–21.9° gravity, percentage depletion is limited to 81⅛ to 63¼ cents per barrel. Recent sales of proven but undeveloped properties range around $1 per barrel.

and create the risk of immobilizing or removing vital elements in exploration and development. The same forces apply, of course, even to the largest companies, but with their public responsibilities and the complexities of size, any changes may take effect more slowly, even though surely.

An illustration shows the kind of problem constantly before a typical corporate operator in his financial planning. A corporation has properties with estimated oil reserves of 500,000 barrels, expected at present prices to gross $2.82 per barrel, or a total of $1,410,000, and to net after production costs and local taxes $2 per barrel, or $1,000,000. With depletion of 27½ percent amounting to $387,750 taxable income is $612,250, and tax at 52 percent is $318,370, leaving the corporation a net income after taxes of $681,630 (example I below).

Without percentage depletion, and assuming a low or zero adjusted cost basis, tax would be $520,000, and net income after taxes, $480,000 (example II below).

Calculating next the tax effect of distributing these earnings to shareholders, the following table shows amounts retained by shareholders in different tax brackets, and also shows, for illustration, the present worth of such receipts assuming a discount factor of 30 percent.

As an alternative, example III assumes sale of the corporate stock at $500,000, or for $1 per barrel of underlying oil reserves, or sale by the corporation of its properties at the same price, followed by liquidation.

	Effect on shareholders with income-tax rates of[1]—		
	30 percent	50 percent	70 percent
Example I—with percentage depletion:			
Net income available for distribution	$681,630	$681,630	$681,630
Balance after tax on shareholder	477,141	340,815	204,489
Present value, assuming a discount factor of 30 percent	333,999	238,571	143,142
Example II—no depletion available:			
Net income available for distribution	480,000	480,000	480,000
Balance after tax on shareholder	336,000	240,000	144,000
Present value, assuming a discount factor of 30 percent	235,200	168,000	100,800
Example III—sale of stock or properties outright as a long-term capital gain:			
Sale price	500,000	500,000	500,000
Amount of tax (maximum)	75,000	125,000	125,000
Balance available to shareholder—present value, not subject to a discount	425,000	375,000	375,000

[1] A 30-percent individual rate applies to taxable income of $6,000 to $8,000, 50 percent rate to $16,000 to $18,000, and 69-percent rate to $38,000 to $44,000.

Even at the recent historically high position of a free securities market, and with the current depletion allowance effective, oil securities sell at a material discount under their breakup or liquidating value.

The Chase Manhattan Bank carries on a continuing review of 30 oil companies, summarized in its annual publication, Financial Analysis of the Petroleum Industry. The bank has furnished a summary, unpublished, showing that the market valuation at August 18, 1955, of common stocks outstanding of the 30 oils (excluding the 5 international companies with large foreign holdings) had a weighted average of 69 percent of appraised value at December 31, 1954, on present worth basis of underground oil and natural gas reserves plus working capital plus estimated value of property, plant and equipment (excluding production facilities) and other assets minus prior obligations.

Statutory depletion provides income-tax recognition for "wasting" assets, and recognizes the disposition of capital in the extractive processes. It permits the replacement of capital values used up in resources production.

Sometimes referred to as an incentive, it does in reality only bring such taxation toward a "neutral" position. By tending to equalize taxation, considering the nature of the business, it does not deprive producers of their natural incentive, as well as the opportunity, to engage or continue in the production of natural resources.

The Treatment of Development Expenses

In the development and operation of mines or other natural deposits and oil and gas wells, there are costs of exploration, development, and production.

Production costs are currently chargeable against income. In general, mine development costs, except expenditures for property subject to depreciation, are currently deductible. It often becomes difficult, if not impossible, to draw a line between mine development and production, and costs which under different circumstances might be development tend to become merged into production costs.

For oil and gas wells, regulations classify drilling and development costs as "tangible" and "intangible." As for mines, costs subject to the allowance for depreciation, "tangible" costs, are capitalized. "Intangible" costs are immediately deductible under regulations in effect since 1918, and under section 263 of the 1954 law. These are costs such as grading and making a location, labor, and other expenditures involved in boring the hole in the ground, testing and surveying, and costs of installing equipment. Such expenditures do not result in a tangible asset which could be sold or salvaged for any other purpose.

Unlike most mining operations, where development may continue at a controlled rate for an extended time, the drilling of an oil or gas well may be completed with modern equipment in a few days or a very few weeks. In both cases, however, development costs are allowed as current expenses, but subject to an election to capitalize and deduct ratably in future periods. For oil and gas, the election, once made, is binding for all years.

This treatment is a direct incentive to mineral and oil and gas development, and may perhaps be likened to rapid or immediate amortization. The costs involved are so substantial, and at this stage the risks may be so material, that such treatment is an important consideration in resources development.

The initial expenditure for drilling and equipping oil and gas wells is usually a major portion of the cost of operation over the entire productive life. Taking into account not only the equipment placed immediately in and upon the well, but all facilities required for the development of a property, the intangible portion may amount to about 50 to 65 percent of the total development cost.

Without the current allowance for such intangible costs, the cash flow of many operators would be so impaired that development of properties would be retarded. Lease obligations customarily provide for continuous development. Without the option to expense intangibles, many operators would find it necessary to sell or farm out por-

tions of leases to prevent default, or to employ burdensome types of financing, or carved out oil interest, to have the property drilled. If the independent producer were burdened with added financial problems in drilling development wells, his need to restrict expenditures would involve risks that untold millions of barrels of oil in less obvious formations might remain untested or undiscovered, left "behind the pipe"—with losses to the economy out of all proportion to the relatively minor effect of an immediate, rather than an amortized, allowance for the intangible costs of well drilling.

There seems to be no serious opposition to the current expensing of development costs for minerals, except in the case of oil and gas wells, where it is sometimes advocated that it results in a double deduction. This proposition appears to revolve around the option to charge the intangible portion of development costs to expense. The 1918 regulation provided that if capitalized, the amount should be recovered by an allowance for depletion. The regulations undoubtedly should have treated such expenditures, if capitalized under the option, as subject to depreciation. If that had occurred, the discussion of a so-called double deduction might never have occurred. There are convincing reasons advanced that these costs are more nearly of a depreciable than a depletable nature. To illustrate, in other industries grading, excavating, foundations, installation of materials and equipment, and similar costs are included in the total cost of facilities subject to depreciation.

Practical aspects of the problem

About 35 to 50 percent of total oil and gas development expenditures represent tangible costs which are capitalized and are not currently deductible.

During the development stage of a typical property, it is likely that a property shows a loss, or a limited net income. Percentage depletion, limited to 50 percent of net, is thus nil or reduced up to 50 percent of drilling costs. For the operator this has the same overall effect as reducing the amount allowed as intangible drilling costs.

The complexities which could arise if intangible drilling costs were required to be capitalized might well compare with the earlier administrative difficulties with discovery value, which made a formula for its substitution a practical necessity. The drilling of every well is a unique and different operation. Mechanical difficulties of varying degrees are often encountered. Drilling bits, drill pipe, or other tools may twist off or be lost in the hole, and costly "fishing jobs" may result. Wells are often drilled and then plugged back to a higher productive zone, with part of the hole abandoned. Drilled to the wrong side of a fault, a well may be sidetracked up the hole, and whipstocked or directionally drilled across the fault to a productive sand. Testing of productive potentials and characteristics may be done as a part of the drilling operation.

Under any treatment, equity would dictate that a material portion of drilling costs would be written off in any event—"fishing jobs," like casualty losses, could hardly be capitalized for tax purposes, nor dry holes, nor sidetracked or abandoned portions of hole, and the like. And in the important projects of water flooding of subsurface formations for secondary recovery, drilling of additional wells required for this operation takes on the nature of producing costs.

It is thus concluded that the current expensing of mining development costs and intangible drilling costs is an incentive, and provides cash flow for development through immediate deductibility, although the monetary and tax effects are substantially reduced because:

(*a*) A substantial portion of development costs are now capitalized in all events.

(*b*) By reductions in statutory depletion during the development stage, the overall effect is similar to the disallowance of a material portion of intangible development costs.

(*c*) By reason of the nature of development and drilling operations, equity and realistic treatment would call for expensing the often considerable costs of partially abandoned hole, plugbacks, mechanical failure, and the like.

Exploration Costs

Some resources development involves little or no exploration. Timber, sand, and gravel, and to a partial extent coal, are examples. On the other hand some minerals, oil and gas, and sulfur are found as a result of great exploration effort and financial risk.

A report by the President's Materials Policy Commission states in part:

> * * * exploration expenditures are given considerably less generous treatment than development costs, which is difficult to reconcile with the comparative importance of these two types of expenditures for the long-run supply problem.[11]

In the search for oil and gas, the costs of geological and geophysical exploration programs and related exploratory activity may be deducted only when the activity does not result in the acquisition or retention of potentially productive properties. Otherwise such costs must be capitalized.

An awkward and almost disheartening situation has developed in the application of this rule to these important modern techniques, and the administrative problems and resulting costs for producer and the Treasury seems to require some better solution.

All such exploration costs must now be allocated against areas or properties. Pages would be required to describe the problems here involved, the calculations, and the methods of allocation. Finally, capitalized costs are assigned to individual properties acquired. In the end probably upward of 90 percent of all leases are determined to be worthless and abandoned, and the capitalized exploration costs are then deducted.

While convincing reasons may be advanced that all exploration expenses should be deductible (comparing to research and development expense in other industries), it would appear that at least an immediate step should be taken as follows:

1. Permit the deduction in the year paid or incurred of all geological and geophysical expense.
2. In the event of discovery or development of any property acquired as a result of such exploratory expense, then require the capitalization and addition to taxable income of such expenses attributable to the property.

This should result in a significant stimulation in geophysical and geological activity of the independent producer, as well as reducing

[11] Report, June 1952, vol. V, p. 17.

unnecessary costs of doing business. Although he can expect ultimately to write off the greater portion of such costs (unless property abandonments occur when he lacks offsetting income), the capitalization of these amounts for perhaps a number of years during the lease terms reduces his cash flow and resources available for the all-important exploratory effort.

Percentage depletion at rates now provided in the law recognizes and approximates the capital values of producing properties, and is representative of the value created through discovery. The protection of such capital value is essential if independent operators are to continue to risk funds in discovering or developing the resources they produce.

Provisions in the law for development expenses take into account the nature of the mining and oil industries, and permit current expensing of the intangible portion of such costs. This is an incentive to development, and at the same time is realistic, equitable in the long run, and permits the operator to retain the cash resources needed for sound development. Improvement is needed in the treatment of certain exploration costs so that the independent producer is not retarded in his vital exploration activity.

Only with laws which recognize the fundamental nature of the resources industries will the impact of Federal taxation permit their continued vitality and development, which is basic to the welfare of our national economy, our defense, and our continuing progress.

TAX POLICY AS REFLECTED IN STATUTORY PERCENTAGE DEPLETION FOR OIL AND GAS

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Almost from the day of its enactment that provision of the Revenue Act of 1926 allowing percentage depletion in the case of gas and oil wells has been repeatedly attacked. Until there is widespread, clearer understanding of its effects and of the peculiar circumstances which characterize the gas and oil industry, the provision likely will continue to face bitter opposition.

It is interesting, and certainly a little ironic, that the cumbersome and administratively difficult discovery-value depletion method in effect from 1918 to 1926 was never subjected to such adverse criticism as its successor, percentage depletion, which the Treasury Department asked Congress to adopt in 1926 in lieu of discovery value. This difference in public acceptance of the two methods emerged despite the fact that the basic principle of allowing the owner of a wasting, nonreproducible asset to recoup its value as return of capital rather than as income remained the same. Only the method of recovering capital value was changed.

By the Revenue Act of 1918 Congress said that depletion should be based upon the fair market value as of the date of discovery or within 30 days thereafter. Numerous technical difficulties made discovery valeu impossible to administer fairly—fairly to government and taxpayer alike. Then finally in 1926 Congress responded to the request of

tax authorities and adopted the following provision which remains in effect:

In the case of oil and gas wells the allowance for depletion shall be 27½ percent of the gross income from the property during the taxable year. Such allowance shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph (sec. 204 (c) (2), 44 Stat. 9 (1926)).

To those unfamiliar with the fundamental principle underlying the depletion concept, it seems like rank subsidy and special privilege to allow 27½ percent of gross income as depletion year after year. Yet this was the percentage figure, compromised between 25 and 30 percent, believed to realize about the same results as discovery-value depletion without the guesswork of determining discovery value and without the severe economic injustice arising from miscalculation. In fact, before the 27½-percent rate was adopted, the Joint Committee on Internal Revenue Taxation, headed by L. H. Parker, after thorough-going research had arrived at a figure of 32-percent depletion as the average of gross yield from the sale of a barrel of crude oil under discovery-value depletion experience. On occasions thereafter, Congress has reviewed the question of the rate and has repeatedly confirmed it. So the figure of 27½ percent was not, as some people say, merely a number arbitrarily pulled out of a hat.

Furthermore, the assertion often heard from opponents that percentage depletion is purely statutory grace is open to serious question. Certainly it is not purely so.

The 16th amendment had to be adopted before a Federal income tax could be laid. Until then such a tax had been prohibited by the constitutional limitations applying to direct taxes. The amendment simply reads:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

But the application of an income tax is not as simple as the wording of the amendment. What is income? was an early question that the courts had to settle. In the case of *Eisner* v. *Macomber* (252 U. S. 189 (1919)) in which it was ruled that stock dividends were not income subject to tax, the Supreme Court went so far as to define income from property as—

not a gain accruing to capital, not a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal, that is income derived from property. Nothing else answers the description.

When that "something of exchangeable value proceeding from the property" happens to have in it a part of the property itself, more than income is involved. There is a return of capital. In the case of wasting assets such as the products of mines, wells, and timber tracts the term "depletion" is used to mean the value of the assets extracted or severed. A counterpart but not a synonym is "depreciation," also an accounting term, applying to the value of buildings, machinery, equipment, and similar man-made replaceable capital used up in producing a product or a service. Such used-up capital value must be

subtracted (along with all expenses of production and sale) from gross income in arriving at income subject to tax. If depletion and depreciation are not accounted in that manner, then a return of capital is included in income. In other words something more has proceeded from the property than mere income.

In *U. S.* v. *Ludey* (274 U. S. 295), the Court said:

> The depletion charge permitted as a deduction from gross income in determining the taxable income of miners for any year represents the reductions in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets.

Again in *Anderson* v. *Helvering* (310 U. S. 404), the Court held:

> The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance.

Depletion allowance, then, is not purely statutory grace. It is a deeply rooted, sound economic concept, recognized in standard accounting practice and sanctioned by the courts.

A careful review of the perennial conflict over percentage depletion indicates that a real difference in the debate arises from the valuation of the depleted quantity. Some opponents of the existing percentage depletion provision concede that depletion must be allowed, but they say that it is unfair to permit as total depletion more than the costs which the owner of the wasting asset incurred in finding and developing the asset. After 100 percent of the costs are recovered there then should be no more depletion allowed on that property unless further outlay should be made and capitalized for depletion.

This position is not in strict accord with the economic concept of depletion, because it assumes that return of capital is synonymous with return of capital cost or capital outlay. Also implicit in the position is the assumption that capital cost, when recovered and reapplied, will find and develop a similar amount of the wasting asset to replace the quantity severed. Both are false assumptions.

Unless the oil industry can continue to find oil to replace that which has been taken out, obviously the industry, like merchants unable to obtain inventory to replace goods sold, must go out of business. To allow as depletion merely the cost of finding the severed oil and not the value of the oil severed severely handicaps the producer in his efforts to replace the wasting asset. Even with the percentage depletion now allowed no assurance can be had that such an expenditure will find an amount of oil for the producer that will replace his depleted asset. On the other hand, some other producer may find even more oil with his depletion allowance. Such are the vicissitudes of oil discovery.

Data show that the finding of new oil deposits is becoming increasingly difficult and certainly far more expensive as deeper wells have to be drilled. The average cost of a wildcat well at present high prices and at the greater depths now being drilled is about $90,000. Sometimes 1 well will run as high as a million dollars, despite the fact that only 1 wildcat in 53 has added as much as a million barrels of oil to the Nation's reserves, and the chances are 1 in 248 of finding a 10-million-barrel well or better. Only once in 1,201 tries will a well turn out to be in the 50-million-barrel class.

It is true, as critics have said, that when individual producers are singled out and cited as examples there seems to be injustice in the percentage depletion allowance, and, therefore, to be grounds for charging "favoritism." However, when the industry as a whole is taken into consideration an entirely different conclusion must be drawn.

There is no reason to believe that the removal of percentage depletion would eliminate the extremes of wealth in the oil industry. Those extremes arise from the element of luck, very largely.

Removal of depletion allowance would only cause the discoverer of oil to sell his holdings, take his capital gains at the tax rate so applying, and look for further finds which in turn he would sell. The buyer, on the other hand, would set up for depletion 100 percent of his cost. Assuming reasonable estimation of the quantity of oil recoverable, it is difficult to see how the Government would gain any more revenue than it does at present or how the extremes in individual wealth would be reduced.

It is significant to point out in this connection that the existing provision of the revenue law applying to capital gains fits like hand-in-glove with the depletion provision. In fact, in *West* v. *Commissioner of Internal Revenue* (150 Fed. 2d 723), the Circuit Court of Appeals (Fifth District) held:

> The depletion allowance was intended to encourage production, and may be regarded as a substitute for the capital gains allowance where the taxpayer, instead of selling, leases or operates his own mineral holdings.

Oil production is not a manufacturing or processing operation. When lifted to the wellhead, oil is sold in its natural form. The courts have ruled that oil in the ground is realty—a capital asset just like land. The sale of oil at the surface of the well is very similar to an installment sale of property. And plainly it has again and again been ruled that if the oil should be sold in its entirety in the ground the sale is a capital-gain transaction.

The language of the Select Committee on the Investigation of Internal Revenue (S. Rept. No. 27, 69th Cong., 1st sess., January 7, 1926) was forceful and to the point:

> This increment in value, due to discovery, is the same increment which is realized if the oil well or mine is sold as a whole instead of by the ton or barrel, yet if the well or mine is sold as a whole instead of by the ton or barrel, taxable gain is the difference between the cost or March 1, 1913, value and the price obtained for the property.
>
> The increment in the value of the property due to discovery of minerals, oil or gas can in no way be differentiated in principle from the increment in value of real estate, stocks, bonds or other property.

If no concession should be made to capital gains and such gains should be treated as ordinary income (and percentage depletion be removed too), then it is reasonable to predict that the inducement to explore for oil would be so reduced because of the extra hazards that the Nation's reserves would fall and the price of oil and its products would rise appreciably. If demand should be sufficiently inelastic to support a price increase large enough to stimulate discovery effort equivalent to that under percentage depletion, there is reason to suppose that the price would have to increase substantially. However, it is doubtful whether the demand even approaches such inelasticity.

Taking into account the urgent need for large oil reserves for national security and for our peacetime use, one can venture the assertion that the removal of percentage depletion would only be a step in the direction of ultimate nationalization of the oil industry. That is a bitter alternative. In fact, opponents of percentage depletion at unguarded moments have offered the alternative of subsidized exploration—one step removed from nationalization. (See Harvard Law Review, vol. 64, No. 3, p. 364, in which Dean Erwin R. Griswold of Harvard Law School suggests direct subsidies to explorers.)

If it were not for the peculiar economic nature of the oil and gas industry, one might argue properly that its incentive and regulation should and could be left to market price. The President's Materials Policy Commission considered this point carefully and in its report of June, 1952, stated:

> Because of the past erratic price behavior of minerals and the long interval between additional investment and yield from production, the Commission concludes that incentives provided through the price structure are unlikely to bring about enough exploration and development to meet the national need for domestic production of scarce minerals.

Then, the Commission very tersely observed:

> There is a real danger in perennial tampering with these percentage depletion rates.

Critics of percentage depletion seem never to grasp fully the vital fact that the oil producer's capital must continuously revolve in the highly unpredictable business of finding oil—that he cannot be reasonably certain that his capital can be replaced at a price or cost comparable to the value of capital depleted, as can the merchant who replenishes his stock of goods or the manufacturer who replaces his depreciated machinery. Granted all are subject to the vagaries of price fluctuations, yet the latter are minor compared with the capricious search for oil. If such understanding could be grasped by the critics, they would then realize what the oil producer means when he says that his capital would be largely taxed away if percentage depletion and capital gains should be removed—not taxed away immediately but in sizable portions each time his capital turned. You would have a situation somewhat analogous to "the take of the house" on each roll of the dice or the wheel—with "the house" in the long run getting all the capital. Those who fathered the 16th amendment never intended for the income tax to be so applied—and the courts have consistently excluded return of capital from the definition of income.

Oil is the only major industry where at least three-fifths of every dollar of sales must be reinvested to find and develop new capital assets to replace assets depleted.

Oil exploration requires funds that are difficult to obtain through credit processes, since the hazard is so great. The explorer depends upon venture capital and upon the over-all difference between cash income and cash outgo to provide funds for exploration and development. To him the removal of percentage depletion would be a serious blow, more especially now that tax rates on ordinary income are so high. With his chances in the game of finding oil being about 1 out of 9, the odds would stack even higher with the Government ready to take the bulk of his capital assets in taxes when he should find such assets.

If oil production were as lucrative as some critics say, then an abundance of funds would be forthcoming, eagerly seeking a fling at the game, but such is not the case.

It is true that once the independent operator finds oil and possesses a capital asset he then can arrange his financing in part through commercial banks and other credit sources, assigning oil runs as security. But, again, the 27½-percent depletion allowance looms large in credit financing. Take it away from the operator and further financing would be very difficult, to say nothing of the great burden of meeting outstanding loans and continuing in business. According to the Independent Petroleum Association of America, 30 of the larger oil companies have been forced to borrow over $5 billion in the past 20 years, despite assertions from various sources that the 27½-percent depletion allowance is excessive.

The statement is frequently made that depletion "benefits" go to some people who do not take any risks. Royalty owners are specifically cited. The economic interest of the landowner or the royalty owner legally stems from the fact that in America, he and not the Government is presumed to be the rightful owner of mineral rights and to be the beneficiary of a fair return from such holdings when and if value is determined, hence a right to share in the depletion allowance.

Although it is true that the royalty owner does not assume the same degree of risk associated with the producer or developer, his role is important in the industry. He has been an effective ally of the small producer and by protecting his own interest he has made it possible for individual producers to enter the business without having first to acquire enormous property holdings.

Furthermore, through royalty interests widespread economic benefits have gone to hundreds of thousands of people in this country, many of whom are small farmers. And annual lease payments are made to still more in whose land no reserves have been found as yet, and may never be found.

The charge of "subsidy" is often heard against percentage depletion. Sometimes the cry is "special privilege." If one means by "subsidy" or "special privilege" a deduction to one industry that is not available to others, then percentage depletion available to natural-resource industries will fall in the category so labeled. Those who hurl the charge of subsidy or special privilege forget that the rule of classification in our tax system was developed in recognition of the fact that all taxpayers are not alike in economic circumstances. In practice and in theory it is well established in this country that taxpayers may be "classified" into separate categories on the basis of differentiating characteristics and taxed differently from taxpayers in other classes. As long as taxpayers within the same classification are treated alike, then there is no violation of uniformity, there is no discrimination. A tax system which did not take into account the fundamental differences existing among taxpayers would be unjust, indeed. In our complex economy it is paradoxical that only by treating classes of taxpayers differently can we treat all taxpayers fairly.

Different types of businesses have always required different tax treatment. Savings and loan associations, insurance companies, banks, railroads, cooperatives, and personal holding companies are a few of

many examples of businesses that have been taxed differently from other corporations.

Of course the classification must be reasonable and not arbitrary. In part, at least, percentage depletion has been justified for the oil and gas industry to compensate for the extra hazards inherent in the industrial and to encourage the necessary development of a vital natural resource.

The courts have repeatedly recognized that the producer of petroleum is in a business which presents problems and difficulties not common to other businesses—not shared by other taxpayers. No more forceful language on the point was ever used than that of the Texas Court of Civil Appeals in *Logan* v. *Elliott* (61 S. W. (2d) 157):

> The uncertainties of finding oil, the vicissitudes of drilling and production, the whimsical traits of wells after being brought in, are common knowledge. All of them make such a contract highly speculative in its nature. It is generally a gamble upon the fickle wheel of fortune.

Furthermore, in our democratic society we have used for a long time the power to tax as a means of achieving certain nonfiscal ends in the interest of the general welfare. We tax not only for revenue but to restrain or contain those practices that are considered to be socially or economically undesirable, and we accord favorable tax treatment to activities we want to encourage or stimulate.

Another important part of Federal tax policy relating to oil and gas is "expensing of intangibles." Because both percentage depletion and expensing of intangibles are permitted under the law, some critics claim "double" deductions.

The fallacy of the "double deduction" claim arises from the failure to understand that there are two distinct economic steps involved—(*a*) the exploration and discovery of oil, and (*b*) the development and production of oil. Percentage depletion has been allowed by Congress as a method of recovering the value of the capital asset (oil) discovered. Expenses of development and production are allowed in a different manner—a manner more nearly comparable to the treatment of expenses by any other business for tax purposes. In oil operation, expenses are divided into two classes: "tangibles" and "intangibles." Tangible expenses are those entailed for physical equipment such as casing, tubing, pumping equipment, and such items which have a salvage value if the well is abandoned. The investment in tangible equipment is recovered through depreciation over the anticipated life of the property in the same manner as other businesses recover their investment in physical equipment and in buildings.

Intangible development expenses, however, may be recovered optionally by the oil operator in capitalized form for return over a period of time, or they may be recovered as an expense in the year incurred. Because intangibles are such items as wages, fuel, repairs, hauling, supplies, etc., "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas," they do not result in an asset which can be sold or salvaged as such. They are current expenditures. Since the operator would not recover his intangible outlay under the depletion option except over a long period of time, he generally elects to treat his intangibles as current charges for tax purposes, enabling him to get back his money quickly to use in further operations. The only concession to him under the law is

the time concession—he is allowed to deduct his expenditures only once.

Evidence is abundant that tax provisions applying to oil and gas have accomplished well their nonfiscal purpose of stimulating the search for oil reserves, and that search has enlarged the Nation's proved reserves from 7,500 million barrels in 1925 to 29,560,746,000 barrels on January 1, 1955, at the same time supplying our growing domestic and military needs year by year.

Reports from authentic sources based upon thorough research show beyond any reasonable doubt that the demand for oil can be expected to continue to grow vigorously in the years ahead. The President's Materials Policy Commission predicted in 1952 that the demand for crude oil and its products would more than double by 1975. Domestic demand in 1950 amounted to 6,510,000 barrels per day and last year was 7,752,000, but by 1975 it will be 13,700,000 barrels per day. Present reserves are only about 5.9 times the estimated demand for 1975.

Here is probably the most impressive way to express the task that lies ahead: The ratio of proved reserves to annual production for the past 30 years has been running around 12.5. If we assume that such a ratio is comfortable, then we must have proved reserves of about 62,500 million barrels by 1975.

It will be necessary to have new discoveries and developments amounting to around 5 billion barrels per year on the average for the next 2 decades just to be as relatively well off as we are right now. Yet the largest amount ever coming from new discoveries and new developments in any one year was 5,138 million barrels in 1951.

Although the projected demand for 13.7 million barrels per day by 1957 seems almost incredible, we have only to look backward at what has happened to demand over the past 35 years to realize that the estimate is not unreasonable. Total demand in 1920 was 535,380,000 barrels or about 1.4 million per day. By 1930 it had increased to 1,082,494,000 barrels (about 3 million per day), or an increase of 102 percent. By 1940 it had grown to 3,981,000 barrels a day, up 33 percent from 1930. By 1950 it was 6,500,000 barrels a day, up 66 percent from 1940.

Actually the demand for crude has increased fourfold in this country since World War I. Greatest single source of increased demand has been from the development of automobile, bus, and truck transportation; and in rail and water transportation there has been an extensive displacement of coal by liquid fuels. Air transportation, civilian and military, has grown phenomenally as a user of oil products. Substantial inroads have been made by oil and its products in still other directions—for residential and commercial heating, for numerous new industrial purposes, particularly in the realm of chemistry.

In some lines of use, oil has come into close competition with other sources of energy. Particularly is this true in stationary heat and power. Development of more hydroelectric powerplants would offer some relief in the use of oil for these purposes, depending upon comparative unit costs, and whatever developments in the practical application of atomic power that may come seem more likely to be in the same direction.

There is left, then, the vast demand from transportation for which there appears to be no energy substitute remotely practical as a replacement for liquid fuels.

Just about any way you approach the daily demand estimate of 13.7 million barrels by 1975 you have to admit that it is not fantastic.

The oil industry's record to date has been phenomenal. Few, if any, industries can match the record. The technical performance of the industry has been outstanding. Proved reserves have steadily increased. Production volume has been enlarged greatly. The quality of motor fuels, lubricants, and other petroleum products has been raised, while the real cost of refining has been reduced substantially. With this spectacular performance have come lower prices all along the line so that today petroleum products are not less than 15 percent lower in constant dollar price than they were 25 years ago; despite the fact that crude oil costs about a fourth more to find.

At the same time there is no evidence that the industry as a whole has made exorbitant profits. On the contrary profits of corporate units in the oil industry have not been out of line with profits of other industry categories, such as manufacturing.

The industry is confident that the job ahead can be done. Its past record qualifies it for a fair chance to do the job, and a fair chance surely means, above all, a satisfactory economic and political environment.

To date our Federal tax policy has treated the industry fairly. Results testify to the wisdom of that policy. To remove or modify tax provisions in effect successfully over almost 30 years would seriously impede the industry in its efforts to meet the challenge that lies before it.

No one knows for sure the ultimate discovery potential in the United States. Efforts to estimate it hinge around a lot of assumptions and definitions of terms, but one estimate in 1948 fixed the amount yet to be discovered at 54 billion barrels. If that were correct, then the discoverable amount is now down to less than 40 billion barrels because of discoveries since 1948.

How seriously we can take these figures is something none of us can answer. The President's Materials Policy Commission was inclined to discredit them by pointing out (1) that the industry continues to discover oil roughly in proportion to exploratory effort; (2) that a large part of new proved reserves has been found in areas that had already been intensively explored and which were thought to be negative; (3) that past estimates of ultimate discovery have all turned out to be much on the low side.

However, the Commission did say that although—

> domestic crude production is still far from the end of the road, even under fairly optimistic assumptions it probably cannot keep pace with rising domestic needs up to 1975.

Some people have been predicting for a long time that our oil would be gone in 10 or 20 years. Yet the industry has kept right on enlarging proved reserves to an all-time high at the beginning of this year.

Because of the vital importance of oil to the Nation's welfare, and because it is one of our great basic resources, public policy has long since become injected into the oil business. America's security in this age of mechanized warfare alone makes it impossible to ignore the public interest in any reasonable approach to the oil situation. The logic is unassailable:

1. Our country's welfare takes top priority over all else—over individual interests, over industry interests, over political inter-

ests—so that all national policies should be based upon what is best for the welfare of the United States and her citizens.

2. That in an unfriendly world such as currently exists, America's security is absolutely essential to her welfare.

3. That this Nation's security in a very great measure depends upon her military and economic strength.

4. That, in turn, her military and economic strength would be greatly impaired without an adequate energy supply. (Petroleum products and natural gas furnish more than 50 percent of all the energy supplies in this country.)

5. That an adequate energy supply must be provided within the borders of continental United States. (We cannot depend upon foreign oil for our security.)

It is difficult to refute this logic, but it builds a case for the role of Government only to the extent that the private domestic oil industry is unable to fulfill the responsibility of finding and developing adequate reserves of crude oil and natural gas, as well as adequate productive capacity.

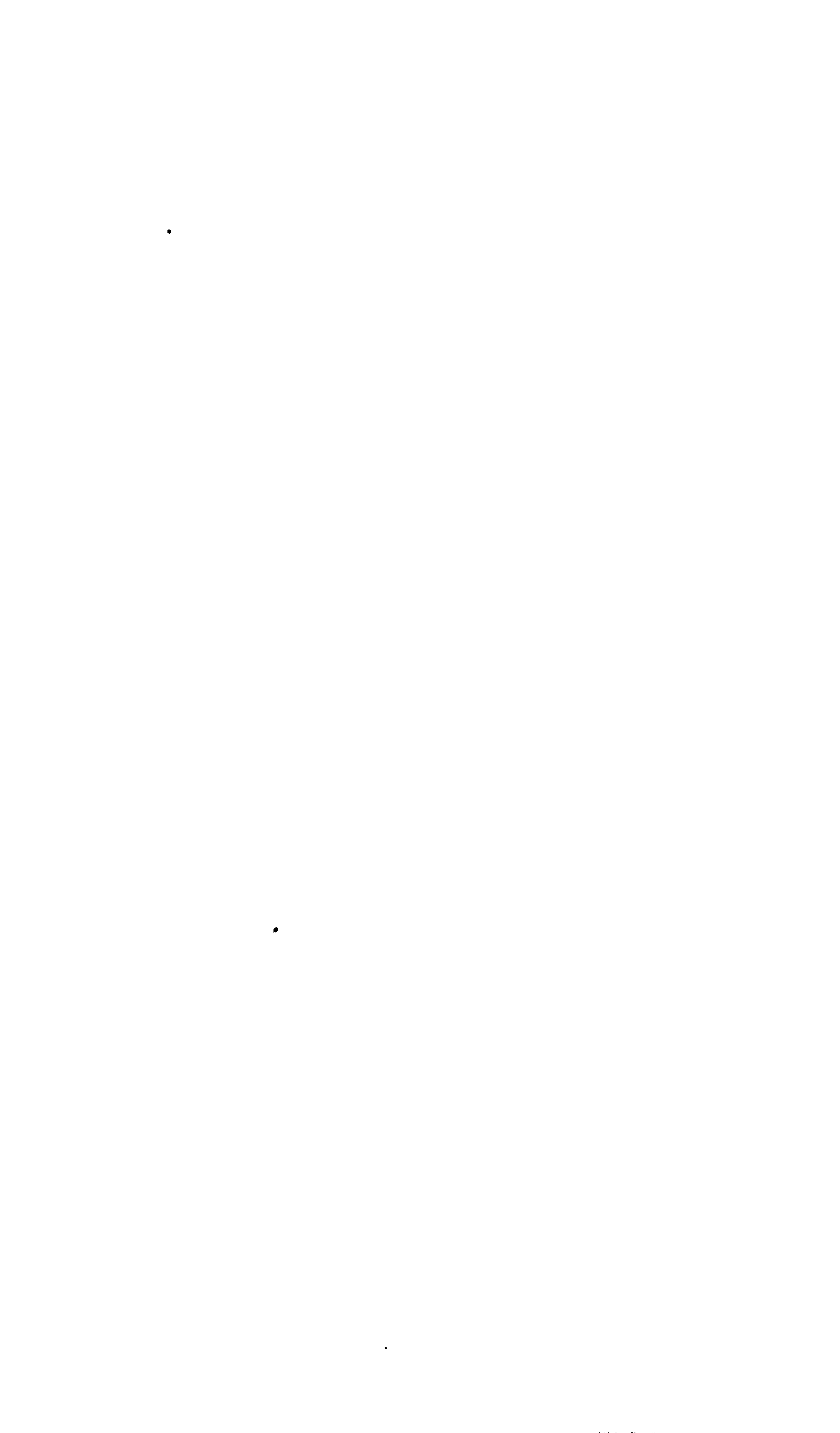
In the light of the overall situation, there seems little doubt but that modern Government can, and does, have a marked influence upon the functioning of industry, and especially the oil industry. Most of us are reconciled to that fact. Through tax policies, through fiscal, monetary, and credit policies, and through its tariff policy, the Government does condition economic environment. And in our day it is an accepted thing for the Government even to subsidize in the public interest.

It would be difficult to refute the claim that without the existing tax provisions applying to oil and gas it is seriously doubtful whether the industry's record could possibly have been realized. The Subcommittee on Tax Policy of the Joint Committee on the Economic Report is studying Federal tax policy as the latter might contribute to "economic stability and growth." The danger is great that the Nation's economic stability and growth will be impaired not stimulated, by changing the tax policy now applicable to the oil and gas industry. The record speaks loudly and clearly against such change.

Our country is the only major Nation of the free world with sufficient oil inside its own borders for peace or war. President Eisenhower told the American people that the production of oil and steel—

> are deterrents upon the men in the Kremlin. They are factors that make war, let us say, less likely.

It cannot be denied that Federal tax policy applying to the development of oil and gas resources has contributed in a large measure to this fortunate position.



X. THE EFFECTIVENESS OF TAX DEPRECIATION POLICY IN COUNTERACTING ECONOMIC FLUCTUATIONS AND PROMOTING ECONOMIC GROWTH

WEAKNESSES OF ACCELERATED DEPRECIATION AS AN INVESTMENT STIMULUS

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INTRODUCTION

Like any other item that enters into the determination of taxable income, the amount of depreciation allowed for tax purposes affects business decisions. Variations in it can change the rate at which business firms find it worthwhile to purchase depreciable assets, and thus alter productive capacity and the rate of economic growth. Cyclical fluctuations in capital formation may also be modified both in amplitude and in length through depreciation modifications. And, since tax allowances may also affect business accounting, they may enter into decisions about prices, wages, dividends, and the like.

In addition to these economic effects, depreciation allowances have equity consequences in that they alter the definition of income and the amount of taxes different business firms pay. This question—the effects of various depreciation methods on the accuracy with which income is measured—has been the primary focus of past discussions. Important as it is, I intend to give primary attention to certain of the economic consequences of accelerated depreciation methods—methods that are not designed to improve the measurement of income or achieve greater equity, but rather to stimulate certain economic effects.

The economic aspects of depreciation policy have received increasing public attention during World War II and in the immediate postwar years. Many countries adopted various kinds of accelerated programs to achieve one or more economic results. England, for example, was motivated primarily by the desire to stimulate the replacement of obsolete plants and to gain a stronger position in postwar world markets. Sweden had used rather extreme forms of optional depreciation for countercyclical reasons even before World War II. Canada's depreciation program was geared to deflationary prospects in the immediate postwar period, and was intended as a shot in the arm to pick up deficient demand. None of these initial programs has stood without modification. When deficient demand turned into excess demand and inflation threatened, all of these programs were suspended or modified. Canada not only stopped but actually reversed its policy by postponing normal depreciation on assets purchased in inflationary period.

In 1954 the United States embarked on such a program for the first time in a peacetime period. An examination and appraisal of

this specific program in the following section represents an introduction to an analysis in the last section of the major problems connected with any kind of accelerated-depreciation device.

Appraisal of 1954 Depreciation Legislation

The Internal Revenue Code of 1954 permitted unrestricted use of the sum-of-year-digits depreciation for the first time,[1] the declining-balance method at double the straight-line rate,[2] and any other methods that give no more than this latter method over the first two-thirds of the useful life of an asset. In addition, existing methods of depreciation, such as the straight line, were continued. These new methods were limited to new depreciable assets with a life of 3 or more years, the costs of which were attributable to 1954 or later years.

This legislation falls into the accelerated-depreciation category. It was clearly designed to speed the rate of economic growth rather than to improve the equity of the income tax. The administration's case rested on hoped-for economic effects of the change in depreciation policy, not on whether or not the definition of taxable income would be improved, and no evidence was brought forth indicating existing depreciation methods were inadequate or inaccurate in measuring income. Moreover, the new methods were made applicable only to new assets acquired after a certain period, rather than to all assets of a particular kind. Obviously, if the primary desire were equity, limitations on the kinds of assets that could get special treatment would be inappropriate.

How well can these provisions be expected to achieve their goal of economic growth through investment stimulation? Any specific decision by business management about the purchase of new depreciable assets will be likely to take into account the fact that taxes can be postponed under the new depreciation methods. Depreciable assets thus become more profitable to invest in than they previously were. This postponement of taxes permits a more rapid recovery of the cost of the asset, thus saving interest and reducing risk. These are factors increasing the incentive to invest. In addition, the ability to invest is increased through the reduction in taxes presently payable, and the consequent increase in working capital.

INCENTIVES TO INVEST

Consider, first, the effect of the new policies on investment incentives. The value of the postponed taxes to a firm will depend on the rate of discount for risk or interest that is used in the investment decision and on the tax rate. The present value of tax postponement can then be expressed as a percentage of the cost of the depreciable asset whose purchase is contemplated. Table 1 shows the difference between the present worth of sum-of-year-digits depreciation and straight-line depreciation under various assumed discount rates and

[1] The sum-of-year-digits method results in a depreciation rate determined by dividing the number of years remaining in an asset's life by the sum of each of the digits in its life.

[2] The declining-balance method applies a constant depreciation rate to initial cost less total depreciation already taken.

asset lives. The present value of the tax postponement from using sum-of-year-digits depreciation can then be found by multiplying these figures by whatever tax rate one wishes, on the assumption that future tax rates remain unchanged.

Table 1.—*Present worth of depreciation deductions as percent of cost of asset sum-of-the-years-digits and straight-line methods*

Length of life	Sum-of-the-year-digits Discount rates of—			Straight-line Discount rates of—			Excess of SYD over SL Discount rates of—		
	4 percent	12 percent	20 percent	4 percent	12 percent	20 percent	4 percent	12 percent	20 percent
	Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
10	85	66	50	81	55	39	4	11	11
20	75	48	33	68	36	22	7	12	11
30	68	38	25	57	25	15	11	13	10
40	61	31	20	49	20	11	12	11	9
50	56	26	16	43	16	9	13	10	7
100	37	14	9	24	8	5	13	6	4

Source: E. Cary Brown, The New Depreciation Policy Under the Income Tax: An Economic Appraisal, National Tax Journal, VIII (March 1955), p. 92.

These data reveal that the stimulus to investment in depreciable assets is modest at best, and is surprisingly little affected by the expected life of the asset or by the rate of discount applied to it. Given a particular rate of discount, the present value of the tax savings from the new method rises as the expected life of the asset rises until it reaches a maximum and then begins to taper off. Given the expected life of the asset, the present value of the tax savings rises as the discount rate rises, but again it reaches a maximum and then tapers off. Over a fairly wide range of asset lives and of rates of discount, the tax savings from the new method computed at a 50-percent rate appear to be about 5 percent of the initial cost of an asset. In other words, it is as if investment yields after tax were increased roughly by about 5 percent (not 5 percentage points). For example, it would mean that 10 percent yields would now be 10½ percent, 20 percent yields 21 percent, and so on. This is nearly an across-the-board increase in yields. It does not appear to be directed toward particular types of firm, degrees of risk, or the like. It then become strikingly similar in its incentive effects to a cut in the income-tax rate.

ABILITY TO INVEST

The 1954 depreciation revisions will also change the ability to invest in depreciable assets. The amount of taxes postponed by a particular firm will depend on the rate of growth of its depreciable-asset purchases, on future tax rates, on the expected lives of its depreciable assets, and on the extent to which it avails itself of the new methods. Moreover, these postponed taxes can become virtually a permanent reduction. While taxes are only temporarily postponed on one particular depreciable asset since early excess depreciation is offset by later deficient depreciation, the continued purchase of depreciable assets continues this temporary postponement. As long as the firm continues to purchase depreciable assets at the old rate, the tax postponement never has to be made good. The temporary postponement through

excess depreciation on these new purchases matches deficient depreciation on old purchases. Only when the firm's purchases of depreciable assets shrink, or when it liquidates, are the postponed taxes ever recovered. When the firm increases its rate of purchase of depreciable assets the permanent tax postponement actually grows.

Estimates of the amount of revenue losses from the new methods have been made by the staff of the Joint Committee on Internal Revenue Taxation, on the assumption that purchases of depreciable assets continue at present rates. These show that the amount of tax reduction will start out modestly in the first fiscal year at less than one-half billion dollars, rise rapidly to over $1 billion in 1960, and gradually decline to zero by 1970. But if there is growth in the rate of purchases, the tax reduction will be considerably larger. Assuming a rate of growth of 3 percent as in the past, my estimates (table 2) place the figures at over $2 billion in 5 years, over $4 billion in 10 years, nearly $4 billion in 15, over $2 billion in 20 years, from which point on the revenue loss would grow at 3 percent per year.

TABLE 2.—*Aggregate straight-line and sum-of-year-digits depreciation, growth in depreciable-asset purchases 3 percent per year, 20-year assets, 50 percent tax rate*

[In billions]

Year	Purchases of depreciable assets [1]	Depreciation			Year	Purchases of depreciable assets [1]	Depreciation		
		Straight-line	Sum-of-year-digits	Difference (SYD−SL)			Straight-line	Sum-of-year-digits	Difference (SYD−SL)
1	$27.8	$1.3	$2.6	$1.3	11	$37.6	$17.7	$26.0	$8.3
2	28.7	2.8	5.0	2.2	12	38.7	19.5	28.0	8.5
3	29.6	4.3	7.8	3.5	13	39.8	21.3	29.6	8.3
4	30.4	5.7	10.3	4.6	14	41.1	23.5	31.6	8.1
5	31.4	7.3	12.8	5.5	15	42.3	25.5	33.0	7.5
6	32.3	8.8	15.2	6.4	16	43.6	27.6	35.4	7.8
7	33.3	10.5	17.4	6.9	17	45.0	30.0	37.0	7.0
8	34.4	12.3	19.7	7.4	18	46.4	32.3	38.6	6.3
9	35.4	14.0	21.9	7.9	19	47.6	34.3	39.8	5.5
10	36.4	15.7	24.2	8.5	20	49.2	37.0	41.2	4.2

[1] Assumed to grow 3 percent per year from a base of $27 billion.

Source: Ibid., p. 88.

What fraction of this large increase in net income after taxes will find its way into further purchases of depreciable assets is impossible to predict on the basis of present knowledge. But this improvement in working capital would be available for capital formation—either inventories or fixed capital, for debt repayment, for payment of dividends, or for retention as added working capital. Undoubtedly some will be used for purchases of depreciable assets.

APPRAISAL

The 1954 depreciation revisions then represent a costly method of getting a modest investment stimulus. There are other, cheaper alternatives. For example, a cut in the corporate income-tax rate of 2½ percentage points would appear to achieve the same investment stimulus by increasing yields after tax by about 5 percent.[3] Moreover, the

[3] For corporations subject to the 30-percent rate, the rate reduction would have to be 3½ percentage points.

distribution of this incentive would be approximately the same as that achieved by the new depreciation methods.

Such a cut in the tax rate on present corporate income would amount to about $1 billion per year and would grow in 20 years, assuming 3-percent growth, to less than $2 billion. In comparison, the new depreciation methods will reduce corporate taxes by a larger amount in virtually every year. As a rough guess, the difference would be $30 billion over the first 20 years.[4] It seems fairly clear that direct rate reduction should be substituted for the new depreciation methods as a cheaper way of getting the same investment stimulus.

General Problems of Accelerated Depreciation

In view of these conclusions regarding the 1954 depreciation revisions, a number of more general questions arise. Is accelerated depreciation inherently a more costly way of creating an investment incentive than a straight rate reduction? When its incentive effects are strengthened, does it create other problems? For example, how does it affect the cyclical timing of investment? How are pricing and other decisions affected?

RELATIVE INCENTIVE EFFECTS OF ACCELERATED DEPRECIATION

These conclusions regarding the 1954 depreciation changes cannot generally be applied to accelerated depreciation since there are many other forms it can take. Other forms permit full or fractional write-off of the cost of assets in the year acquired or over a 5-year period and have received considerable attention. One important feature of such plans as compared with the recent one enacted in the United States is that the accelerated-depreciation portion of the allowance is the same regardless of the expected economic life of the depreciable asset. The firm is thus led to decide between two assets of different ages solely on their economic merits, and not on their favorable or unfavorable treatment under the tax law.[5]

A second feature of these accelerated-depreciation methods is that they enhance the position of the risky investor as compared with the safe investor over a wider range of asset lives. And, finally, they offer a sharply higher investment incentive than present methods, and, if pushed far enough, can provide more per dollar of revenue loss than that achieved by rate reduction.

If these methods can overcome one part of the criticism of existing methods, what then are the remaining ones? The major criticisms are the effects on economic stability and on the behavior on business decisions about prices, wages, and dividends.

EFFECTS ON TIMING OF INVESTMENT PURCHASES

Accelerated depreciation can affect the timing of investment either by creating cyclical changes in financial ability or in investment incentives.

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[4] Total business expenditures on plant and equipment in 1954 are estimated at $27 billion, of which the Council of Economic Advisers estimates $23 billion to be corporate. The estimate in the text is based on table 2, assumes a 50 percent tax rate and reduces this result by the ratio of corporate to total purchases of depreciable assets—84 percent. The total revenue loss, personal and corporate, would run to $35 billion.

[5] It can be noted parenthetically that the present form of the allowance discriminates against longer-lived assets.

1. Ability to invest

A common charge against accelerated depreciation is that it will reduce the sensitivity of tax yields to economic fluctuations, since it weights current rates of investment more heavily in computing depreciation than do normal methods. It tends to increase disposable income of firms at a time of boom through decreasing their taxes. In a depression, when rates of purchase of depreciable assets are subnormal, accelerated depreciation falls below normal, and the resulting increase in taxes decreases business disposable income. If this were inevitable, accelerated depreciation would reduce the countercyclical effectiveness of income taxes on business firms.

But before examining this question, a few factors should be placed in perspective. First, while it is perfectly clear that accelerated depreciation responds more quickly than normal depreciation in situations of long-run growth, it is not so clear that this is true for short-run fluctuations, whether superimposed on an underlying situation of growth or of stability.

Second, much depends on whether economic fluctuations in the future are minor, such as in 1923, 1927, 1949, and 1954, or major, such as 1921 or the great depression of the thirties. If the fluctuations are minor, virtually no countercyclical issue arises. In 1949, for example, business purchases of depreciable assets (in real terms) were about 10 percent below the rate in 1948 and in 1950; in 1954, they were 6 percent less than the 1953 rates. Different kinds of depreciation could vary by no more than these amounts, and ordinarily would by considerably less. But, a fluctuation of this magnitude is less than $1 billion in taxes, surely not a size of first-order importance. If, on the other hand, fluctuations will be major, different depreciation methods have quantitative significance. Real purchases of depreciable assets in 1933, for example, fell to less than one-third of their 1929 rate and did not really recover until after World War II.

But even though it is possible for various depreciation methods to have quantitatively significant differences when there are major economic fluctuations, there is no presumption against accelerated depreciation in favor of normal methods. Whether it will behave more or less cyclically than normal depreciation depends on the kind of cyclical pattern in the purchase of depreciable assets, the duration of the business cycle, and the durability of assets.

The following illustration will emphasize the danger of generalizing about this. Suppose cyclical fluctuations are symmetrical over a period of 8 years—the usually accepted average length of major business cycles so far observed. Suppose, further, that all depreciable assets have a life of 20 years. Five-year depreciation is then noticeably more stabilizing than normal 20-year depreciation in that it results in less depreciation in the upswing (first 4 years in table 3) and more in the downswing (last 4 years in table 3). One-year depreciation, on the other hand, increases depreciation in the upswing relative to the use of a 20-year period since it would follow the pattern of purchases.

TABLE 3.—*Comparison of cyclical depreciation patterns, 8-year symmetrical cycle, 20-year assets*

Period	Purchases of depreciable assets[1]	Amount of depreciation under depreciation period of—		
		5-year	8-year	Normal 20-year
1	129	166	200	188
2	200	152	200	188
3	271	166	200	195
4	300	200	200	205
5	271	234	200	212
6	200	248	200	212
7	129	234	200	205
8	100	200	200	195

[1] Purchases in period $t = 100\left(1+\sin\frac{\pi}{4}t\right)$.

An illustration of this kind obviously does not establish accelerated depreciation as more countercyclical than normal depreciation. The results depend on the particular assumptions underlying the illustration. While the ones chosen are not unreasonable, different results could be obtained by altering the shape or duration of the cycle, the average length of life of asset, and the methods of depreciation. One-year depreciation, for example, would clearly have a cyclical pattern. But this illustration does eliminate the belief that accelerated depreciation necessarily or presumptively reduces the countercyclical effectiveness of the tax. No general answer, therefore, seems possible in the abstract. These doubts about the direction, coupled with the relative quantitative unimportance of the amounts should reduce worry about this aspect of the question.

2. Cyclical effect of investment incentives

This, of course, is not the whole story. Accelerated depreciation has been accused of stimulating investment incentives cyclically, even under constant tax rates. The case rests on the following considerations. In the boom profits are high. Business firms are aware of their ability to write off rapidly the cost of depreciable assets purchased, and are encouraged to invest in them. In the depression, on the other hand, losses are sustained and rapid depreciation cannot provide added stimulus. Indeed, if the period of losses is expected to be followed by a period of profits, a rapid writeoff may actually be disadvantageous to the individual firm.

For this result to follow it is necessary that tax deductions be lost if they are not taken in a year of boom or high activity. That is to say, other years in the cycle are either low profit or loss years. But recent economic history has given us two recessions with high profits—1949 and 1953. In 1949 the number of profitable corporations fell by less than 2 percent and their income declined about one-sixth to slightly over $30 billion. Deficit corporations increased 14 percent and their deficits rose $0.6 billion to $2.4 billion. The 1954 recession appears to have fallen even less heavily on corporate profits. These, of course, are aggregate amounts. Separate industries or firms could have been affected in different ways. But still it seems a safe generalization that relatively few profitable firms slipped so far as to make deficits. In contrast, in 1932 the number of profitable corpora-

tions dropped nearly 200,000 from 1929; aggregate net income fell from $11.7 billion in 1929 to $2.2 billion. Deficit corporations in the same period rose from 187,000 to 369,000; net losses from $2.9 billion to $7.8 billion. If future cyclical swings are like those of recent years, depreciation could be absorbed in a recession almost as easily as in a boom. If they are like the great depression of the thirties, it will be much harder to absorb depreciation in depression years.

But even in this case expenses in loss years, even when they cannot be fully deducted from income of that year, can reduce taxes of other years. Under present law a 2-year carryback and a 5-year carryforward of losses is provided. Under these circumstances, it is unlikely that firms would fail to receive some tax benefit from accelerated depreciation in a year of loss. Only if they never really expected to make profits in the next 5 years, and did not make them in the 2 preceding years, would this be true. In such a situation, taxes would have little or no effect on their investment decisions in either a boom or recession.

Moreover, a special assumption must be made about the formation of business expectations about future income in order for the described result to take place. A firm must expect good years to be succeeded by bad, and bad years to be followed by good. The usual complaint about business behavior is that this cyclical behavior is usually not expected; that instead there is a tendency toward the belief that existing conditions will continue. There is overinvestment in good years because it is expected to be justified by the continuance of large future profits; underinvestment in depression years because weak markets are expected to last indefinitely. If business firms expect existing levels of profits to continue, accelerated depreciation, even without loss offsets, would not have much cyclical effect on investment incentives. Expected continuance of boom profits would not induce the firm to rush its investment in order to secure a full offset from accelerated depreciation. Expected continuance of depression losses would not induce the firm to postpone investment to a time in which accelerated depreciation could be taken.

Finally, accelerated depreciation, if used for tax purposes, may also be used in the firm's accounts. If it is, it could reduce book profits after taxes in a boom and decrease them in a depression. (Whether or not it actually will was analyzed in the preceding section.) While some students of business behavior place considerable emphasis on this factor as a damper on business optimism in a boom and a cushion under depression pessimism, it is probably too minor to warrant emphasis as a stabilizer.

Effects on Other Business Decisions

The possibility that accelerated depreciation may be used by business firms in their own accounts may have a significant effect on other managerial decisions, however. There is, to be sure, no inherent reason why accelerated depreciation will be used in business accounts, nor, if used, that it must enter into managerial decisions. The tax law permits separate sets of boks. But what evidence is available

points toward the continuation of past practices under which book depreciation tended to conform to tax depreciation.[6]

If used in the firm's accounts and in business decisions, accelerated depreciation may raise prices through artifically overstating costs, depending on the degree and kind of competition the particular firm faces. Such an eventuality could lead to a decrease in the quantity demanded of the firm's products, and some slackening of the demand for enlarged capacity. If demand did not fall off at the new prices, there would result some redistribution of income from consumers to business, with, perhaps, some effect on aggregate demand. On the other hand, failure to raise prices could reduce profits and perhaps dividends.

Existing knowledge does not allow an accurate prediction of the consequences flowing from the use of accelerated depreciation in managerial decisions. It seems sufficient to point out here that it represents an artificial, distorting influence on decisions. These decisions would be improved if based on as accurate a measure of depreciation as can presently be made by accountants, engineers, managers, economists, and other interested groups. This is a major weakness in the use of accelerated depreciation as an investment stimulus. What are the alternatives? Two obvious ones present themselves: rate reductions and investment credits.

Alternative Stimulating Devices

Rate reductions cannot achieve the same effects as some of the extreme forms of accelerated depreciation do. For example, 1-year depreciation substantially eliminates the disincentive effects of the income tax, yet large yields of taxes would still be collected under it. This same effect could be achieved by rate reductions only by virtual elimination of yields. In view of the pressing financial needs of the country, elimination of tax yields does not seem a fruitful approach to tax revision at the present time.

Tax credits, over and above normal depreciation, upon the purchases of depreciable assets can, however, duplicate the incentive effects of accelerated depreciation. They can be granted in the year when the asset is purchased or spread over several years subsequent to its purchase. (A carryforward of unused tax credits would, of course, be a feature of any such plan to avoid discriminating against firms with low profits or losses in any particular year.) Tax credits also have the important advantage that they would not creep into business accounts and distort business decisions. Since normal depreciation would be deducted from the firm's taxable income, it would ordinarily be used in the firm's accounts. These tax credits could be varied from time to time as economic conditions warranted without creating a major wrench in business accounting policies. The British after a number of years of experimentation with accelerated depreciation have gone over to what they call an investment allowance system

[6] "Adoption by many corporations of accelerated depreciation for corporate accounting, when they adopt it for taxes, is indicated." William J. Edmonds, The Effect on Business Decisions of Changes in Tax Depreciation Policy, National Tax Journal VIII (March 1955), p. 113. But note this qualification: "Subsequent information reaching the author indicates a trend among large companies toward the declining-balance method for tax purposes but with no changes contemplated in accounting practices at this time. P. 112 n Preliminary results of a study by Prof. E. K. Smith confirms the view that firms using the new depreciation methods for tax purposes will also tend to use it in their own accounts.

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which permits a 10-percent credit for industrial buildings and a 20-percent credit for machinery and equipment. Careful study of their experience has not yet been made but is urgently needed.

The tax credit for investment can be made to stimulate economic growth still further by limiting it to expenditures on depreciable assets in excess of normal depreciation. Then, only if the firm were spending more than the amount necessary to maintain the book value of existing depreciable assets would additional tax reduction be granted. Static and declining firms would receive only normal depreciation on their replacement purchases; growing firms would receive normal depreciation on all purchases plus a tax credit for purchases in excess of normal depreciation. In order to avoid encouraging business concentration through growth by the purchase of existing firms and assets, the tax credit should be restricted to purchases of new assets. This distinction is now made under the 1954 law and seems relatively easy to handle administratively.

One further advantage of the tax credit for investment in depreciable assets is that it nicely complements the most satisfactory method of eliminating or reducing double taxation of dividends, namely, the tax credit to corporations for dividend payments. Corporations could then receive a tax credit either for purchase of depreciable assets or for dividend payments; the tax consequences of decisions about retention and use or payment as dividends could be placed roughly on a par.

Conclusion

1. The 1954 depreciation changes are a more costly way of securing an investment stimulus similar to that achieved by reducing the corporate income tax around 2½ percentage points.
2. Accelerated depreciation provides a stimulus to investment that cannot be duplicated by rate reduction. It does not involve a reduction in the countercyclical effectiveness of the income tax of any serious magnitude. It does, however, tend to distort business decisions about prices and dividends.
3. Tax credits for investment provide the same kind of stimulus but avoid this distortion. They can still further stimulate growth by being limited to the excess of expenditures for new depreciable assets over normal depreciation.

FOUR WAYS TO WRITE OFF CAPITAL EXPENDITURES—CAN WE LET MANAGEMENT CHOOSE?

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I. Introduction

It is essential that there be some control over the amount of income deductions representing cost of using up long-lived assets; otherwise the tax laws would be nullified, for taxpayers would choose to state their capital wastage costs as a sum large enough to cancel out all taxable income. Congress has therefore been long and properly con-

[1] For major assistance in preparing this manuscript I wish to express my gratitude to Winfield Smith of Joel Dean Associates. For helpful suggestions, I am indebted to my associates, James Lorie and Stephen Taylor.

cerned with the depreciation provisions of the tax laws. At the same time there has been a growing awareness of the part this revenue-gathering mechanism plays in determining the composition, amount, and timing of economic activities and an increasing willingness to seek better ways of reconciling the Treasury's revenue needs with the impersonal rules of a free economy.

In dealing with problems of defining and estimating tax depreciation, Congress has before it a wide variety of concepts of capital wastage. Tax-depreciation control has taken many forms and could take many more. As we shall see, historical accidents and ancient modes of thought have had much to do with determining the system we have, and notions of abstract fairness have sometimes obscured the fact that any particular depreciation rule has economic effects that are inescapable, however unfair it may seem. This analysis takes a fresh look at the major alternative concepts and the usual justifications given for them. It then goes on to consider their effects on managerial behavior and the consequences of allowing taxpayers a wider range of choice among writeoff methods.

II. How Depreciation Rules Affect Business Decisions

It is important to understand at the outset how tax depreciation (and taxes) should affect business decisions, and how they really are affecting them in a large and growing number of cases. What is income and what is depreciation for tax purposes are determined by Congress, the Treasury and the courts. These definitions may or may not resemble those a business firm finds managerially useful in carrying on its own affairs and in making the investment and other decisions which, in the aggregate, affect income, employment, the composition of output, technological progress and economic stability. But no matter how much business measurements of income and depreciation differ from tax definitions, tax depreciation affects business decisions, and especially so in recent years. This is because high tax rates make methods of tax-depreciation important. The best and the worst methods (defined from any viewpoint you choose) are indistinguishable in their practical effects when the tax rate is low, but they may have vitally different impacts when tax rates are around 50 percent.

Taxes affect decisions because they are cash flows whose size and time distribution are importantly affected by business actions. What makes the Government's definition of income important to the corporation is that the Government takes 52 percent of it. It follows, then, that tax-depreciation methods affect business decisions only because of their effect on the size and timing of income-tax payments and not through any real or imagined similarity between these depreciation methods and the nature or economic behavior of asset values.

If a businessman defines income, investment, or depreciation in some way not used in tax computations, there is often the opportunity of arranging his affairs so that income according to the Government's definition is smaller than income according to his own or, at least, more favorably arranged over time. Thus the tax bite on what the businessman regards as his income is minimized through shifts in production methods, etc. This entirely legal and unavoidable form of

tax avoidance can have important effects on economic activity in general.

Taxes are only a cost and tax reductions through depreciation are only a benefit. Both should be treated like any other cost or revenue item in considering an individual business decision. Since many, possibly most, business decisions aim at maximizing the excess of revenues over costs, taxes affect these decisions and tax depreciation affects investment decisions especially.

This use of "cost" says nothing about tax incidence, i. e., who "pays" the taxes in the end. Wherever resources are at all mobile the ultimate incidence pattern is, to an important extent, the product of resource shifts. When all these have occurred in response to the cost and revenue effects of the tax, final incidence may be on the person or firm who writes out the tax check or it may be far, far away.

III. ALTERNATIVE CONCEPTS OF CAPITAL EXPENDITURE WRITEOFF

In this section I want to review several of the more interesting or important depreciation procedures that are used in one way or another in our tax system. Although it is usual to think of the system as having only 1 major kind of depreciation rule, or 2 at the most, an economist would have to say that there are at least 4 very distinct methods. Each of them has some useful features and each is quite capable of being applied to the entire field, although with quite different results. I will postpone to the last a discussion of the "standard" depreciation method, under which original asset cost is tax-depreciable under a schedule intended to cover the asset's entire useful life.

For a better appraisal of the economic consequences of this type of "timetable" tax depreciation characteristically applicable to corporation assets, we shall first examine three other concepts of capital wastage which may be novel and instructive alternatives to the conventional procedure. These are (1) percentage depletion, (2) "final reckoning" depreciation, and (3) "cash flow" depreciation.

A. PERCENTAGE DEPLETION

Percentage depletion is allowed for many mineral deposits and other more or less natural resources. Under it, a certain proportion of the current market value of each year's production is treated as a capital wastage allowance, deductible from taxable income, without regard to historical acquisition costs of the asset.

Percentage depletion has three distinctive traits:

1. The income deductions permitted are not limited to original cost of asset or any inflation-adjusted derivative thereof.

2. The rates are fixed by Congress. They are unrelated to producers' opportunity costs or reservation prices, except insofar as Congress hits on a correct estimate of these.

3. The depletion allowance is based on (*a*) current-dollar values of the product, not book value or original cost of the asset, and (*b*) production volume, not time.

The conventional justification for using percentage depletion instead of timetable depreciation, which would limit the capital wastage deductions to the original cost and spread them over a specified life, is that for some assets, notably minerals, life and capital value cannot be predicted even within the wide error ranges tolerated for machinery and buildings. It is much more apparent that the costs of discovering and preparing to exploit mineral and forest resources often bear no useful relation to these assets' capital values than in the case of machinery and buildings. This is partly because there is a more elastic supply of industrial buildings and equipment, so that their cost and economic value are often tolerably close.

Furthermore, if so-called wasting assets were taxed on the basis of timetable depreciation, a strange set of economic circumstances would result. Up to the end of the depreciation period, tax-deductible costs would include capital wastage allowances, so that after-tax income would be large compared with income after the end of the depreciation period; later the absence of deductions for capital wastage would swell taxable income and shrink the after-tax cash income flow. Two mines that were otherwise economically similar might thus show quite different after-tax profits, so that a mineowner's incentive to produce a ton of ore would depend on his mine's position in the depreciation timetable. Percentage depletion avoids this illogical result.

If, however, we compare the tax depreciation problems in the treatment of forests, minerals, and other "wasting assets" where depletion is now used, with the problems of treating buildings and machinery, I think we must acknowledge that the differences are of degree rather than kind. For all assets acquisition costs imperfectly reflect lifetime capital value, and both asset life and lifetime output are hard to forecast because they depend so much on future obsolescence, replacement and opportunity costs, marginal products, and other factors unknown at the time of acquisition. The strange and undesirable results that would follow if the incentives for mineral extraction were to depend on a mine's depreciation position actually occur in the case of other assets. Economic lives of manufacturing assets really do depend in part on whether there is any depreciation left as an income deduction and whether this depreciation represents high or low price levels. To an economist, and possibly to anyone, it does not seem desirable that asset lives should be affected by tax accidents. The optimum life of long-lived assets ought to be determined without intrusion of such artificial and fortuitous factors, but it isn't.

Percentage depletion has an additional feature which makes it especially attractive during and after a major change in price levels. Of all the permitted methods of allowing for capital consumption in tax calculations, only percentage depletion is inflation and deflation-proof. In my work for a wide variety of industrial firms I have repeatedly been impressed with the serious overstatements of real corporate income (and income-tax liabilities) that result when low historical costs of long-lived assets are written off against today's inflated income. In some cases real corporate income has actually been negative, in the sense that there has been shrinkage in the firm's physical size and inflation-adjusted earning power, yet book income has been substantial and income taxes have been large. The Treasury and most of the accounting profession have strongly resisted all attempts at stating corporate income after some provision for re-

placing depreciable assets at present higher costs, and I do not want to reopen this controversy here. But it is instructive to note that the problem does not exist under percentage depletion, because the depletion recoveries are always based on current product values, not asset costs of 1947, 1933, or 1927.

These novel features of percentage depletion help explain why some people with no ax to grind have looked with sympathy on proposals to extend something like it to all industry. The big problem, which exists to some extent even in the extractive industries, is to determine the value of the extracted product. It may be difficult to attach market values to ore in the midst of a wilderness, but the problem is small compared with that of attributing a dollar value to the contribution of a particular machine, or even to all depreciable assets of a company.

There is, however, another way of looking at depletion, which is to regard it as substituting (1) a perpetually lower rate on a "more gross" income for (2) a higher rate on income that is net of a fixed recovery of original cost. In this sense, depletion could easily be applied to any taxpayer who chose to use it instead of the timetable method. Whether the lower rate would be too much, not enough, or just right, to produce the economically optimum use of long-lived assets would be difficult to determine. But so is it in the case of mineral deposits and other assets to which percentage depletion is now applied.

Furthermore, I have my doubts about the wisdom of trying to use the tax system to protect some or all taxpayers from some of the effects of inflation. The way to deal with the problem of inflation may be to prevent it and not to weaken, through grants of relief, the public's already weak incentives to oppose inflationary policies. The real lesson to be learned from percentage depletion is that there is at least one depreciation method that could be applied to all assets and which would accord consistent treatment to economically similiar assets as well as avoid confiscatory taxes during an inflation.

B. "FINAL RECKONING" DEPRECIATION

Another way of treating asset writeoff is to postpone it until the asset is entirely used up or is finally disposed of by its owner. Thus the two distinctive features of final reckoning depreciation are:

1. No capital consumption allowance is permitted during ownership life, and
2. Taxable gain or loss is only recognized on sale or retirement of the asset.

Land owned in fee is the most important kind of asset so treated under our tax laws. The usual reasons given for this are that land is not consumed in any regular or predictable fashion and the only gain or loss that is administratively practical to recognize, among the many that are always occurring, is that realized when the books are closed on a particular parcel.

I do not think that these reasons make a really clear case for treating land in this special fashion, or, if they do, why many other kinds of assets should not be treated in the same way. Land can be used up like any mineral deposit or machine. Like land, the whole story on the ultimate profitability of any long-term invest-

ment can seldom be known until the books are finally closed. Once again, the differences, if any, are only of degree, and abstract reasoning does not provide a very useful guide to tax policy.

If we turn to the economic consequences of requiring that land be treated under the final reckoning method, we find that corporate-tax rates, costs of capital and inability to secure depreciation deductions provide very strong incentives for most manufacturing and trading companies to avoid holding land. The most popular way to do this is through long-term leasing from financial institutions. Insurance companies especially have become large holders of commercial and industrial land. One of the reasons why these financial institutions find land a more attractive investment than do the occupants is certainly the lower income-tax rate paid by life-insurance companies. This illustrates two points I made earlier: that tax depreciation is only important as a source of tax deductions, and that the differences among depreciation methods only become important when income-tax rates are high.

The sale-leaseback movement is thus largely a natural and inevitable product of the tax laws and especially of the depreciation rules applied to land. These leaseback arrangements tend to tie up land and other resources, sometimes in uneconomic uses, because the long-term lease contracts are usually restrictive and quite difficult to alter. They destabilize corporate income by encouraging the substitution of fixed payment obligations for common stock.

No administrative or technical problems would impede the extension of the final reckoning system to any other kinds of assets. But because its effects are so clearly undesirable where it is now applied, I think that any extension would be a mistake. Its chief lesson for us is that taxpayers will seek to avoid investing in assets that are singled out for especially unfavorable writeoff treatment, often with undesirable consequences for the economy as a whole.

C. CASH-FLOW DEPRECIATION

Under cash-flow depreciation, investment outlays are expensable immediately. There may be a taxable gain later if the asset has any disposal value.

This treatment is, in the United States, accorded to (1) all expenditures which result in no tangible, physical asset, (2) to a limited number of expenditures for physical assets which tend to have very short lives, and (3) to highly variable amounts of installation and starting-up expenditures for investment projects that are otherwise treated as depreciable assets.

Traditional ways of looking at investments, which were borrowed largely from accounting conventions of decades ago and from rules to encourage the conservative statement of assets, probably gave rise to the notion that outlays for "intangibles" should be expensable for tax purposes. But whatever may be the value of these accounting conventions for certain uses, it is hard to see how the future economic value of an investment in research, for example, is much more or much less certain than the economic value of an investment in a plant to use a new process or in a standard machine that may be obsoleted at any time. It is not even certain that only "tangible" assets can be

sold and intangibles cannot; sometimes neither can be sold and sometimes both can be.

From an economic standpoint, the conclusion is inescapable that many expenditures now eligible for cash-flow depreciation have all the important features of a long-term investment: their timing is highly discretionary, they cost money now, and they are made in the hope that they will produce benefits in the future, sometimes very far in the future.

Cash-flow depreciation could easily be extended to cover all assets. It would, in fact, vastly simplify the work of the taxpayer and the tax collector, because assets would be written off at the time of purchase, when all the records were available and fresh, and the whole apparatus for recording and checking allowable depreciation rates and accruals could be junked. Similarly, all legal and administrative disputes over expendability versus depreciability of particular outlays would come to an end.

In addition, universal application of a cash-flow depreciation method would have these advantages:

1. It would conform to the most advanced of all methods now in use for presenting and evaluating investment decisions. Just as sources and uses-of-funds statements have now become common in business and Federal budgeting, the discounted cash-flows method is being increasingly used for measuring investment worth. According to this method, investments are portrayed in terms of their cash outlays and their receipt streams, ignoring such noncash items as depreciation. This disposes entirely of the problem of how assets "really" depreciate and the problem of how to apportion each year's revenue among capital costs, return of investment and profit. Both of these questions have always had a peculiarly metaphysical aspect, and recently many business firms have discovered that they need not be answered at all in order to reach investment decisions that are economically correct.

2. Cash-flow depreciation would treat all outlays equally, without creating mystical or artificial distinctions based on Treasury rulings. Business firms would be free to meet the economic demands of the free market in whatever way promised the lowest real costs to the firm and society. They would no longer have the incentive that now exists to do it the tax-expensing way even where a depreciable long-term investment is economically superior.

3. Firms in the greatest need of funds for expansion would benefit from the privilege of expensing their investments. The result would fit in well with our goal of a dynamic and expanding economy, encouraging every firm to become or remain an innovator. These benefits would be most valuable to those small and growing companies whose inability to tap the organized capital markets holds back their growth and slows down the spread of so many new and valuable developments. Dynamic large firms would also benefit, of course, but to a lesser degree because they already have access to sources of additional capital on reasonable terms.

4. Conversely, firms with low or negative investment programs would bear a heavier tax burden. With the end of their need for new capital the Government's tax take would automatically step up. In addition, once all of a firm's earnings prospects had vanished, there would not be the incentive that now exists to preserve or merge it

in order to utilize its valuable depreciation base, because there would be no base left under cash-flow depreciation. Thus moribund companies would be speedily dissolved and their assets released for more desirable economic uses, with the Government sharing in any proceeds of dissolution.

Some of these features of cash-flow depreciation are explored further in the next section as part of the discussion of timetable depreciation. The point I want to make now is that cash-flow depreciation has some very attractive features that should entitle it to serious consideration. Going further, I believe that, of the four major methods presented in this paper, the cash-flow rule is the most suitable for universal application.

D. TIMETABLE DEPRECIATION

Conventional timetable tax depreciation, the only kind now used for most long-lived tangible assets, has these traits:

1. Eligible expenditures do not result in deductions from taxable income now but are deductible in installments over a period of years.
2. The number of years has usually, but not always, corresponded to someone's notion of useful life.
3. The timetable has had a variety of forms, including straight line, SYD,[2] double declining balance, or crooked straight lines. (The last has been caused by combining fast and normal writeoffs.)
4. End-of-life gain or loss is determined by comparing depreciated value with disposal value.

Historically, two factors probably account for the wide use of timetable depreciation in the tax laws.

1. Wartime, which saw the first use of the corporate income tax and most of its subsequent growth, is a time of pressing needs for revenue and strong public demands for taxation of excess profits, whatever these are. Long-run results are ignored in the drive to get money now, especially from those who seem to be fattening on the war. This makes tax officials look with favor on any definition of the income-tax base which produces a large base now.

2. Accounting theories and investigations of how assets really wear out have long sanctioned the device of spreading costs of certain assets against the income of many years, in order to state income fairly and to "provide for the replacement of an asset at the end of its useful life." This fitted in very well with the desire to produce high wartime tax collections from expanding firms.

These notions of equity are only one set out of many that, in a vacuum, might seem equally plausible. Their application, however, leads to peculiar results and suggest that some other standard might well guide us in the future.

In World War II, for example, a number of special measures adopted to finance expanding private production would have been less important or unneeded if cash-flow depreciation had been in effect. In addition, the wide use of 5-year writeoffs partially nullified the standard depreciation timetable and thus permitted growing firms to retain a much larger part of their pretax cash income during the war years.

[2] Sum-of-the-years' digits.

Even in peacetime, however, the timetable method seems to me to produce undesirable and avoidable results. Some of them arise because of the coexistence of this and other tax treatments for investment outlays, while others are characteristic of the timetable method itself.

1. A pervasive and durable bias is created against investment expenditures that do not result in tax reductions now or very soon. Research, advertising, employee and executive training, company bowling teams, and all the rest of the expensable investments are not bad in themselves; they can confer some benefits on the direct participants, the economy, and our society. But the same can be said of investments in plant and equipment. When the tax laws permit these intangible investments to be expensed and require that physical assets be depreciated, often over many years, we inevitably get more intangible investments and less plant and equipment than businesses' judgment would favor or than we ourselves really want, in any economic sense.

2. Small firms which have opportunities for rapid expansion but are not big enough to have ready or reasonable access to capital markets are held back. Even where the owners have taken nothing out of the firm in order to devote all possible funds to growth, the Government makes itself a prior claimant on cash-flows long before the owners or investors realize any returns.

3. Firms of low profitability but with substantial undepreciated assets become more attractive investments because their cash income is tax free. Firms which, in an economic sense, are identically situated, are unequally taxed if their assets were acquired at different times or different price levels.

4. Large amounts of talent are diverted to finding a way around or through the necessarily arbitrary distinctions between expensable and depreciable expenditures, and in blocking these attempts. Since the distinctions are partly mystical and are difficult to apply in many special situations, there is a minimum of predictability and a maximum of oppoftunity for sharp practice. People who understand tax effects are rewarded financially, although it is hard to see how society is better off by creating these new jobs and specialties.

In sum, timetable depreciation sets up a will-o'-the-wisp by assuming that there is some knowable or determinable timetable that is fair and represents the way in which assets really depreciate, even though nobody can write an accepted definition of what depreciation is. For managerial purposes, and also for public policy, it is sometimes desirable to make an estimate of the degree to which a firm, an industry, or the Nation is maintaining the real economic value of its plant. But no depreciation method now in general use comes close to this, least of all the one imposed by our tax laws. For a difficult problem of economic analysis, the tax laws substitute a simple and mechanical process which is plainly wrong and which has, in any case, little to do with the public policy problems of extracting a given amount of Government revenue with the least damage to the competitive and innovative vigor of our economy.

The belief that these timetables have some real significance is gradually dying out. Managers and accountants recognize the value of keeping separate books for the tax collector. And Congress itself drastically alters the traditional timetable through 5-year writeoffs

and the new SYD and double declining balance options. All that remains is to recognize that it is neither necessary nor relevant that any particular tax treatment of long-lived asset costs should correspond to some theory of the amount or timing of capital wastage.

IV. Which Method Would Business Choose?

If we were to offer a choice to business firms, it seems certain that the majority of firms would choose to adopt the cash-flow writeoff method for most of their capital outlays.[8] There would be some exceptions to this even apart from those stemming from managerial ignorance. For example, firms with low or negative current income and little expectation of substantial income within whatever loss carry-forward period is allowed would probably pick longer writeoff periods for their current investments. Some firms would find that percentage depletion would benefit them most, and would choose it if it were offered. The rest, if they were acting wisely, would write all new investments off for tax purposes in the first year.

The attractiveness of fast writeoff from a managerial viewpoint lies in its effect on tax timing. A cash-flow writeoff would reduce taxable income by the full amount of the investment's cost—and taxes by about half of that—in the first year. In all subsequent years, of course, income and taxes would be higher because there would be no unrecovered depreciation to charge against the later years' income. The net effect is thus to postpone tax payments, as compared with the payments that would be made under a timetable system. We have already seen why this would be especially valuable to rapidly growing firms, particularly if they were small. But other firms would use cash-flow depreciation as well, because almost any rational firm would prefer a lump-sum tax reduction this year to the same reduction spread out over a number of years in the future.

V. Should We Let Management Choose?

We have now reviewed the four major writeoff methods and have seen why most private firms would decide on the cash-flow method if they were offered a choice. In this final section I want to examine some of the public policy aspects of allowing such freedom of choice. Does this proposal conceal some tremendous loophole or windfall to private industry? Would it have startling and undesirable effects on Government revenues? What would be its effects on the level and stability of prices, production, and investment? When, if ever, is the best time to move in this direction? Recent experiments in Europe will tell us a lot on this subject, once they have been adequately summarized and studied by the experts. Meanwhile the following analysis may provide some of the answers.

1. Cash-flow writeoff would certainly improve resource allocations among firms and consumers, with a consequent increase in the economy's ability to provide the goods and services people want most and at lowered real cost. It would do this by leaving producers free to

[8] I am leaving out percentage depletion because so much would depend on the spread between the prevailing income-tax rate and the lower rate on gross income under percentage depletion.

meet the market's demands in the best way, whether this involved outlays that are now expensable or those that must be written off over an extended period according to present law.

2. It would increase our national investment in long-lived physical assets, since these are just the types of investment that present law discourages. Whether or not we want this depends largely on whether we value the consequent improvement economic efficiency. Some think this would worsen the problems of economic instability, since the latter may grow with greater reliance on long-lived production facilities. If we are unable to master the economic fluctuations of a high-investment economy we perhaps should direct public policy toward discouraging productive investments and rely instead on a greater degree of handwork, etc., even though it is less efficient. Our present tax laws seem to take this defeatist view, which I hope is unjustified. I think the reasoning is wrong. Instability comes because expenditures are discretionary, not because they result in bricks and mortar.

3. A cash-flow writeoff system would provide a built-in private investment stimulus operating in good times and bad and always tailored to the performance of the individual firm. Even in bad times, when most firms can find no promising investment projects, a substantial minority are expanding dynamically, and are hungry for capital. Cash-flow writeoff would automatically provide these firms with needed encouragement, and would do it without setting up an unwieldy and fallible administrative apparatus to receive and pass upon requests for fast writeoffs or other assistance.

4. Conversely, this system would dip more heavily than timetable depreciation into the net cash receipts of firms that had temporarily or permanently lost their ability to expand, whether this happened in periods of high or low overall economic activity. Such firms might object to the higher taxes but, with no investment demands on their funds, they could hardly protest that the burden was impeding their investment programs.

5. Wide use of cash-flow writeoffs might require some additional measures to restrain investment demand when the outlook was for overfull employment and raising prices and incomes. Taxpayers, facing the prospect of high income taxes unless they found some projects to invest in, might create such a demand for investment goods that further inflation would result. This would be even more likely if it were believed that the current level of tax rates would fall in a few years. In one form, however, this problem is already with us; the response of advertising outlays, which have always been immediately expensable, to wartime excess-profits taxes is only one example of the tax-reducing possibilities that have always existed. The way to meet this problem, both for outlays that are expensable under present law and for those that would become expensable under the cash-flow writeoff proposal, is by such devices as selective excise taxes on individually scarce commodities or a spendings tax if inflationary pressures are general. The income tax cannot be used as the sole method of smoothing the investment cycle without causing undesirable side effects and impairing its performance of the tasks for which it is best suited. Other fiscal and tax devices are available with which to accomplish the rest of the job.

CHANGES IN METHODS OF DEPRECIATION AND THEIR EFFECTS

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I should like to address myself to the probable effects of the new methods of depreciation allowed for tax purposes under the Internal Revenue Act of 1954. I shall bring out first the purely arithmetical or mathematical implications of the new methods, implications which have received insufficient public attention. I shall then discuss the probable effects of these implications on tax receipts and the economy in general.

ESSENTIAL RELATIONSHIPS AND SIMPLIFYING ASSUMPTIONS

It may be best to concentrate on the simplest forms of the two new methods likely to be most widely applied for tax purposes. These are the declining-balance method, with rates double the acceptable straight-line rate, and the sum-of-the-years-digets method.[1]

It must first be understood that the transition to any form of rapid or accelerated depreciation results in higher annual depreciation charges. This is true for the individual firm. It is true for the economy as a whole. Secondly, it must be recognized that double-rate declining balance and sum-of-the-years-digits depreciation are both in effect methods of rapid depreciation. And thirdly, it must be realized that, even apart from the (lengthy) period of transition, rapid depreciation, in firms or economies where the annual rate of acquisition of depreciable assets is growing, will increase permanently the annual rate of depreciation charges. These points have been developed elsewhere.[2] I shall proceed here directly, therefore, to a consideration of probable effects of changes in methods of depreciation on total tax receipts and the economy as a whole.

We shall endeavor first to estimate the probable differences in depreciation charges in future years with various methods of depreciation now acceptable for tax purposes under certain simplifying but not unreasonable assumptions. At this point we shall indicate the assumptions. We shall explain later the possible (minor) effects upon our conclusions of the divergences which may be found between our assumptions and reality.

(1) All depreciable properties have an expected life for tax depreciation purposes of 25 years. (While, of course, the expected life of property is quite varied, this is a reasonable estimate of the average life of all depreciable property.)

(2) The future rate of acquisition of depreciable properties either remains constant or grows at a steady "compound interest" rate of 4 percent. In either event, it must be noted, no allowance is made for

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[1] I shall refrain generally from consideration of peculiarities introduced by the widespread use of group and composite depreciation accounting, partly because of the unavailability of precise quantitative data as to current practice and partly because of delays in issuance of the final Internal Revenue Service regulations, applying particularly to the use of the years-digits method in composite or group accounting. However, there is no evidence that consideration of such peculiarities and details would alter the broad outlines of the facts which I have to present.

[2] Cf Robert Eisner, Depreciation Under the New Tax Law, Harvard Business Review, January–February 1955, and works cited therein; and E. Cary Brown, The New Depreciation Policy Under the Income Tax: An Economic Analysis, National Tax Journal, March 1955.

possible effects of different methods of depreciation upon the rate of acquisition of depreciable properties.

(3) All properties depreciable for tax purposes, acquired on or after January 1, 1954, are depreciated without regard for actual retirement, until 100 percent written off, by either (*a*) straight line, (*b*) double rate declining balance, or (c) the sum-of-the-years-digits.

With these assumptions we can estimate the differences in aggregate charges by the various methods as a ratio of some initial rate of acquisition of depreciable properties. We can then fill in an estimate of the actual dollar rate of properties depreciable for tax purposes and come up with dollar estimates of depreciation charges over future years, on properties acquired on or after January 1, 1954. Total depreciation charges would of course include as well as the depreciation on pre-1954 properties, but since these are not involved in the changes in tax depreciation methods they will be excluded from the analysis.

Some General Comparisons

Table 1 compares the ratio of depreciation charges on all new property additions to the rate of property additions for the different methods of depreciation. We assume no rate of growth in the rate of property additions, thus beginning with the assumption which will most deemphasize, as we shall note below, the conclusions to which we shall be driven. Nevertheless, we may observe that depreciation charges are higher by both declining balance and years-digits methods than by the straight line, from the very inception of the new methods in the year "0." By the year "3" charges under either of the new rapid methods are more than 11 percent higher (measured as a ratio of the rate of gross additions or capital expenditures) than they would be under the old straight-line method. But what is most impressive is that these differences continue to mount. By the year "5" the declining balance ratio is 14.7 percent higher and the years-digits ratio is 16.4 percent higher. In the year "8" the declining balance ratio reaches a peak excess of over 16.7 percent; in this year the years-digits charges reveal a ratio 21.5 percent higher and that figure continues to rise to a peak of almost 24 percent in the year "12." While in this first table these ratios decline after their peaks, ultimately to zero or below, one must note that the zero point for the declining balance excess is not reached until about the year "20" and for years-digits not until the year "25." What all this means is that the new methods will not give higher depreciation charges and consequently lower tax liabilities for just a few years, then to be followed by a period in which the initially higher charges are counterbalanced by lower charges (and higher tax liabilities). Rather, the higher depreciation charges (and tax losses) will continue for 20 to 25 years (until after 1974) and, it may be added, after that lengthy period, only some of the higher declining balance excess will gradually be dissipated and none of the years-digits excess will be dissipated.

TABLE 1.—*General comparison of depreciation methods, no growth in rate of gross additions*

[Annual depreciation charges on property acquired in year "0" and later, expressed as ratio of annual gross additions. Life of property equals 25 years. Half-year depreciation taken in year of addition.[1]]

Year	Straight line	Declining balance	Years-digits	Declining balance minus straight line [(3)−(2)][2]	Years-digits minus straight line [(4)−(2)][2]
(1)	(2)	(3)	(4)	(5)	(6)
0	0.0200	0.0400	0.0385	0.0200	0.0185
1	.0600	.1168	.1138	.0568	.0538
2	.1000	.1875	.1861	.0875	.0861
3	.1400	.2525	.2553	.1125	.1153
4	.1800	.3123	.3214	.1323	.1414
5	.2200	.3673	.3845	.1473	.1645
6	.2600	.4179	.4445	.1579	.1845
7	.3000	.4645	.5014	.1645	.2014
8	.3400	.5073	.5552	.1673	.2152
9	.3800	.5467	.6060	.1667	.2260
10	.4200	.5830	.6537	.1630	.2337
11	.4600	.6163	.6983	.1563	.2383
12	.5000	.6470	.7398	.1470	.2398
13	.5400	.6753	.7782	.1353	.2382
14	.5800	.7013	.8136	.1213	.2336
15	.6200	.7252	.8459	.1052	.2259
16	.6600	.7471	.8751	.0871	.2151
17	.7000	.7674	.9013	.0674	.2013
18	.7400	.7860	.9243	.0460	.1843
19	.7800	.8031	.9443	.0231	.1643
20	.8200	.8188	.9613	−.0012	.1413
21	.8600	.8333	.9751	−.0266	.1151
22	.9000	.8467	.9859	−.0533	.0859
23	.9400	.8589	.9935	−.0811	.0535
24	.9800	.8702	.9982	−.1098	.0182
25	1.0000	.8806	1.0000	−.1194	.0000
30	1.0000	.9213	1.0000	−.0787	.0000
35	1.0000	.9181	1.0000	−.0519	.0000
40	1.0000	.9658	1.0000	−.0342	.0300
45	1.0000	.9774	1.0000	−.0226	.0000
50	1.0000	.9852	1.0000	−.0148	.0000

[1] Mr. Bernard Backhaut has assisted in the statistical calculations underlying this table, and tables 2 through 7, below. These are derived ultimately from various of the algebraic formulations presented in the mathematical appendix of the supplement to my Depreciation Under the New Tax Law (see footnote 2 above), which is available on request to Readers Service Department, Harvard Business Review, Boston 63, Mass.

[2] Occasional slight inconsistencies in figures of various columns in this table and tables below are due to rounding.

The results above are obtained with the very conservative assumption that the dollar rate of gross additions or expenditures on capital subject to depreciation remains constant. Actually the rate of gross capital expenditures increased at an average rate of over 4 percent in the quarter of a century from 1929 to 1954. We have accordingly constructed table 2 on the assumption that the rate of gross additions or capital expenditures will continue to increase at a 4-percent rate in the future. Again measuring in terms of the ratio of depreciation charges to gross additions in the year "0," we find that with declining balance the excess over straight line rises to a peak of some 22 percent in the year "11," never falls to zero but rather reaches a low point of some 3.4 percent in the year "25," and then begins to rise again. With years-digits the excess over straight line reaches a peak of almost 36 percent in the year "17," falls only to about 26 percent in the year "25" and then begins to rise again. Thus, not only do the rapid methods of depreciation offer initially higher depreciation charges. Charges remain higher, year after year—permanently—when the phenomenon of growth is taken into account.

TABLE 2.—*General comparison of depreciation methods, 4 percent annual growth in rate of gross additions*

[Annual depreciation charges on property acquired in year "0" and later, expressed as ratio of gross additions of year "0." Life of property equals 25 years. Half-year depreciation taken in year of addition]

Year (1)	Straight line (2)	Declining balance (3)	Years-digits (4)	Declining balance minus straight line [(3)−(2)] (5)	Years-digits minus straight line [(4)−(2)] (6)
0	0.0200	0.0400	0.0385	0.0200	0 0185
1	.0608	.1194	.1154	.0576	.0546
2	.1032	.1938	.1923	.0906	.0891
3	.1474	.2666	.2692	.1192	.1219
4	.1933	.3370	.3462	.1438	.1529
5	.2410	.4055	.4231	.1645	.1821
6	.2906	.4723	.5000	.1817	.2094
7	.3422	.5378	.5769	.1956	.2347
8	.3959	.6761	.6539	.2062	.2579
9	.4518	.6657	.7308	.2139	.2790
10	.5008	.7285	.8077	.2187	.2978
11	.5703	.7911	.8846	.2208	.3144
12	.6330	.8534	.9615	.2203	.3285
13	.6984	.9158	1.0385	.2174	.3401
14	.7644	.9784	1.1154	.2139	.3509
15	.8369	1.0414	1 1923	.2044	.3553
16	.9104	1.1051	1 2692	.1946	.3588
17	.9869	1.1695	1.3461	.1826	.3593
18	1.0663	1.2349	1.4230	.1685	.3567
19	1.1490	1.3014	1 4999	.1524	.3510
20	1.2349	1.3692	1.5769	.1343	.3420
21	1.3244	1.4385	1.6538	.1141	.3295
22	1.4172	1.5093	1 7307	.0921	.3135
23	1.5140	1.5820	1.8077	.0680	.2937
24	1.6146	1.6565	1 8846	.0420	.2700
25	1.6991	1.7332	1.9615	.0340	.2624
30	2.0673	2.1531	2.3865	.0858	.3193
35	2.5152	2.6488	2.9036	.1336	.3884
40	3.0601	3.2419	3.5326	.1818	.4726
45	3 7231	3 9570	4.2980	.2339	.5750
50	4.5297	4.8202	5.2292	.2905	.6995

FORECASTS OF DEPRECIATION CHARGES

We may now begin to apply these abstract relations to some dollar-and-cents forecasts which should give at least a roughly approximate idea of what is in store. Unable to secure exact figures, I have utilized some very rough-and-ready techniques to estimate total expenditures on (tax) depreciable properties in 1954, the year "0" of tables 1 and 2, at $34.2 billion.[3] Any error in this estimate will affect our estimates of depreciation charges proportionately but will not influence their relative magnitudes. Thus, if the true figure for 1954 expenditures on depreciable properties is 10 percent higher than our estimate, all estimated depreciation charges under our assumptions should be 10 percent higher. And, of course, if the true figure were, say, 10 percent less, all estimated depreciation charges would be 10 percent less.

Ignoring growth

Tables 3 and 4 estimate, accordingly, depreciation charges which would be made for tax purposes in the years beginning with 1954 on properties acquired on or after January 1, 1954, with universal use of

[3] I arrived at this figure by excluding from the total of gross private domestic investment in new construction and producers' durable equipment ($50.1 billion), two-thirds (about $9.5 billion) of residential housing construction to account for owner-occupied housing for which depreciation would not be applied in income-tax returns, some $2 billion for other nonresidential building which was apparently chiefly of the nonprofit variety, some $2.4 billion for capital outlays charged to current expense and (conservatively) all of some $2 billion for petroleum and natural gas well drilling because of uncertainty as to how much of this would be depreciated for tax purposes.

each of the major depreciation methods allowable under the Internal Revenue Act of 1954. Columns (5) and (6) of each of these tables reveal the increased annual charges which would result from use of, respectively, double rate declining balance and years-digits depreciation instead of the straight-line method to which taxpayers were fairly effectively restricted previously. We may observe in table 3 that, ignoring the growth phenomenon, the increase in annual depreciation charges under the rapid depreciation methods is relatively moderate at first, under $700 million in 1954, under $2 billion in 1955, and just under $3 billion in 1956. But this rapidly mounting progression continues. By 1960, declining balance annual charges would be $5.4 billion more than straight-line charges. And years-digits charges would exceed those with the straight-line method by $6.3 billion. To begin to anticipate the sting in all this, with current tax rates, the United States Treasury would, under the assumptions of our analysis, be losing some $3 billion in taxes in the year 1960, if taxpayers took full advantage of the rapid depreciation offered under the 1954 tax law. Increased depreciation charges under the more rapid years-digits method would not reach their peak, as compared with straight-line charges, until 1966, at which time the annual excess would be about $8.2 billion and the tax loss to the Treasury, under present tax rates, roughly $4 billion in that year alone.

TABLE 3.—*Estimated annual tax depreciation charges, 1954–2004, no growth, 25-year life*

[Straight line, declining balance, and years-digits, compared, no growth in rate of gross additions, 25-year life of property, post-1953 additions only, half-year depreciation taken in year of addition]

[Estimates in billions of dollars]

Year	Straight line	Declining balance	Years-digits	Declining balance minus straight line [(3)−(2)]	Years-digits minus straight line [(4)−(2)]
(1)	(2)	(3)	(4)	(5)	(6)
1954	0.7	1.4	1.3	0.7	0.6
1955	2.1	4.0	3.9	1.9	1.8
1956	3.4	6.4	6.4	3.0	2.9
1957	4.8	8.6	8.7	3.8	3.9
1958	6.2	10.7	11.0	4.5	4.8
1959	7.5	12.6	13.1	5.0	5.6
1960	8.9	14.3	15.2	5.4	6.3
1961	10.3	15.9	17.1	5.6	6.9
1962	11.6	17.4	19.0	5.7	7.4
1963	13.0	18.7	20.7	5.7	7.7
1964	14.4	19.9	22.4	5.6	8.0
1965	15.7	21.1	23.9	5.3	8.1
1966	17.1	22.1	25.3	5.0	8.2
1967	18.5	23.1	26.6	4.6	8.1
1968	19.8	24.0	27.8	4.1	8.0
1969	21.2	24.8	28.9	3.6	7.7
1970	22.6	25.6	29.9	3.0	7.4
1971	23.9	26.2	30.8	2.3	6.9
1972	25.3	26.9	31.6	1.6	6.3
1973	26.7	27.5	32.3	.8	5.6
1974	28.0	28.0	32.9	0	4.8
1975	29.4	28.5	33.3	−.9	3.9
1976	30.8	29.0	33.7	−1.8	2.9
1977	32.1	29.4	34.0	−2.8	1.8
1978	33.5	29.8	34.1	−3.8	.6
1979	34.2	30.1	34.2	−4.1	0
1984	34.2	31.5	34.2	−2.7	0
1989	34.2	32.4	34.2	−1.8	0
1994	34.2	33.0	34.2	−1.2	0
1999	34.2	33.4	34.2	−.8	0
2004	34.2	33.7	34.2	−.5	0

TABLE 4.—*Estimated annual tax depreciation charges, 1954–2004, 4 percent growth, 25-year life*

[Straight line, declining balance and years-digits, compared, 4 percent per annum growth in rate of gross additions, 25-year life of property, post-1953 additions only, half-year depreciation taken in year of addition]

[Estimates in billions of dollars]

Year (1)	Straight line (2)	Declining balance (3)	Years-digits (4)	Declining balance minus straight line [(3)−(2)] (5)	Years-digits minus straight line [(4)−(2)] (6)
1954	0.7	1.4	1.3	0.7	0.6
1955	2.1	4.0	3.9	2.0	1.9
1956	3.5	6.6	6.6	3.1	3.0
1957	5.0	9.1	9.2	4.1	4.2
1958	6.6	11.5	11.8	4.9	5.2
1959	8.2	13.9	14.5	5.6	6.2
1960	9.9	16.2	17.1	6.2	7.2
1961	11.7	18.4	19.7	6.7	8.0
1962	13.5	20.1	22.4	7.1	8.8
1963	15.5	22.8	25.0	7.3	9.5
1964	17.4	24.9	27.6	7.5	10.2
1965	19.5	27.1	30.3	7.6	10.8
1966	21.7	29.2	32.9	7.5	11.2
1967	23.9	31.3	35.5	7.4	11.6
1968	26.1	33.5	38.1	7.3	12.0
1969	28.6	35.6	40.8	7.0	12.2
1970	31.1	37.8	43.4	6.7	12.3
1971	33.8	40.0	46.0	6.2	12.3
1972	36.5	42.2	48.7	5.8	12.2
1973	39.3	44.5	51.3	5.2	12.0
1974	42.2	46.8	53.9	4.6	11.7
1975	45.3	49.2	56.5	3.9	11.3
1976	48.5	51.6	59.2	3.2	10.7
1977	51.8	54.1	61.8	2.3	10.0
1978	55.2	56.7	64.5	1.4	9.2
1979	58.1	59.3	67.1	1.2	9.0
1984	70.7	73.6	81.6	2.9	10.9
1989	86.0	90.6	99.3	4.6	13.3
1994	104.7	110.9	120.8	6.2	16.2
1999	127.3	135.3	147.0	8.0	19.7
2004	154.9	164.9	178.8	9.9	23.9

Including growth

An even more striking picture is presented in the probably more realistic table 4, recognizing the growth phenomenon. Assuming a 4-percent annual growth in the rate of gross additions of depreciable property, we find that in 1956 either declining balance or years-digits depreciation would exceed straight line depreciation by over $3 billion. The declining balance excess reaches a peak of over $7.5 billion in 1965. At that time years-digits charges would exceed those with the straight line method by over $10.7 billion. The annual excess of years-digits over straight line charges would continue to rise until 1971, at which time the figure would be almost $12.3 billion for that 1 year. The loss to the Treasury in that 1 year at present tax rates, under our usual assumptions, would be in the neighborhood of $6 billion. And again it must be emphasized that this is not a temporary loss which will be made up in later years. In later years there will be new losses. For, as table 4 indicates, annual depreciation charges with the rapid depre-

ciation methods will always exceed those with the straight line technique. The excess will, it is true, diminish to a low point, in 1979, of a little over $1 billion with declining balance and under $9 billion with years-digits. But even then the Treasury would be losing something and the loss would begin to increase again after 1979. What is more, we may note parenthetically, the option of switching from declining balance to straight line, which has not been considered explicitly in this paper, would be likely to permit higher depreciation charges with this combination than those indicated in our tables for declining balance charges alone.

Longer-lived properties

Tables 5 and 6 are analogous to tables 3 and 4 but are constructed with the assumption that the life of depreciable property is 33⅓ years rather than 25 years. They may be seen to demonstrate that while magnitudes are altered, the fundamental propositions suggested above are unchanged and we may generalize that the precise length of life of property will not substantially affect our arguments. In particular, the longer life of property delays somewhat the period when the annual excess of rapid depreciation reaches its peak. But without growth, the peaks are just as high and, with the realistic growth assumption, the peaks and the ultimate excesses are even higher. Thus, if depreciable properties lasted 33⅓ years, declining balance charges would exceed straight line charges by over $8.5 billion in 1972; years-digits charges would exceed straight line charges by about $15.5 billion in 1981.

Accumulation of annual differences

Tables 1 through 6 all deal in annual depreciation charges. Finally, in table 7, we accumulate the differences in depreciation charges between each of the rapid depreciation methods and the straight line technique, with the growth assumption for 25-year properties and without the growth assumption for both 25- and 33⅓-year properties. We may concentrate our attention on the 25-year-growth combination, which probably offers the optimum set of assumptions for purposes of this analysis. We note then that, by 1957, rapid depreciation methods now allowable under the Internal Revenue Act of 1954 would have permitted increased depreciation charges of almost $10 billion—and tax losses to the Treasury of nearly $5 billion. By the end of 1960, the increased depreciation allowable under the more rapid years-digits method would have totaled over $28 billion—a tax difference of perhaps $14 billion at present rates. By the end of 1970 the years-digits excesses would have totaled $135 billion. And by 1979, after 25 years under the 1954 tax law, allowable increased charges with years-digits would be $233 billion. With declining balance the allowable increased charges would be $132 billion. Thus, with the assumptions we have made, the tax loss to the Treasury over the next 25 years, and correspondingly the tax gains to those taxpayers affected, could be over $100 billion at present tax rates.

TABLE 5.—*Estimated annual tax depreciation charges, 1954–2004, no growth, 33⅓-year life*

[Straight line, declining balance, and years-digits, compared, no growth in rate of gross additions, 33⅓-year life of property, post-1953 additions only, half-year depreciation taken in year of addition]

[Estimates in billions of dollars]

Year	Straight line	Declining balance	Years-digits	Declining balance minus straight line (3)−(2)	Years-digits minus straight line (4)−(2)
(1)	(2)	(3)	(4)	(5)	(6)
1954	0.5	1.0	1.0	0.5	0.5
1955	1.5	3.0	3.0	1.5	1.4
1956	2.6	4.9	4.9	2.3	2.3
1957	3.6	6.6	6.7	3.1	3.1
1958	4.6	8.3	8.5	3.7	3.9
1959	5.6	9.9	10.2	4.2	4.6
1960	6.7	11.3	11.9	4.6	5.2
1961	7.7	12.7	13.5	5.0	5.8
1962	8.7	14.0	15.0	5.3	6.3
1963	9.7	15.2	16.5	5.4	6.8
1964	10.8	16.3	17.9	5.6	7.2
1965	11.8	17.4	19.3	5.6	7.5
1966	12.8	18.4	20.6	5.6	7.8
1967	13.9	19.4	21.8	5.5	8.0
1968	14.9	20.2	23.0	5.4	8.1
1969	15.9	21.1	24.2	5.2	8.2
1970	16.9	21.9	25.2	4.9	8.3
1971	18.0	22.6	26.2	4.7	8.3
1972	19.0	23.3	27.2	4.3	8.2
1973	20.0	24.0	28.1	4.0	8.0
1974	21.0	24.6	28.9	3.5	7.8
1975	22.1	25.2	29.6	3.1	7.6
1976	23.1	25.7	30.4	2.6	7.3
1977	24.1	26.2	31.0	2.1	6.9
1978	25.1	26.7	31.6	1.5	6.5
1979	26.2	27.1	32.1	1.0	6.0
1980	27.2	27.6	32.6	.4	5.4
1981	28.2	28.0	33.0	−.3	4.8
1982	29.2	28.3	33.3	−.9	4.1
1983	30.3	28.7	33.6	−1.6	3.4
1984	31.3	29.0	33.9	−2.3	2.6
1985	32.3	29.3	34.0	−3.0	1.7
1986	33.3	29.6	34.1	−3.7	.8
1987	34.2	29.9	34.2	−4.3	0
1988	34.2	30.2	34.2	−4.0	0
1989	34.2	30.4	34.2	−3.8	0
1994	34.2	31.4	34.2	−2.8	0
1999	34.2	32.2	34.2	−2.0	0
2004	34.2	32.7	34.2	−1.5	0

TABLE 6.—*Estimated annual tax depreciation charges, 1954–2004, 4-percent growth, 33⅓-year life*

[Straight line, declining balance, and years-digits, compared, 4 percent per annum growth in rate of gross additions, 33⅓-year life of property, post-1953 additions only, half-year depreciation taken in year of addition]

[Estimates in billions of dollars]

Year	Straight line	Declining balance	Years-digits	Declining balance minus straight line (3)−(2)	Years-digits minus straight line (4)−(2)
(1)	(2)	(3)	(4)	(5)	(6)
1954	0.5	1.0	1.0	0.5	0.5
1955	1.6	3.1	3.0	1.5	1.4
1956	2.6	5.1	5.0	2.4	2.4
1957	3.8	7.0	7.1	3.2	3.3
1958	5.0	8.9	9.1	4.0	4.2
1959	6.2	10.9	11.2	4.7	5.0
1960	7.5	12.8	13.3	5.3	5.9
1961	8.8	14.6	15.5	5.9	6.7
1962	10.2	16.5	17.6	6.4	7.5
1963	11.6	18.4	19.8	6.8	8.2
1964	13.1	20.3	22.0	7.2	9.0
1965	14.6	22.1	24.3	7.5	9.7
1966	16.2	24.0	26.6	7.8	10.3
1967	17.9	25.9	28.9	8.0	11.0
1968	19.7	27.9	31.2	8.2	11.5
1969	21.5	29.8	33.6	8.4	12.1
1970	23.4	31.8	36.0	8.4	12.6
1971	25.3	33.8	38.4	8.5	13.1
1972	27.4	35.9	40.9	8.5	13.6
1973	29.5	38.0	43.4	8.5	14.0
1974	31.7	40.1	46.0	8.4	14.3
1975	34.0	42.3	48.6	8.3	14.6
1976	36.4	44.5	51.3	8.1	14.9
1977	38.8	46.8	54.0	8.0	15.1
1978	41.4	49.1	56.7	7.7	15.3
1979	44.1	51.6	59.5	7.5	15.4
1980	46.9	54.1	62.4	7.2	15.5
1981	49.8	56.6	65.3	6.8	15.5
1982	52.8	59.2	68.2	6.4	15.4
1983	55.9	62.0	71.2	6.0	15.3
1984	59.2	64.8	74.3	5.6	15.1
1985	62.6	67.7	77.5	5.1	14.8
1986	66.1	70.7	80.7	4.5	14.5
1987	69.6	73.8	83.9	4.1	14.3
1988	72.4	77.0	87.3	4.4	14.7
1989	75.3	80.7	90.8	5.4	15.5
1994	91.6	99.4	110.5	7.7	18.8
1999	111.5	121.5	134.4	10.0	22.9
2004	135.6	148.3	163.5	12.6	27.9

TABLE 7.—*Estimates of cumulative differences in tax-depreciation charges, 1954–79*

[Years-digits and declining balance versus straight line, no growth, and 4 percent per annum rate of growth of gross additions with 25-year life of property, no growth with 33⅓-year life of property. Cumulated from cols. (5) and (6) of tables 3 through 6 [1]]

Year	No growth, 25-year life		4-percent growth, 25-year life		No growth, 33⅓-year life	
	Declining balance minus straight line	Years-digits minus straight line	Declining balance minus straight line	Years-digits minus straight line	Declining balance minus straight line	Years-digits minus straight line
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1954	0.7	0.6	0.7	0.6	0.5	0.5
1955	2.6	2.5	2.6	2.5	2.0	1.9
1956	5.6	5.4	5.8	5.5	4.3	4.2
1957	9.8	9.4	9.8	9.7	7.4	7.3
1958	14.0	14.2	14.7	14.9	11.0	11.2
1959	19.0	19.8	20.4	21.2	15.3	15.8
1960	24.4	26.1	26.6	28.3	19.9	20.9
1961	30.0	33.0	33.3	36.4	24.9	26.8
1962	35.8	40.4	40.3	45.2	30.2	33.1
1963	41.5	48.1	47.6	54.7	35.6	39.9
1964	47.0	56.1	55.1	64.9	41.2	47.0
1965	52.4	64.2	62.7	75.6	46.8	54.5
1966	57.4	72.4	70.2	86.9	52.4	62.3
1967	62.0	80.6	77.6	98.5	57.9	70.3
1968	66.2	88.6	85.0	110.5	63.2	78.4
1969	69.8	96.3	92.0	122.7	68.4	86.7
1970	72.8	103.7	98.6	134.9	73.4	95.0
1971	75.1	110.6	104.9	147.2	78.0	103.2
1972	76.6	116.8	110.6	159.4	82.4	111.4
1973	77.4	122.5	115.8	171.4	86.3	119.5
1974	77.4	127.3	120.4	183.1	89.8	127.3
1975	76.5	131.2	124.3	194.4	92.9	134.9
1976	74.7	134.2	127.5	205.1	95.6	142.2
1977	71.9	136.0	129.8	215.2	97.6	149.1
1978	68.1	136.6	131.2	224.4	99.2	155.5
1979	64.1	136.6	132.4	233.4	100.2	161.5

[1] Slight discrepancies due to rounding.

RELAXING THE SIMPLIFYING ASSUMPTIONS

We should at this point examine a bit further our assumptions, which have permitted us to offer such seemingly precise estimates. For it must be understood clearly that the precise character of these estimates would disappear as soon as we recognized that:

(1) The amount of 1954 additions of property depreciable for tax purposes was not exactly $34.2 billion.

(2) The rate of additions of such property will certainly fluctuate over the years and cannot be counted upon to stay constant or to grow at a neat, constant 4-percent rate.

(3) Depreciable property varies widely in expected life. Even if the average expected life were 25 years, or 33⅓ years, most properties would differ from the average property.

(4) For a variety of reasons (including in some cases, plain ignorance) all taxpayers will not take full advantage of the rapid depreciation methods potentially available.

(5) Relevant tax rates in fact, differ, depending upon status of the taxpayer (cooperate or individual, rich or poor, etc.), and cannot be expected to remain the same in the future.

However, stating the real qualifications above should enable us to see quickly that they make no crucial difference. Thus, in regard to

(1), as indicated earlier, any error in our base estimate of $34.2 billion would be carried proportionately on all other magnitudes and is not, in any event, likely to be very large.

As for (2), fluctuations in the rate of gross property additions or in the rate of growth of gross property additions would actually tend to be diminished by the averaging effect of successive fluctuations, so that annual depreciation charges would differ much less from our estimates as a result of fluctuations in property additions than the amount of the fluctuations themselves. It should be pointed out, however, that rapid depreciation, by giving greater significance to newer properties or more recent property acquisitions, would tend to make depreciation charges higher (and tax liabilities less) in periods of boom or inflation when capital expenditures are high than in periods of depression or deflation, when capital expenditures are low. This, it must be noted, is generally considered undesirable from the standpoint of combating cyclical fluctuations in economic activity.

In regard to (3), shorter expected lives of property than those we have assumed will, as suggested earlier, increase the near-future excesses of depreciation charges under the rapid-depreciation methods, but will reduce the total amount of such increased charges, particularly if growth is assumed. Variation from the average expected life on the part of particular properties will also tend to hasten the increase in depreciation charges under the rapid methods.

On point (4), to the extent any substantial number of taxpayers do not utilize the rapid methods our conclusions must of course be watered down. Thus if only half of the depreciable properties are actually written off by the rapid methods our various dollar estimates must be halved. It is my impression, however, that preliminary data indicate that the bulk of taxpayers are using the rapid methods. It seems reasonable to expect that as the Internal Revenue Service position is clarified on a number of relevant issues and as information is diffused, taxpayers will utilize the methods offering them the greatest tax savings.

Finally (5), the question of tax rates, particularly expected future tax rates, is not one that I am in a peculiarly good position to illuminate. I do presume that the bulk of property depreciable for tax purposes is acquired by corporations and that the bulk of these corporations (taxwise) is hovering around the 50-percent tax bracket. But this is, of course, far from universal and I should be extraordinarily foolhardy to offer prognostications on this subject. To the extent that marginal tax rates are or will be considerably less than 50 percent our estimates of tax reductions resulting from increased depreciation charges should be adjusted downward.

EFFECTS ON THE ECONOMY

I have left to last a most important and possibly most controversial assumption: that the rate of additions of depreciable property will not in itself be affected by the allowable rate of depreciation. This is a difficult assumption because some who have supported the rapid methods of depreciation for tax purposes have argued precisely that they will encourage capital expenditures. To the extent that they do, they will in one sense exaggerate the tax savings we have estimated, since depreciation charges will then be higher both because of the more

rapid depreciation rates and the increased rates of property additions. However, if capital expenditures are in fact increased by the new depreciation methods, it may be argued that total income will be increased and total taxes, which depend, of course, largely on total income, will actually be increased.

I have expressed myself on other occasions as to the likely effect of rapid and accelerated tax depreciation on the level of capital expenditures and the economy as a whole.[4] I shall hence be brief here. The fundamental points are, I believe: (1) Any reduction in taxes in itself is likely to raise national income and, in varying degree, its components. (2) Few if any reductions in tax rates (considering an increase in allowable tax depreciation as an effective reduction in tax rates) are likely to raise income by enough to leave total tax receipts as much as or more than they were before the reduction in tax rates. (3) If a reduction in tax rates is not to be allowed to reduce tax receipts it must be accompanied by an increase in some other tax rates. If Congress thus raises other rates to make up for the decrease in tax receipts resulting from higher depreciation charges the effect on national income becomes uncertain and will depend upon the nature of the various tax changes, the state of business, and other matters, some of which the economist can predict safely and others of which are susceptible at best to informed guesses. (4) We can generalize that higher depreciation charges tend in themselves to encourage expenditures for plant and equipment, which expands our capacity to produce. If these are to be counterbalanced by increases in other taxes (so as to prevent a net loss in tax receipts) these other taxes are likely to bear relatively more on the demand for output. Thus we should on the one hand be increasing our capacity to produce and on the other hand restricting our demand for that production. To the extent that we are concerned with the danger of unemployment, recession, or depression, this would appear to be a dangerous path. However, to the extent we are concerned with inflation, this might represent an appropriate set of measures. (5) Aside from the effect on the economy as a whole, it appears safe to assert that higher depreciation charges, balanced by other increases in tax rates, are likely to counter to some extent the trend of recent decades to more progressive taxation. For tax savings would be enjoyed largely by corporations and generally by those acquiring large amounts of property. However, some of the business tax savings would undoubtedly be passed on to the consumer and the compensating increases in tax rates could conceivably be concentrated among corporate or upper income tax rates, so that the distribution effect of the higher depreciation charges as between upper and lower income groups would be largely eliminated. There would remain nevertheless the fact that higher depreciation charges would benefit most those businesses that are capital intensive, that is, whose costs for depreciable plant and equipment are relatively high, as opposed for example, to commercial establishments, whose plant and equipment costs are relatively low. (6) To the extent that the tax losses to the Treasury brought on by higher depreciation charges are accompanied by decreases in Treasury outgo we may of course all be better off by the amount of the no longer needed governmental ex-

[4] Harvard Business Review, January–February 1955, especially pp. 72–74, and Accelerated Depreciation: Some Further Thoughts, the Quarterly Journal of Economics, May 1955, pp. 285–296.

penditures with which we have dispensed. However, here one should offer the ironic but economically sound comment that elimination of unnecessary governmental expenditures and the taxes which had supported them can leave the economy worse off. For people do not generally spend all of their tax savings and total demand for goods is immediately reduced by the difference between the eliminated governmental expenditure and the amount of the concomitant tax savings that the taxpayers do actually spend.

SUMMARY AND CONCLUSION

We may conclude by summarizing briefly. Under reasonable assumptions, we may estimate the changes in tax deductions based on depreciation resulting from the rapid depreciation options of the Internal Revenue Act of 1954. These estimates reveal that with the newly allowable methods, depreciation charges will be substantially higher and taxpayments correspondingly less than they would have been with the old straight-line depreciation. These higher depreciation charges and consequent tax losses to the Treasury will not prove temporary phenomena. The tax losses will actually be less initially but may mount to an annual rate of $2 billion by 1957, $5 billion by 1964, and as much as $6 billion by 1970, if all taxpayers take full advantage of the most rapid of the depreciation methods now available. By 1979, after 25 years under these depreciation provisions, the total resultant loss in tax receipts to the Treasury will be in the order of $100 billion, assuming the continuance of present corporate and individual income-tax rates.

The effects of these substantial changes in our tax structure will depend upon a number of things, such as what Congress does about replacing the lost tax revenues or about reducing governmental expenditures. To the extent that higher capital expenditures are encouraged at the expense of other expenditures which are discouraged by the substitute taxes or reduced governmental demand, it would appear that the more rapid depreciation tends to stimulate productive capacity relative to the demand for the output of that capacity. This will appear dangerous to those concerned with the possibility of unemployment or depression, desirable to those concerned with inflation. The new methods of depreciation do appear likely, however, to complicate the problem of reducing cyclical fluctuations in economic activity. For they will reduce tax liabilities in time of boom and raise them in time of depression, relative to what they would have been with the old straight-line method. In regard to distributional (as opposed to aggregate) effects, the more rapid depreciation may to some extent reverse the past trend to a more progressive tax structure and will fairly clearly benefit much of "heavy" or capital intensive industry, possibly at the expense of commercial establishments and other segments of business whose costs relate to a much lesser degree to depreciable plant and equipment.

SIGNIFICANCE OF DEPRECIATION ACCOUNTING WITH SPECIAL REFERENCE TO PLANT REPLACEMENT

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There continues to be a great deal of sloppy thinking and careless description with respect to the subject of depreciation cost, leading at times to serious misunderstanding and questionable policies. This condition is especially noticeable among economists and financial experts who have never taken the trouble to master the fundamentals of accounting (and who should learn to speak with less assurance about matters of which they know very little), but it must be admitted that accountants themselves have contributed substantially to the confusion. The writer believes that it is worthwhile, accordingly, to make another effort in the direction of clarification, at the level of underlying concepts and procedures, and this is a major objective of this paper.

What is depreciation cost?

At bottom there is nothing puzzling or controversial about depreciation, despite the countless pages that have been written which treat the subject as something mysterious and argumentative. Depreciation is simply plant cost (or value) in the absorbed or expired stage. The periodic depreciation charge is a portion or section—in dollar terms—of the package of plant facilities employed in business operation. Depreciation is plant capacity consumed, and the slice consumed is of the same prosaic substance as the rest of the loaf.

Depreciation is explicit, out-of-pocket cost

As indicated by the above definition depreciation is an actual, explicit cost; depreciation is not a phony, assumed, or hypothetical charge. It follows that it is erroneous to contrast depreciation with other charges by stating that it is "not an out-of-pocket cost." It requires actual expenditure of funds to acquire the boiler just as it does to acquire the coal used, and a portion of the cost of the boiler represents expenditure just as clearly and definitely as does a portion of the cost of a shipment of coal. It is true, of course, that the expenditures for coal may be more frequently recurring than the expenditures for boilers, but one cost is no less real and valid than the other.

All costs are on same footing

There has been so much exaggeration of the special nature of depreciation that the fact that all costs of production are on the same bass, fundamentally, deserves emphasis. Periodic income accounting consists essentially of the matching of the revenues realized and recognized in the period with the associated costs—the charges reasonably assignable to such revenues. In this process there is no difference between the significance and effect of one class of charge as compared with another. If any actual cost or a part thereof is omitted, earnings applicable to stockholders' equity will be overstated, and such overstatement—if substantial—may lead to misunderstanding and unwise decisions on the part of management or other interested parties. (One very definite result of such an omission might be an increase in income taxes.) But this is just as true of the cost of employees' service or coal burned as it is of the cost of plant capacity. Each dollar of ex-

pense bears the same relation to the total revenue received and the net income realized as every other dollar so charged. The same may be said where operation results in a net loss. Suppose, for example, that the flow of revenue from customers in a particular period amounts to $90,000 and that the total of all applicable deductions (including plant cost—depreciation—of $10,000) is $100,000, with a consequent loss of $10,000. In this situation there is no point to such observations as "we broke even except for depreciation" or "we recovered all expenditures from customers other than depreciation." The actual fact is that revenues were sufficient to cover 90 percent of each and every type of cost incurred, including plant consumed.

Depreciation is not an optional cost, a borderline cost, a take-it-or-leave-it charge. There is nothing imaginary about plant facilities and such facilities cannot be dispensed with in carrying on operations; hence the cost of such facilities cannot reasonably be ignored or put in a subordinate position in computing income.

It is true, of course, that special problems are associated with the measurement of the portion of plant cost appropriately assignable to the revenues of the particular year or other accounting period. A unit of plant may be regarded as a bundle of services, to be received subsequent to installation, but there may well be considerable uncertainty as to what will be the intensity of use from period to period and what will be the total time through which the particular facility will be effective. Coal is consumed in physical installments, and this affords a satisfying basis on which to measure the amount requisitioned and burned in a particular year. The boiler, on the other hand, is used in its entirety to furnish a series of services, and it may weigh about as much at retirement as at date of accuisition. Here, too, however, there has been a tendency to overemphasize minor differences. Basically it is services that are desired and received in the case of the coal pile as well as in the case of the boiler—the principal differences being the frequency of renewal and the degree of physical transformation resulting from use. Moreover, there is plenty of room for argument as to the amount of coal—in dollars—which should be charged to operations in the particular period. Coal in stock is subject to deterioration and there has been a great deal of controversy regarding the pricing-out process (in the case of all types of inventory).

"Reserve" for depreciation

Much of the confusion regarding the nature and significance of depreciation accounting no doubt originates in unfortunate procedure and bad terminology—the indirect method of crediting plant account for estimated accrued depreciation plus the use of the word "reserve" in describing the account credited. On every hand one finds examples of misunderstanding in this connection. To illustrate with one case: Some years ago a New York attorney (a very able chap) was elected chairman of the board of a certain company. He took the assignment seriously and shortly after his election spent a week at the company's office, studying the recent financial reports and other accounting data available. Just before returning to New York he called in the controller and executive vice president and told them that he had been carefully going over the accounts and statements and had been shocked to discover that the "reserve for depreciation" of $14 million was

missing. "I can't find this fund anywhere," he told them, and then he added bluntly, and with a bit of table pounding by way of emphasis: "I've got to leave for New York, but I'm coming back in 2 weeks and if that reserve hasn't been located by then someone is going to jail." The controller finally was obliged to take the time to prepare a funds statement covering the entire history of the company for the chairman's examination, and even though he was disarmed somewhat by this presentation it is safe to say that he never clearly understood the "reserve for depreciation."

The technical accounting for depreciation literally has nothing to do with the accumulation of funds. The "reserve" or "allowance" to which estimated plant cost consumed is conventionally credited is simply an offset to the plant account; far from representing a fund it measures the "hole in the doughnut," as Professor Hatfield put it years ago. It's a case of the use of the sectional bookcase method of accounting for plant cost; cost as incurred is recorded in one section and absorbed or expired cost in another. Assume, to illustrate, that a boiler costs $100,000 installed and that the portion of such cost properly attributable to operation the first period of use is $10,000. The indirect method of crediting plant under these conditions may be indicated as follows:

Boiler—Cost

√	100,000		

Boiler—Accrued depreciation
("Reserve for depreciation")

		(1)	10,000

Boiler cost charged to operations

(1)	10,000		

The first two of these accounts taken together constitute the boiler account. The first section shows the total cost of the boiler when acquired; the second shows the amount of such total cost which has been consumed in operation; the two taken together show the unabsorbed balance of $90,000. To label this second section a "reserve," as is still frequently done in practice, is of course absurd, and is almost bound to lead to confusion—especially when this section is reported as an independent account, apart from the other section to which it is related.

In the case of the cost of coal (and other kinds of inventory), in contrast, direct subtraction rather than offsetting is the conventional procedure. It would be quite possible, however, to record coal consumed in the same way as plant consumed is ordinarily booked. Assume, for example, that a company buys a stock of coal at a cost of $40,000 and that the estimated amount consumed in the following period is $20,000. Applying the offsetting procedure, these data would appear in the accounts as follows:

Coal—Cost

√	40,000		

Coal—Estimated amount consumed
("Reserve for coal consumption")

		(1)	20,000

Coal cost charged to operations

(1)	20,000		

It is a fair guess that if the above were the established procedure for recording coal consumed—and especially if the title shown in parenthesis were used—there would be as much confused talk about coal "reserves" and "coal replacement funds" as we find in the area of the boiler account and boiler cost consumed.

Recognizing depreciation does not provide funds

Many people appear to believe that the process of depreciation accounting—accruing depreciation—automatically provides funds and that all that is necessary to obtain more money is to accrue more depreciation. This is a completely mistaken view. Accounting is an important instrument of business administration, but, fortunately or unfortunately, it has no magic power. Funds are provided by the delivery of product to customers at a price, not by accounting. Moreover, there is very little realism in the notion that the flow of funds from customers can be increased merely by increasing the amount of plant cost charged to current operations. No doubt there are some roundabout relationships between cost accounting and the volume of receipts from customers, but it is daydreaming to imagine that such receipts increase or decrease automatically as depreciation cost is increased or decreased.

Moreover, the recognition of depreciation cost—plant capacity consumed—has no direct relation to what becomes of the money received from customers. Fund utilization is a fairly complex process and the details will vary with changing conditions and changing managerial attitudes. Receipts from customers are used to pay current accounts as they fall due, including payroll, taxes, etc., to pay interest on loans, to reduce long-term debt or redeem preferred shares, to expand inventories, to acquire additional plant facilities or other noncurrent resources, to pay dividends, to build up cash backlog. In this overall process it is seldom, if ever, that the amount of depreciation accrued during the year is a decisive factor in molding decisions as to particular expenditures, and seldom, if ever, will the increase in the total cash balance show any close relationship to the current depreciation charge; and among those relatively rare cases where funds for plant acquisitions are segregated temporarily in separate bank accounts it is almost impossible to find a case where the amount so segregated bears any relationship to the data of plant consumed.

Depreciation accounting and replacement

It follows from the foregoing that the relationship between depreciation accounting and the timing and financing of replacements is by no means as close as is commonly assumed. Systematic recognition of depreciation is necessary as one step in the process of compiling the costs assignable to revenue and determining the magnitude of periodic net earnings (or loss), and the technical accounting for depreciation, in the strict sense, is in no way affected by the possibility of replacement or the conditions of replacement (except as such factors may modify service life of property in use). Indeed, depreciation accounting will follow the pattern outlined earlier even where there is a virtual certainty that the depreciating property will not be replaced. Take, for example, the case of a mining shaft constructed for the purpose of exploiting a mineral deposit which will be exhausted at the planned rate of extraction long before there would be any need for

rebuilding the shaft. In this situation it is necessary to recognize the depreciation of shaft periodically, in the determination of total operating cost, notwithstanding the fact that the depreciating asset will never be replaced, and the accounting procedure will not be changed in any way by the fact that no replacement is contemplated.

Importance of replacement cost

The preceding statement is not intended as an effort to minimize the importance of the process of plant renewal and the level of replacement cost. Properly interpreted as the cost of replacing the capacity to serve represented in existing plant facilities, such cost is of outstanding significance to management. Current replacement cost is important in planning property utilization, in making departmental comparisons, in pricing policies, in determining insurable value, in setting up maintenance standards, in deciding when to retire, and so on. Indeed, in any period of rapid technological change and sharply moving prices it is imperative that the data of replacement cost (properly defined) be made continuously available as a basis for administrative decisions. (And if the accountant isn't man enough to supply the necessary information somebody else will have to undertake the job.)

It is important to note that the replacement cost referred to is not the estimated cost of replacing the boiler or other plant assets at the end of the estimated service life, perhaps many years in the future. It is hardly worth while even to attempt to guess what amount will have to be expended say 10 years hence to replace the capacity to render service embodied in an existing facility. Those who define replacement cost in this way and then object to the use of such data in accounting are simply shooting arrows at a man of straw of their own making. The most significant fact to management—and to all others financially interested—is the current level of the plant cost required to carry on production. That is the cost that is reflected in new construction and equipment purchases; that is the cost that is most influential in the market process and is the most meaningful guide to decisions. As has been pointed out many times by economists, it is not what some unit of plant did cost but what it would cost currently to acquire the unit (or the capacity represented) that is significant (assuming, of course, a relatively free, competitive market structure). To refer to a homely example, a person renting an automobile recognizes that in fixing the rent it is not what he paid for the car that is important but rather the current cost of cars capable of rendering the same service.

To clinch the matter it should only be necessary to point out that a business enterprise cannot be regarded as operating successfully in a particular year unless the current flow of revenue from customers is sufficient to cover the current cost of labor and other services, the current cost of materials consumed, and the current cost of plant capacity consumed, as well as taxes and other charges, and provide a capital-attracting level of net earnings for stockholders. Many business enterprises, of course, do not achieve a condition of successful operation in this sense every year, and many may fail to reach this standard for several successive years (and some never reach it), but there is little room for argument with respect to the general conditions necessary to justify the conclusion that the business is being conducted successfully.

Should depreciation charges be based on current replacement cost?

This brings us to the much-discussed question: Should periodic depreciation of plant facilities be computed as a slice of the number of dollars expended at date of acquisition to acquire the facilities or as a slice of the number of dollars which would be required currently to replace the particular facilities (in the sense of capacity). This has always been a live subject in certain quarters but interest in it has been greatly intensified as a result of the severe and sustained advance in the level of prices in the last 10 to 15 years.

Extended discussion of the matter is not feasible in this paper but a few observations are in order. As indicated above, plant capacity consumed expressed in current cost is a more significant managerial figure than plant consumed expressed in the recorded dollars at date of acquisition (so-called actual cost). The costs deducted from revenue to cover personal services, materials, etc., are largely current in character (having been incurred, usually, either in the period in which charged off or in the immediately preceding period), and it can be argued that a more meaningful figure of earnings results if the cost of plant consumed is also put on a current basis. In this country, however, this is not generally accepted accounting practice, and such procedure has thus far not been countenanced for income-tax purposes. In the years 1946–48, it is true, quite a number of prominent corporations made a start in this direction in their published income statements, but the movement did not "catch on," in part as a result of opposition from professional accountants and Government agencies and a shift of attention to the possibilities of "accelerated" depreciation in the case of new construction and new acquisitions. There is an alternative to specific replacement cost depreciation, moreover, which produces somewhat similar results and yet can be defended as being within the settled framework of a financial accounting structure rooted in "actual cost." This alternative approach to a very real problem of measurement has long been orthodox procedure in a number of foreign countries and deserves serious consideration in accounting practice and in the measurement of taxable income in the United States. The balance of this paper will be concerned largely with this possible method of amending and improving ordinary depreciation accounting, with special emphasis on the sound determination of taxable income.

Currency debasement and accounting

The change in the price level in the last 10 to 15 years represents or reflects a change in the monetary unit employed in this country. We continue to use the old name, the "dollar," but the 1955 dollar is hardly a close relative of the prewar 1940 dollar. The situation is often roughly described by saying that we are now operating with a "50-cent dollar." The erosion of the purchasing power of our currency, it is true, has not been as serious as the erosion that has occurred with respect to many foreign monetary units, but a decline in value of 50 percent—taking us halfway to zero—is a serious change, not to be shrugged off.

This development has created a very real problem of measurement for accountants, and as yet no decisive steps have been taken to meet

the difficulty. Accountants are very meticulous in their handling of accounts expressed in part in foreign currencies, and insist on careful conversion of dissimilar units to a common denominator. No accountant—or anyone else—would think of adding 1 French franc and 1 United States dollar together and calling the result "two dollars." And even where the same name is used, and the difference in value is slight, as in the case of the present-day United States and Canadian dollars, no public accountant employed by an American company with a Canadian branch would permit a financial statement to go out over his name without careful conversion of every figure originally expressed in Canadian dollars into its equivalent number of United States dollars. At the same time our accountants have thus far shown little or no hesitation in adding 1 1940 domestic dollar to 1 1955 domestic dollar and reporting the result as "two dollars," without qualification or explanation.

Correct measurement of "actual cost" of plant and plant consumed

In financial accounting the difficulty posed by the change in the value of the dollar focuses in the measurement of cost—"actual cost"—and the major problem in this area in turn is that of measuring total plant cost and cost of plant periodically consumed, as plant account is the outstanding example of a record consisting—in the raw—of an array of heterogeneous dollars. Other cost factors, in general, are renewed at frequent intervals, and hence the accounts with such factors are, for the most part, expressed at least roughly in current, homogeneous monetary units.

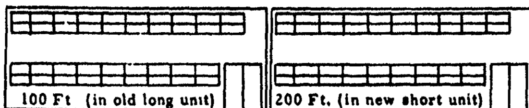
It should hardly be necessary to state that it is unsound measurement, unsound statistical practice, to combine unlike measuring units without a process of conversion. In the field of physical measurement the need for conversion of unlike units to a common denominator is universally recognized. Thus no one would dream of adding short tons and long tons, or meters and yards, without conversion. And in the field of financial measurement conversion is an old story, in measuring changes in real wages, in farm prices, in exports and imports, in gross national product, and so on. Indeed about the only spot where we have persistently avoided such conversion and kept our heads in the sand—despite the efforts of many writers and special professional committees—is in the area of business accounting, especially in the matter of income determination.

To make my point entirely clear I want to present a simple example. Assume that a building were erected with a width of 100 feet and that sometime thereafter the foot were officially shortened to 6 inches. At this point a second building is built alongside the first of the same width (and precisely the same in every other respect). This second building is evidently 200 short feet wide, or 100 long feet wide, whichever way you care to put it, and the first building may be similarly and accurately described. Now the problem arises of measuring the total frontage of the two buildings, in terms of the prevailing short foot. As shown by the accompanying cut and tabulation it would be a sheer inaccuracy to combine the original records of width without conversion. The result of adding the unlike measuring units, 300 feet, is an arithmetic monstrosity, with no meaning whatever. The obviously correct total, expressed in short feet, is 400 feet.

Now precisely the same problem arises in describing the total cost of two buildings originally expressed in dissimilar monetary units. Let's assume that the first building referred to above was erected in 1940 at a cost of 100,000 1940 dollars and that the second building was

TOTAL WIDTH OF TWO ADJACENT BUILDINGS

If 1st Building is 100 Long Feet Wide and 2nd Building is 200 Short Feet Wide

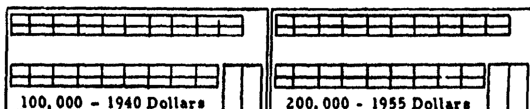


	Relative Length of Foot (New Foot = 1.00)		Number of Feet (Unconverted)		Number of Feet Converted To New Foot
FIRST BUILDING	2.00	x	100	=	200
SECOND BUILDING	1.00	x	200	=	200
TOTAL WIDTH			~~300~~		400

TOTAL COST OF TWO ADJACENT BUILDINGS

If 1st Building Cost $100,000 in 1940 Dollars and 2nd Building Cost $200,000 in 1955 Dollars

(assuming one 1940 Dollar equals two 1955 Dollars)



	Relative Value of Dollar (1955 Dollar = 1.00)		Cost in Dollars (Unconverted)		Cost Converted to 1955 Dollars
FIRST BUILDING	2.00	x	$100,000	=	$200,000
SECOND BUILDING	1.00	x	200,000	=	200,000
TOTAL COST			~~$300,000~~		$400,000

built in 1955 at a cost of 200,000 1955 dollars. (Construction costs have, of course, more than doubled, but this fact is ignored for the sake of simplicity.) Under these circumstances, as shown emphatically by the accompanying cut and tabulation, it is a downright misstatement to allege that the total cost of the 2 buildings is $300,000. This figure is meaningless. One can truthfully say that 1 building cost 100,000 1940 dollars and the other 200,000 1955 dollars but these figures cannot properly be combined without conversion one way or the other. Assuming that one 1940 dollar is worth two 1955 dollars

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the obviously correct total of "actual cost," expressed in 1955 dollars, is 400,000.

And it follows that in determining the annual depreciation charge—the fraction of capacity consumed—on an actual cost basis, it is necessary to compute the charge in terms of the converted total to find a correct figure. Assume, to illustrate, that 5 percent of cost is a reasonable estimate of periodic depreciation. To take 5 percent of the summation of originally recorded dollars, without conversion, results in the clearly inaccurate figure of $15,000. The correct figure is either 10,000 1940 dollars (converting backward) or 20,000 1955 dollars (using the current unit as the common denominator).

Inventory cost and plant cost

There is a major inequity in our present tax structure in that owners of depreciable assets are placed at a serious disadvantage as compared to investors in inventories of materials and merchandise. Inventories are seldom held more than a year or so, and this means that in this area relatively current dollars of cost are deducted from current dollars of revenue. Moreover, through the use of the LIFO procedure authorized by Congress some years ago the process of matching current revenues with current costs is facilitated for owners of inventoriable assets. Under this procedure the taxpayer is permitted to measure the cost of goods sold in terms of the costs most recently incurred, and thus serious overstatement of income is avoided. The LIFO treatment rests on the view that a taxpayer is not making any money to the extent that receipts from customers are absorbed in replacing the stock of goods be started with; he isn't earning anything simply by holding his own.

But no such procedure is as yet available to the investor in depreciable assets—the area in which the impact of the change in the value of the dollar is serious and sustained, as emphasized above. The owner of a stock of materials or merchandise is allowed to state his cost in terms of the same kind of dollars that are used in describing his revenues. On the other hand the owner of the dump truck, the boiler, the hotel building, or any other type of depreciable business property is afforded no such opportunity.

The inequity is especially glaring in the case of long-lived property. Thus the owner of a building acquired in 1940, with cost recorded in 1940 dollars, is required by the present tax structure to treat one 1955 dollar of revenue as the full equivalent of one 1940 dollar of investment. He is assumed to be breaking even when he is recovering only 50 percent of his actual investment.

There are many cases throughout the business field where the major investment is in the form of long-lived depreciable property, and there are still many cases where the major part of the total plant capacity is represented by facilities acquired in prewar days. The outstanding examples are, of course, found among the railways, telephone companies, and electric, gas, and water utilities, where a very large part of the total resources employed is represented by plant facilities with a typical service life of 25 years or more. Companies in these areas, moreover, operate with their selling prices under rigorous control. There has already been an enormous erosion of real capital in these enterprises, and if such concerns are to continue to attract private capital, under a sound capital structure, it is imperative that they be

permitted to retain from revenues, not subject to tax, the funds necessary to make good the plant investment consumed in rendering service, measured in the same kind of dollars as are being received from customers.

In amending the Internal Revenue Code in 1951 Congress took a small step in the right direction with respect to homeowners in providing that if an owner sells his property there is no taxable gain if the proceeds of sale are invested in another residence. This recognizes, implicitly, the point that the writer is urging: namely, that a taxpayer realizes no gain from the disposition of an asset if the entire proceeds are needed to maintain the integrity of the purchasing power invested—the actual cost of the property. This principle should be extended by Congress to all depreciable property, including recognition of the fact that gradual disposition of an asset through use in producing revenue over a period of years is on all fours, as far as equity is concerned, with a lump-sum disposition by sale.

One way to remedy matters—perhaps the most practicable—would be to grant a procedure akin to LIFO for the purpose of measuring periodic depreciation. This would at least tend to eliminate the favoritism shown to the investor in merchandise and materials as compared to the investor in plant facilities in the present tax structure.

Again the question of replacement funds

It should be emphasized that permitting the taxpayer owning plant facilities a depreciation deduction based on actual cost, correctly measured, as recommended above, would not assure the collection from customers of an amount sufficient to replace the capacity consumed when retirement of existing facilities is acquired. Correct measurement of cost will prevent the overstatement of net earnings (or understatement of losses), and likewise prevent confiscation of capital via the income tax in terms of year-by-year calculations, but correct accounting—as explained earlier—will not in itself provide the volume of revenues necessary to produce a level of net earnings sufficient to justify the description "successful operation." Moreover, where there is sustained inflation, amounting to a continuing erosion of the value of the dollar, there may unavoidably be a serious erosion of capital invested. In a competitive market there may be reasonable expectation, speaking generally, of a selling price sufficient to cover total cost correctly measured in current dollars, plus adequate earnings, but there is no reason to assume that the customer can be assessed with the additional amount needed to make up past deficiencies. It is highly desirable that cost be measured correctly in a period of inflation, and that tax deductions be based on such correct measurements, but no formula of computation—including the use of specific replacement cost as a depreciation base—can assure receipt of funds adequate to cover cost of replacing capacity when the date of retirement rolls around.

In other words, the risks of business operation are not removed by accurate annual measurement of cost and tax deductions based on such measurement.

Depreciation accounting and plant expansion

In drafting this paper the writer intended to give some attention to the alleged relation of depreciation accounting to plant expansion.

Having already exhausted my allotted space I can only make the briefest comment on this subject. Certain economists and publicists have been telling us for some years that due to technological development and liberal depreciation deductions we have had little need for capital formation; the "depreciation funds" have been keeping things going nicely. This is the sheerest humbug and cannot be supported statistically or otherwise. The available evidence clearly shows, particularly over the past 15 years, that the total depreciation charged to revenue by American business has fallen far short of the amount required to replace the capacity consumed during the period, at prevailing prices, with full recognition of all technological improvement. Let's not be beguiled any longer by this bit of fakery.

Plant expansion requires additional investment of net earnings or additional paid-in capital. Moreover, a substantial portion of reported net earnings (which have been grossly overstated because—especially—of our failure to measure actual depreciation correctly from year to year) is absorbed by a corrected statement of total accrued depreciation.

Spreading plant cost over service life

One more brief comment and I'm through. In the foregoing I have neglected the interesting topic of estimating service life and methods of spreading total plant cost over estimated life. It should be noted here that even if correct overall measurement of depreciation, in uniform dollars, is provided for the problem of spreading the total cost of a facility over the useful life remains. With respect to methods of spreading it is this writer's opinion that the matter should be left primarily to the taxpayer and his accountant within broad limits. The simple straight-line procedure, with service life conservatively estimated, seems to me to be adequate in most cases. On the other hand I have no serious objection to the use of systematic decreasing-charge procedure, particularly for specialized equipment with a highly uncertain service life. I must confess to a bit of surprise at seeing that hoary textbook curiosity—the sum-of-the-years-digits method—dusted off by Congress and given an official status in the present code. On the other hand I see no objection of consequence to granting taxpayers permission to use this device if it appeals to them.

DEPRECIATION AS A TAX PROBLEM

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With the exception of land, the productive facilities of industry are wasting assets. They deteriorate with time and use, and are subject to obsolescence with the appearance of new techniques and new products. Whatever the particular combination of these factors of wear and obsolescence—and it varies widely from case to case—the end result is the same: The capital embodied in the facilities is exhausted over their productive service lives. It follows, obviously, that capital consumption is an inescapable cost of operation. No net gain or profit results until this cost has first been recouped.

While the wastage of fixed assets must always have been recognized in some fashion by business management, the practice of making regular periodic charges for capital consumption is a development

largely of the last 50 years. Prior to this development many enterprises had no systematic procedure whatever, especially the smaller ones.

Under the informal accounting methods of the earlier period, a good deal of outlay on fixed assets was simply expensed as made, rather than spread over future years via the depreciation account. At the other extreme was the practice, especially prevalent among public utilities, of charging off nothing until the retirement of assets, their cost being absorbed against the income of the final year. An intermediate procedure was to charge them off sporadically during their service lives by arbitrary amounts, usually in years of high profits.

If early depreciation policy was generally primitive for accounting and management purposes, it was even more so for tax purposes. This is illustrated by the two early forays of the Federal Government into the field of income taxation. In the Civil War income-tax law, depreciation was not even mentioned. In the act of 1894 (ruled unconstitutional in 1895) it was expressly disallowed. It was not until the third venture into the field, in the corporate income tax of 1909 (nominally an excise), that the propriety of capital consumption charges was recognized. The act permitted "a reasonable allowance for the depreciation of property."[1]

Importance of the Problem

The importance of depreciation allowances from the standpoint of public policy stems primarily from their role in the financing of productive capital formation. Even on their present inadequate basis, these allowances—or, more accurately, the funds they make available when earned—account for about half of the fixed capital expenditures of American industry. On an adequate, that is to say, a realistic, basis, they would cover a considerably higher fraction, notwithstanding the increase in expenditures that would undoubtedly accompany larger allowances. Depreciation is normally the major source of business investment funds.

This fact should make sufficiently obvious the desirability of realistic depreciation allowances. For it stands to reason that the reporting of capital recoveries as income—the inevitable result of underdepreciation—is bound to affect adversely the supply of capital funds. This would be true even if the erroneously reported income were free of taxation, but it is doubly so under the impact of the high tax rates now prevailing.

The reason for this adverse effect is easily stated. From the standpoint of its availability for capital investment, a dollar reported as taxable business income is subject to a twofold or double erosion. It is reduced both by the applicable income taxes (corporate and personal in the case of an incorporated business, personal in the case of a proprietorship), and by any consumption expenditures made by the owners from dividends or proprietary withdrawals. With the present tax structure, this double erosion ordinarily leaves for investment only a minor fraction of the original dollar. When the dollar is reported as depreciation, on the other hand, it usually remains in-

[1] It is interesting to note that it was in the same year, 1909, that the Supreme Court first recognized depreciation as a proper charge in the regulation of public-utility rates (*Knoxville v. Knoxville Water Co.* (212 U. S. 1)).

tact. As a capital recovery, it is tax free. Moreover, because it is a recovery and not income, it is normally regarded by management as unavailable for distribution, hence, is protected against consumption by the owners. Both forms of erosion are thus avoided. From the standpoint of capital formation, a dollar of depreciation is worth several dollars of taxable income.

Trend Toward Liberalization

There has been a growing realization in recent years of the importance of depreciation as a source of capital funds, and the trend is definitely toward its liberalization. Since World War II, a number of countries have increased their tax allowances in one way or another, and these increases have generally been reflected, voluntarily or by requirement, in enlarged depreciation for accounting and managerial purposes.

One reason for this trend is not far to seek. The levels of corporate and personal income taxation now in effect in many countries have greatly reduced the capacity, or at least the willingness, of the community to save from taxpaid income. This has threatened to dry up an essential source of funds for the improvement and expansion of productive capital and to afflict industry with a kind of chronic financial anemia. The long-range consequences of such a condition no responsible government can contemplate with equanimity. Since it has not been deemed politically feasible to increase saving from taxpaid income through a reduction of tax rates (especially the rates on corporate and upper-bracket personal incomes, from which most of the added saving would come), the obvious course has been to increase tax-free sources of capital funds, chief of which is depreciation allowances.

There is, however, another reason no less cogent. Most, if not all, of the countries effectuating these liberalizations experienced during and after the recent war a substantial degree of inflation. Depreciation allowances are based ordinarily on the original cost of the assets concerned, and are limited cumulatively to the recovery of that cost. This arrangement is satisfactory in an era of relatively stable price levels, but can be seriously, and even ruinously, inadequate after a period of inflation. Under such conditions, the recovery in depreciated currency of the amount originally invested in a currency of greater purchasing power is only a fractional recovery in real terms. It does not suffice to offset real capital consumption. Obviously, if the funds to offset this consumption are not provided by tax-free depreciation allowances, they must come out of savings from taxpaid income—a source already inadequate, as just noted, without this added burden.

Two Kinds of Adjustment

In view of these considerations, it is not surprising that the liberalizations of depreciation mentioned a moment ago fall into two main categories: (1) Those that adhere to original cost as the basis of depreciation, but attempt to increase the currently available allowance by speeding up the recovery of that cost; (2) those that abandon the original-cost basis for a higher one adjusted for the effects of infla-

tion.[2] Some countries have been content with only one type of liberalization; others have employed both.

We have not attempted a systematic review of postwar legislation in this field, and, therefore, cannot offer a comprehensive report. The breadth of the trend toward liberalization is suggested, however, by the number of cases that have come to our attention in a cursory reading. The first type of adjustment—the speeding up of historical-cost depreciation—has been noted in the United States, Great Britain, Canada, Australia, New Zealand, South Africa, India, Pakistan, Germany, France, Italy, Belgium, Holland, and Switzerland. Sweden should also be mentioned here, although her legislation was prewar (1938). The second type—correcting for the inadequacy of the historical-cost recovery itself—has been observed in France, Germany, Austria, Italy, Belgium, and Holland.[3] Careful research would certainly disclose other cases in both categories.

It may be added in passing that while these two adjustments are quite distinct in form and technical characteristics, and are designed to subserve distinct purposes, the attempt has often been made to use the first in lieu of the second. In these cases the recovery of original cost has been speeded up beyond a realistic schedule in an effort to offset the inadequacy of the recovery in terms of purchasing power. In view of this effort, the distinction between the two adjustments is less clear in practice than it is in theory.

Position of the United States

It will be noted that the United States appears on the above list only for the first adjustment, acceleration of the original-cost writeoff. (The reference, of course, is to the Internal Revenue Code of 1954). Notwithstanding an inflation during and after World War II of the general order of 100 percent, there has been no departure, for tax purposes, from historical-cost depreciation.

The importance of this failure to adjust for inflation is indicated by some estimates developed for the year 1953 in the recent book Realistic Depreciation Policy.[4] These showed the then-existing historical-cost tax depreciation to be deficient for that year by nearly $5 billion on business assets alone. This is the amount by which depreciation on these assets measured in 1953 dollars exceeded that measured in the dollars of original investment.

The significance of the omitted adjustment can be indicated by another estimate from the same study. In 1953 the undepreciated balance, or net amount, of all business assets was something like $70 billion higher measured in current dollars than actually shown in original dollars. The corresponding figure today would be around $60 billion. This means that even if we have no further inflation, future depreciation on now-existing assets will fail by this amount to provide a full recovery of the investment still remaining to be depreciated.

While depreciation remains deficient in terms of purchasing power because of past inflation, the Internal Revenue Code of 1954 does

[2] The speeding up of the original-cost recovery does not, of course, increase the amount ultimately recovered, but it can increase the amount taken currently, which is the object of the acceleration.

[3] Both adjustments have frequently been restricted to certain classes of assets only.

[4] Published by the Machinery and Allied Products Institute, 1954.

achieve a marked advance in the writeoff of original cost. Previous adherence by the Internal Revenue Service to the straight-line writeoff over full estimated life, a notoriously lagged method, had given the United States the worst tax-depreciation system of any major industrial country. By authorizing the use of the double-rate declining-balance and sum-of-the-years-digit methods (on assets acquired new after 1953), the current code promises a gradual improvement of our tax depreciation and eventually a better comparison with other countries.

Realistic Versus "Incentive" Depreciation

As indicated a moment ago, some countries have accelerated the recovery of original cost beyond realistic limits in order to compensate for failure to adjust for inflation. In some cases, it has been similarly accelerated without regard for this factor (the Swedish legislation of 1938, for example) simply from a desire to stimulate more capital investment than would be forthcoming under a realistic procedure. In other cases, both purposes have been present. Since the objectives have been mixed, it has been unnecessary to distinguish between incentive depreciation and depreciation than can be realistically justified apart from incentive considerations.

Conceivably it might be desirable, as a means of stimulating capital investment and economic progress, to grant industry regularly a more rapid recovery of its capital via depreciation than can be realistically justified. Or it might be a good thing to grant such an overpaced recovery at certain times only, as part of a contracyclical economic policy. But on these questions we offer no opinion at this time. Instead, we wish merely to inquire whether the new methods offered by the Internal Revenue Code of 1954 do in fact constitute incentive depreciation. Are they unrealistically accelerated, embracing thus an element of incentive or subsidy, or are they, by and large, no more than taxpayers are rightfully entitled to?

This is an important question. For in going beyond the rightful claims of its beneficiaries, incentive depreciation is vulnerable to attack as a subsidy. As a favor granted by government, it can be withdrawn at the pleasure and discretion of government. Realistic depreciation, on the contrary, involves no favor, bonus, or handout of any kind. Its allowance for tax purposes should be deemed a solemn obligation of government, immune alike to political caprice and fiscal vicissitudes. The claim of realistic depreciation is unimpeachably secure.

Pattern of Depreciation

The object of the depreciation allowance is to charge against revenues the wastage of assets employed in their production. This wastage is not physical exhaustion, though that may have something to do with it: it is rather the exhaustion of the capital invested in the assets. Basically, it is the loss of their remaining value with time and use.

In individual cases, of course, this loss of value is likely to be highly irregular over the asset life. It is specifically unpredictable. The depreciation allowance is a projection in advance of the facts, and in the nature of the case must reflect a generalized pattern based on past experience. The real question is, What type of writeoff schedule is appropriate. What type most nearly represents the typical, or average, pattern of value erosion?

It is a matter of common observation that the services of capital assets tend to be less and less valuable as time goes on. There is, of course, no mystery about this phenomenon. The majority of such assets require during their service lives a flow of maintenance expenditures, which as a rule rises irregularly with age and use. Most of them suffer a progressive deterioration in the quality or the adequacy of their service. Moreover, in a dynamic technology such as ours they are subject to the competition of improved substitutes, so that the quality of their service declines relative to the available alternatives even when it does not deteriorate absolutely. All of these factors—rising operating costs, impaired service quality or adequacy, and improved alternatives—combine to reduce the value of the service as the assets age.[5]

Because the most valuable services of a productive asset are used up first, the decline in asset value normally is accelerated, in the sense that it is more rapid in the early part of the service life than later. Granted that the depreciation method should reflect this general pattern, the question remains how much acceleration is warranted. Do the new methods of the 1954 code, which write off roughly two-thirds and three-quarters of cost over the first half of the estimated service life (by declining-balance and sum-of-digits, respectively) go beyond a reasonable degree of acceleration?

New Methods Realistic

Limitations of space do not permit the development here of the full evidence for the reasonableness of a two-thirds to three-quarters write-off over the first half of asset life. The question is examined at length in the book already cited, Realistic Depreciation Policy (chs. 4 and 5). We can summarize the results by saying that both theoretical and empirical evidence appear to justify about this degree of acceleration for short- and medium-lived assets, mostly capital equipment, though perhaps somewhat less for extremely long-lived assets, chiefly buildings and structures.

The theoretical analysis just referred to cannot be reproduced here, but a specimen of the findings may be of interest. The following table shows, for representative assumptions, the computed percentages of original capital value lost during the first third and the first half of asset life:

Service life of asset (years)	Percent of value new		Service life of asset (years)	Percent of value new	
	Value lost in 1st third of life	Value lost in 1st half of life		Value lost in 1st third of life	Value lost in 1st half of life
5	53	73	30	45	65
10	51	71	40	43	63
15	49	70	50	41	61
20	48	68			

[5] This deterioration in the quality of the service, both absolutely and relative to current alternatives, is reflected in a general tendency to reduce the intensity or continuity of use of assets as time goes on. This tendency is analyzed at length in the institute's book, Dynamic Equipment Policy (McGraw-Hill, 1949), and a number of empirical studies of declining use intensity are there summarized in graphical form (chart 1, p. 20).

It is evident that by this theoretical test the first-half loss of value is in the two-thirds to three-quarters range (68 to 73 percent) for service lives of 5 to 20 years, which cover the bulk of capital equipment. It is evident also that the percentage lost is inversely related to the length of the service life.[6]

These findings from theoretical analyses are confirmed by practical observation of the course of values in resale markets. Again we can cite only the main findings of the study under review. These show the loss of resale value over the first third and the first half of life for eight types of equipment.

Type of equipment	Percent of value new		Type of equipment	Percent of value new	
	Value lost in first third of average life	Value lost in first half of average life		Value lost in first third of average life	Value lost in first half of average life
Passenger cars	63	76	Heavy tractors	57	69
Light trucks	52	66	Combines	56	67
Medium trucks	52	66	Cornpickers	56	65
Light tractors	56	65	Hay balers	62	73

By this test also, a first-half writeoff of two-thirds to three-quarters of cost appears to be entirely reasonable.

The investigation points definitely to the conclusion that for equipment at least the new code methods are soundly realistic. When we remember that equipment accounts for the overwhelming bulk (about five-sixths) of business depreciation charges, it will be apparent that any element of "incentive" inherent in these methods is relatively negligible. By and large, they are about as close to realism as we can get in any procedure designed for across-the-board application.

It may be pointed out, moreover, that these writeoff methods are less accelerated in actual application than they appear when considered by themselves. This is due in part to the lag in depreciation recoveries inherent in the rules prescribed by the Internal Revenue Service for the operation of group accounts, and in part to the lag arising from the use of average-life estimates with dispersed actual mortalities. Both of these lags are discussed in Realistic Depreciation Policy (chs. 6 and 7) and need not be further considered here.

Conclusion

As far as the new methods go, they constitute a notable advance toward realistic tax allowances. In our judgment they should be continued on a permanent basis. In addition, further consideration should be given to adjustment of depreciation for the effects of inflation, giving careful study to the experience of other countries. Finally, this committee, if it wishes to appraise the true impact of the new depreciation law, should at an appropriate time give consideration to the regulations of the Internal Revenue Service when they are finally issued.

[6] This observation provides an interesting commentary on a bill introduced in the last session of Congress (H. R. 7694) which would restrict to assets with an estimated life of 10 years or more (instead of 3 years or more as now) the use of the new writeoff methods provided in the 1954 code. Both theory and common observation confirm the tendency of short-lived assets to lose value with greater relative rapidity in the first half of life than the long-lived. The straight-line writeoff, the practical alternative to the new methods, is even worse for the under-10-year assets than for those of 10 years and over.

These regulations should give full effect to the intent of Congress in legislating realistic depreciation policy. They should be reasonable and flexible in applying the basic statute and in establishing permissible writeoff methods and accounting procedures. The Revenue Service should not restrict the taxpayer unnecessarily in applying and adapting these methods to individual company situations. This is not intended to prejudge the final regulations in any way but merely to alert the committee to the fact that the real impact of the new depreciation law will depend in considerable measure on the manner in which it is interpreted and applied by the Service.

In closing, it should be emphasized again that the allowance for tax purposes of realistic depreciation deductions is not a handout, or giveaway to business, big or little. On the contrary, it is no more than business can properly claim and no more than it properly deserves. To allow less is to enforce a distorted reckoning of taxable income, resulting in the taxation as income of what are really capital recoveries. We have already noted that the effect of such taxation is an erosion of the funds available for financing productive capital formation, and an impairment of the vigor of the economy.

It is a grave mistake to regard tax depreciation as a matter in which the average citizen has no interest. This would be true only if he were unconcerned with economic progress and the improvement of his standard of living. But since he is concerned with these things, he has an interest in a broad-gaged intelligent depreciation policy.

That this is a truth more vividly appreciated abroad than in this country is one of the anomalies of the modern world. Surely it is an anomaly that at least prior to 1954 the United States, which regards itself as the exemplar of the private-enterprise economy, should have lagged in this area of policy so far behind even Socialist governments in other lands. Now that it is started on reform, it should persevere until it no longer enjoys the dubious distinction of treating private business in this respect less favorably than do its professed enemies.

XI. ROLE OF COMMODITY TAXATION IN TAX POLICY FOR STEADY GROWTH

THE ECONOMICS OF COMMODITY TAXATION AND THE PRESENT EXCISE TAX SYSTEM

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The term commodity taxation is used with reference to taxes which are designed to rest upon the purchasers of commodities (and, in some cases, services). These taxes are normally levied upon the sellers of the commodities, on the basis of output or sales, or receipts from sales, with the assumption that they will be shifted forward to the consumers through increases in prices.

Commodity taxes may be grouped into two major classes:

(*a*) Excise taxes, sometimes called selective excises or selective sales taxes: Those levied upon the sale (or production) of particular commodities or groups of commodities.

(*b*) Sales taxes, sometimes called general excise taxes: Those levied upon the sale of all commodities except ones specifically exempted.

The terms excise tax and sales tax will be used in this paper with respect to these two classes.

THE BASIC PHILOSOPHY OF COMMODITY TAXATION

The basic philosophy of commodity taxation is the spreading of the burden of the portion of Government expenditures financed by this form of tax in proportion to consumer expenditures, rather than in proportion to income or other criteria. To the extent to which the burden of the taxes is actually shifted forward to the consumers and remains upon them, as is generally assumed, this philosophy is attained. The burden of excises is distributed in proportion to expenditures upon the taxed articles; the burden of a completely general sales tax (limited to consumption goods) would be distributed in proportion to all consumer expenditures. In practice, no sales taxes are completely general, and therefore the distribution of burden is less broad. Sales and excise taxes normally have proportional rates; whether the distribution of their burden relative to income is proportional, progressive, or regressive is dependent upon the relationship between consumption of the taxed commodities and income at various income levels.

To the extent to which the taxes are not fully shifted to consumers, the burden rests directly upon the business firms. If they are unable to shift it to those supplying them with factor units, the burden will remain on their owners, and is certain to be distributed in a very haphazard manner relative to incomes. If the tax could be shifted

back in a uniform fashion to all factor owners, in the manner envisaged in the greatly simplified analytical models of Rolph and others, the burden would be distributed in the same manner as that of a proportional income tax.[1] But the institutional setting is such as to preclude uniform backward shifting.

Taxes shifted forward to the consumers of the taxed commodities may be subject to secondary shifting because the increase in the cost of living index caused by the tax-induced increases in the prices of the taxed goods may result in wage increases. To the extent to which this secondary shifting occurs, the pattern of burden is altered, with a greater overall share resting on those groups which are unable to shift the tax which they bear initially or the additional burden shifted onto them by those gaining higher wages.

The Present Excise Tax System

The present Federal excise taxes may be grouped into four classes, on the basis of the specific pattern of income distribution which is intended. The purely regulatory excises, such as those on adulterated butter or opium, which are not designed to raise revenue are excluded from the present analysis. The four groups include:

1. The so-called sumptuary excises, those on liquor and tobacco products: These are designed to distribute a portion of the total tax burden in proportion to consumption of those products which, in the eyes of Congress, people would be "just as well off without"—ones which persons who wish to use must expect to pay a heavy tax for the privilege of doing so. These levies are essentially designed as deliberate penalties on the use of the taxed products, penalties which, however, are not expected to discourage significantly the use of the products

2. The "luxury" excises: These are imposed upon commodities which are regarded as "luxuries," in the sense that they are not considered to be essential for a minimum standard of living. The use of the commodities is thus regarded as a measure of ability to pay, supplementary to the income measure. This category includes the bulk of the Federal excises, including those on radios and electrical appliances, admissions, jewelry, cosmetics, furs, luggage, communications, transportation of passengers, musical instruments, photographic equipment and sporting goods. In the past the tax on the sale of automobiles has been regarded as a luxury excise, but there has been an increasing tendency to regard this as a benefit-based levy relating to highway finance, and thus classified in (3) below.

3. The benefit-based levies, related to highway finance: The Federal tax on gasoline, although not specifically earmarked for highway purposes, has come to be regarded as a source of funds for the financing of Federal grants for highway construction, and thus to be justified on the basis of the benefit principle. The tax is a convenient device for distributing the costs of the highway grants on the basis of highway use. The taxes on lubricating oil, automobile tires, automobiles, trucks and buses, and automotive parts, may likewise be regarded as benefit-based levies, although in the past they were generally justified on the luxury basis. At present Federal grants for highway pur-

[1] E. R. Rolph, The Theory of Fiscal Economics (Berkeley: University of California Press, 1954), ch. VI.

poses are less than the sum of the revenues from these levies, but if the projected highway program is carried out, the expenditures will easily equal or exceed the revenues of these taxes.

4. Miscellaneous excises: These were introduced at various times solely for the purpose of raising revenue, without consideration of the pattern of distribution of burden. The most important is the tax on the transportation of freight. The tax on business machines also falls into this category.

The yield of the major excises, grouped into the four classes, is shown in table I, for the fiscal year 1955.

TABLE I.—*Excise tax yields, fiscal year ending June 30, 1955*

	Revenue (millions of dollars)	Percentage of total excise tax revenue
Sumptuary excises:		
Liquor	2,726.1	
Tobacco	1,570.6	
Total	4,296.7	47.3
Luxury excises:		
Electrical appliances	88.9	
Radio, phonograph, and TV	136.8	
Light bulbs	18.7	
Musical instruments and records	19.1	
Matches	5.8	
Photographic apparatus	15.2	
Sporting goods and firearms	26.8	
Pencils, pens, and lighters	8.4	
Furs	27.1	
Jewelry	142.4	
Luggage	50.9	
Toilet preparations	71.8	
Telephone and telegraph	520.5	
Transportation of passengers	197.2	
Admissions, etc.[1]	220.2	
Safe deposit boxes	5.6	
Total	1,555.4	17.1
Highway-benefit excises:		
Gasoline and diesel fuel	971.7	
Lubricating oil	69.6	
Tires and tubes	163.7	
Trucks and buses	134.8	
Automobiles	1,047.8	
Automotive parts	136.7	
Total	2,524.3	27.8
Miscellaneous:		
Transportation of freight, including oil	441.3	
Business machines	57.3	
Total	498.6	5.5
Unclassified [2]	216.2	2.3
Total	9,085.8	100.0

[1] Including taxes on cabarets, bowling alleys, dues, coin-operated devices, playing cards, wagers.
[2] Including regulatory taxes, excises on sugar, coconut oil, and stamp taxes on transfer of property, securities, etc.

Source: Treasury Bulletin, September 1955, pp. 48–49.

About half (47 percent) of the excise-tax revenue is thus yielded by the sumptuary excises. The luxury excises yielded about 17 percent of the total, the highway finance levies 28 percent, and the others 8 percent. Expenditures on commodities subject to the sumptuary excises constitute about 6 percent of total consumer expenditures; those on commodities subject to the luxury excises, about 6 percent,

and on the benefit-based levy commodities, 8 percent. The excises as a whole, therefore, apply to commodities on which roughly 20 percent of consumer expenditures are made, apart from excises such as that on the transportation of freight, for which no estimate is possible, since the service involved is not directly an object of consumer expenditures.

It should be noted that the net yield to the Government is less than the gross figures given. In the first place, the tax applies to purchases by the Federal Government in most cases; the revenue on these transactions is offset by an equivalent increase in Government expenditures. Furthermore, apart from direct application of the tax on Government purchases, the prices of many goods which the Government acquires are inflated by various excises, such as those on transportation, communications, etc., which apply to elements entering into the cost of production of the items. Secondly, to the extent that the tax-induced increase in the cost of living raises the wage level, the Government will ultimately be forced to pay higher wages to its employees. Thirdly, to the extent that the tax is not shifted by business firms, or the shifting causes losses in sales volumes, the yield of the corporation and personal income taxes will be directly and immediately reduced. It is impossible to estimate the magnitude of these effects, and thus to obtain the net yield of the excises.

The Economic Significance of the Excises

The economic significance of the excises must be examined from two points of view: That of consumers, and that of business firms, including not only those upon which the tax is levied, but also others whose sales are affected by the presence of the tax.

Effects upon consumers

There are two major types of effects which the excises have upon consumers. In the first place, to the extent that the excises are shifted forward to consumers, and the money incomes of the households are not affected by the tax, consumers must either reduce the volume of savings which they make, or curtail consumption. In practice there is likely to be some effect of each type. For those persons who have a highly inelastic demand for consumption goods, and regard savings as a residual amount left over after consumption, the entire burden of the tax will be borne out of the portion of income that would otherwise have been saved—assuming that the savings margin is of sufficient magnitude. On the other hand, persons spending all of their incomes prior to the tax, or having a highly inelastic demand for savings—that is, a strong determination to save a certain sum annually—will absorb the entire tax burden out of funds which would otherwise have been spent on consumption. These persons will continue to spend the same total amount on consumption, including the tax element, as they previously did, and thus the value of consumer goods acquired (net of tax) will be reduced by the sum of the tax element. It is likely that most families will fall into neither extreme, but will absorb some of the tax out of the portion of income saved and a portion out of that spent for consumption.

The reduction in consumption does not necessarily take place entirely in the taxed commodities. If the demands for these are highly

inelastic, the reduction in consumption will occur primarily in nontaxed goods. Thus, for example, since the demand for cigarettes is known to be highly inelastic, the excise tax on this commodity, to the extent that it is not absorbed out of income that would have been saved, results in a reduction in purchases of other commodities. To the extent, however, that the demand for the taxed article is elastic, the reduction in the consumption will occur in the taxed commodity.

In the second place, excise taxes give an incentive to shift purchases from taxed to untaxed commodities, and thus to reduce the purchases of taxed items much more drastically than would occur merely as a result of the absorption of purchasing power. This influence is particularly strong if the taxed articles have untaxed substitutes. Thus the tax on passenger transportation by public carrier, the demand for which is probably fairly elastic, undoubtedly causes a shifting of transportation toward increased travel by private automobile, with an actual increase in the use of the latter. The tax on admissions to movies, etc., is likely to cause an increase in the demand for untaxed recreational activities.

Thus, in summary, the excises will tend to—

1. Reduce the total volume of savings, to the extent that the taxes are absorbed out of the portion of income that would otherwise have been saved.
2. Reduce the overall level of consumption (in real terms).
3. Particularly reduce the consumption of the taxed articles, except in the cases in which demand is extremely inelastic, partly by reducing the total volume of purchases possible with a given level of income, partly by encouraging persons to buy untaxed substitutes.
4. Increase the consumption of commodities which are good substitutes for the taxed items.
5. Reduce the consumption of those untaxed commodities which persons sacrifice in order to maintain purchases of taxed articles for which their demands are inelastic.

Effects upon producers and other business firms

The excise taxes affect producers and other business firms in three possible ways.

In the first place, it is unlikely that complete shifting of the tax is possible in all cases, and thus a portion of the tax burden remains upon the firms. This is illustrated by the fact that when excise taxes were reduced in 1954 some of the commodities affected did not fall in price (movie admissions in many cases, and some small electrical appliances, for example); the failure of prices to fall when the tax was cut suggests that the tax was not previously being fully shifted. When firms are unable to shift the tax fully, the funds available for expansion are reduced, as well as the incentive to expand, since profits are curtailed. Likewise, the incomes of the owners are reduced.

Secondly, to the extent that consumption of products is curtailed, the sales of the producers and dealers in the products are reduced below the levels which would be attained in the absence of the tax. In an industry which is rapidly expanding, such as the automobile industry in recent years, the net effect is merely to reduce the rate of growth in sales below the figures otherwise possible. Thus, the profit margins of the firms are not necessarily reduced, but the rate of in-

crease in total investment in the industry is lowered. On the other hand, in industries such as the railroad field which are relatively stable, the reduced volume may lessen the profit rate of the firms, and perhaps make it difficult for them to continue to cover their costs. In regulated industries rate increases to compensate for the reduced volume of business may occur.

Thirdly, certain excise taxes result in the altering of methods of production. Several of the excises rest in part or entirely upon purchases by business firms of goods and services for use in production. Accordingly, firms are encouraged to substitute nontaxable articles and services for those which are subject to tax. Thus, the taxation of freight service rendered by public carrier encourages firms to develop their own private motor-carrier operation, which is not subject to tax.

Relative Effects of Excises Compared to Other Taxes

Given the level of Government expenditures, excise taxes must be regarded as substitutes for other taxes, and therefore, in an evaluation of excise taxes, their effects must be compared with those of other taxes.

Relative effects upon consumption

Any form of tax will, of necessity, reduce either savings or consumption or, in practice, partly each. Personal income taxes reduce disposable income, and thus leave a smaller sum in the hands of individuals to use for consumption and savings. It is generally assumed that, per dollar of revenue, an income tax will be absorbed out of savings to a greater extent than excise taxes, partly because a greater portion of its burden is likely to be concentrated on those persons who save high percentages of their incomes, partly because it does not provide the incentive to curtail consumption in order to avoid tax which the excises give. This assumption is not necessarily valid, however; income taxes borne largely in the lower tax brackets could conceivably have greater effect in reducing consumption than those excise taxes borne largely by high-income consumers. But the nature of the present excise-tax system, with its heavy impact upon articles of widespread usage, suggests that it probably curtails consumption to a greater extent than income taxes yielding the same revenue. By contrast, a general sales tax, applying to a much wider range of goods of everyday consumption than the excises, is almost certain to reduce the overall level of consumption to a greater extent than excise taxes yielding the same revenue.

Unlike excise taxes, however, neither income taxes nor sales taxes provide definite incentive to shift consumption patterns from some commodities to others. It is true that as disposable income falls, or the general price level of consumer goods rises as a result of a general sales tax, consumers will reduce purchases of some goods to a greater extent than those of others. But the direct incentive to shift consumption patterns is absent.

Relative effects upon producers

Personal and corporate income taxes directly reduce the net earnings of business firms, to the extent to which they are not shifted forward to consumers. Such shifting is usually assumed to be limited.

Thus, per dollar of tax revenue, they have a greater direct effect in reducing both the funds available for investment and the incentive to undertake investment than the excise taxes. Personal income taxes, especially the higher bracket rates, must also, to some extent, reduce the willingness of individuals to make their capital available for business expansion. The actual magnitudes of these effects are not known. On the other hand, the excise taxes probably have a greater effect in curtailing consumption, per dollar of tax revenue, then income taxes, and thus a greater effect in reducing investment through the effect upon sales of business firms. It must always be kept in mind that investment by business firms depends not only upon the amount of money capital available and the tax rate upon earnings made, but also upon the volume of sales being made by the firms. The net difference between the excises and the income taxes with respect to the volume of investment is difficult to assess.

The differences betwen the excise-tax system and a general sales tax, so far as investment is concerned, is probably not great, except for the fact that the effects of the sales tax will not be concentrated so heavily in particular industries. To the extent to which the sales tax causes greater curtailment of consumption and thus has a lesser effect upon savings, it will have a greater repressive influence upon investment through its effect upon the sales of business firms, but a lesser influence upon the volume of money capital available for expansion.

Neither income taxes nor sales taxes confined to consumers goods provide the incentives given by the present excise-tax system toward the altering of methods of production. In practice, however, as the States and other countries have found, it is very difficult to confine a sales tax to such products, and the taxation of some sales of producers goods results in an alteration of the relative advantages of various methods of production.

Evaluation of the Excise Tax System

Particular taxes can be evaluated only in terms of assumed criteria of desirable tax systems. Three such criteria are frequently employed; namely, (1) the avoidance of adverse effects upon the functioning of the economy, (2) distribution of the burden of the tax in conformity with accepted standards of equity, and (3) administrative feasibility.

Economic effects

The effects of the excise taxes in curtailing consumption and thus production are not objectionable, per se; all taxes have this effect, to a certain extent, and, indeed, from the standpoint of the economic system, the primary function of a tax is to curtail private spending to a sufficient extent that inflationary pressures generated by Government expenditures are offset. However, the excises are likely to have a greater effect on the overall level of consumption, per dollar of revenue, than income taxes, and thus, in periods in which difficulty is encountered in avoiding unemployment, the adverse effects of the excise taxes are greater. The case for elimination of exise taxes is particularly strong in periods when there is any tendency toward unemployment. On the other hand, of course, the excise taxes probably have lesser effect upon the direct incentives toward investment

than higher bracket income taxes, and in periods in which there is strong evidence that investment is lagging because of tax effects upon incentives, there is a good case for lowering high-bracket income-tax rates instead of excises. But it is very doubtful if the lower-bracket rates of income tax have more adverse effect upon incentives than the excises.

A serious complaint against the excise-tax system is based upon the effect of the excise taxes in curtailing consumption and thus output of some products to a greater extent than others. The imposition of an excise tax causes persons to shift consumption from taxed to untaxed articles; to the extent to which this occurs, the Government receives no revenue, yet consumers shift their purchases toward less-preferred goods.

The effect of the taxes in shifting consumption and thus production can be justified in certain instances. In the first place it can be justified whenever the production and use of the product gives rise to certain costs to society which do not enter into the price of the product. Thus the use of alcohol to excess gives rise to loss of worktime, need for care of alcoholics, increased automobile accidents, disrupted homes, and other social evils. Thus the very heavy taxes on whisky and other liquor of high alcoholic content can be justified as a means of placing these social costs upon the users. Secondly, such shifting can be justified when consensus of opinion in the contemporary society regards the use of the taxed commodities as either contrary to the best interests of society, or at least a suitable base for application of penalty taxation. On this basis the entire group of liquor and tobacco taxes may be justified—although many persons (though presumably a minority) regard the levies as an unjustified effort to impose rules of morality via tax legislation.

Thirdly, when the excises serve to cover the expenses of a governmental activity of direct and immediate benefit to those who bear the burden of the excises, the taxes may be regarded as legitimate elements in the costs of the goods, and any curtailment of use which results is not uneconomical. Thus, if the principle is accepted that highway users should pay for the Federal highway program, and the excises on gasoline, lubricating oil, automobiles, trucks, and buses are regarded as means of distributing the burden of the program onto the users, these excises may be justified even though they may result in some restriction of use of the commodities. The merits of a program of making highway users pay for the highway programs are widely known, and do not need to be repeated here.

In the case of the other Federal excises, however, the effects of the taxes in curtailing consumption and thus output are difficult to justify. In some cases obviously objectionable results can be indicated. The tax on public passenger transportation tends to divert persons from using public carriers to driving their own cars, and thus aggravates the problems of traffic congestion which are so serious in many areas. To the extent that persons will use public transportation in these areas, the need for spending large sums of money for additional highway facilities will be less pressing, and real social costs, in the form of accidents and delays from congestion, will be lessened. Even in the case of such excises as those on cameras, electrical appliances, admissions, etc., it is extremely difficult to defend the inevitable reduction in consumption and output which results from the taxes.

A further objectionable feature of the excise system is the effect which certain excises have in altering methods of production employed. Under the reasonable assumption that firms will seek to use the most efficient methods in the absence of the tax, any tax which increases the cost of some methods of production compared to that of others will result in an undesirable loss in efficiency in the production system, and is thus a deterrent to optimum economic development. The most objectionable excise tax in the present system, from this point of view, is that upon the transportation of freight. This tax, despite its relatively low rate, inevitably has some effect in encouraging firms to develop their own highway and water transportation systems instead of using public carriers. As a consequence, the public carriers have greater difficulty in maintaining good service, and, to the extent to which they operate under decreasing cost conditions, their rates tend to rise to offset the lower volume. Thus optimum development of the transportation system is impeded. The tax tends to discriminate against small firms compared to large ones, since the latter can more easily develop their own transport facilities. The tax on freight also tends to alter location of industry in an artificial way, since the tax burden is greater on longer hauls than on short. Recognition of this fact led to the application of a uniform tax per ton on coal, regardless of distance, but not for other commodities.

Finally, certain excise taxes may encourage sale of the taxed commodities through illegal channels. This not only causes loss of tax revenue and discrimination against the taxpaying firms, but may result in deterioration of the quality of the product. The extremely high taxes on liquor, though perhaps defensible on other grounds, are often charged with increasing bootlegging.

Equity considerations

Two sets of excise taxes find special justification on an equity basis, although, of course, these justifications are not universally accepted. In the first place, the sumptuary excises are regarded as equitable on the basis that society regards the use of these commodities as constituting adequate justification for the imposition of special penalty taxation. This point of view is frequently condemned, but it apparently reflects a widely accepted attitude. Secondly, the excises related to highway use may be justified on the basis of the acceptance of the benefit principle for highway finance. Highway users can afford to pay for the highways without serious inequity, and the use of the benefit-based levies lessens the extent to which incentive-affecting ability-based taxes must be used. These excises, with the possible exception of the gasoline tax, were not originally considered to be benefit-based levies, but rather as luxury taxes. But in recent years, with great increases in Federal expenditures for highways contemplated, there has been a growing tendency to justify them on the benefit basis. However, if this is to be done, it is essential that the amounts collected from them do not exceed the Federal expenditures for highway purposes, as is now the case. If these levies are not regarded as benefit-based, the same considerations apply to them as to the luxury excises noted below.

The luxury excises are open to serious criticism on an equity basis. The placing of taxes on certain commodities as representative of taxpaying ability inevitably discriminates against those persons who have relatively high preferences for the taxed goods, compared to

those whose preferences run more heavily in the direction of untaxed articles. A person who prefers photography as a hobby is penalized compared to one who prefers reading or gardening. Furthermore, the present excise-tax system applies to many items of very widespread usage, such as telephone service and cosmetics. A portion of the burden of such taxes falls on persons in the lower-income groups, particularly on older persons with fixed incomes, in a manner which may be regarded as inequitable. The excise-tax structure as a whole is also often criticized as being regressive. Studies of the distribution of the excises by income class, although of limited validity because of inadequacy of data of distribution of consumer purchases by income class, tend to bear out the contention that the pattern of the distribution of the burden of the excises is regressive.[2] However, the regressiveness argument is not, in itself, a very significant one, because of the presence in the tax system of progressive taxes. But it does constitute an argument against excessive reliance on this form of tax.

The taxes labeled above as "Miscellaneous," and particularly the tax on freight, are particularly objectionable on an equity basis, since the burden falls in a completely haphazard fashion, striking in part the use of basic necessities, such as milk and bread, which would not presumably be subject even to a Federal general-sales tax, under typical plans advanced for such taxes.

The excises can also be condemned, from an equity standpoint, on the basis of their burdens upon the owners of business firms. To the extent that the taxes are not fully shifted, the burden rests in an extremely uneven and inequitable pattern on the owners of various types of businesses. The effects of the taxes in reducing earnings through curtailment of output are less significant, from a long-range standpoint, since all taxes will have this effect in part, and outputs of various commodities will shift in such a manner as to tend to equalize profit rates. In a shorter period of time, however, the effects of the taxes upon sales of various products may have very inequitable results on the owners of various types of businesses.

Administrative feasibility

The excises are generally considered to be relatively easy to administer. This is certainly true of some excises, which are collected in their entirety from a relatively few large firms. But most of the excises give rise to more problems than are generally recognized. The retail excises on furs, luggage, jewelry, and cosmetics require collection from large numbers of small sellers, many of them handling only a very limited volume of the taxed products. Some of the manufacturers' excises give rise to continuing problems of definition of taxable commodities, and questions relating to the determination of appropriate prices for tax purposes. In recent years the industries affected by the excises have become increasingly critical of various aspects of administration. Perhaps the most important complaint is against the failure of the Bureau of Internal Revenue to publish summaries of important rulings. Further discussion of administrative questions is beyond the scope of this paper.

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[2] See for example the study by R. Musgrave et al., Distribution of Tax Payments by Income Groups, National Tax Journal, vol. IV (March 1951), p. 34.

Summary.—In summary to the discussion of evaluation of the present excise-tax system, the following generalizations can be offered:

1. Strongest justification can be found for the liquor and tobacco taxes, although the effects of the high rates of the former on illicit production suggest the need for reexamining the rate structure.

2. In view of the prospect of rapidly growing Federal expenditures for highway purposes, there is substantial merit in regarding the excises on gasoline and diesel fuel, lubricating oil, tires and tubes, automobiles, trucks and buses, and automotive parts as benefit-based levies for purposes of financing highways; if this is done, these taxes can be justified provided that the yield does not exceed the amounts used for Federal highway purposes.

3. Against the other excises, the main objections include (1) the shifting of consumption, and thus of production, from taxed to untaxed products which inevitably results; (2) the discrimination against persons having relatively high preferences for the taxed objects; (3) the discrimination against the owners of business firms adversely affected by these taxes; (4) the incentive given business firms by some of the excises, particularly that on freight, to alter methods of production, with consequent loss in efficiency; and (5) in periods of unemployment the greater deflationary influence exerted by the excises compared to other taxes. The chief merit of the excises compared to other taxes is the lesser effect which they have upon incentives to undertake expansion than that arising out of the upper-bracket income-tax rates. The significance of this merit depends upon the actual extent to which income taxes deter incentives. The evidence of such effects is not substantial.

Alternatives to the Present Excise-Tax System

There are two major alternatives suggested for the elimination of the undesirable features of the present excise-tax system.

Replacement by a sales tax

The first alternative is the replacement of the present excises (except those on liquor and tobacco) by a general sales tax, as recommended by the NAM. This would preserve the present revenue from the indirect taxes and thus permit greater reduction in income taxes than would otherwise be feasible; the supporters of this move argue that such a change would facilitate economic development by lessening the adverse effects on incentives arising out of the present income-tax structure. On the other hand, the present discrimination among consumers and among business firms would be avoided since the tax would apply uniformly to all products.

Against such a program there are several significant arguments. (1) The tax system as a whole would be made somewhat more regressive that it now is, and the absolute burden on the lowest income groups would be increased. This is, of course, not a conclusive argument. But to many persons it represents an objectionable change in the pattern of tax-burden distribution. While the Federal tax structure is progressive with respect to relative burden on the higher income groups compared to that on the lower, it is not significantly progressive, and may be regressive, within the lower and lower middle income groups. Secondly, the State and local tax system contain

important regressive elements, such as the sales taxes and property taxes.

(2) The use of a Federal sales tax would involve Federal entrance into the tax field which is now the most important source of State revenue and increase the amount of duplication of taxation. The argument that the duplication would be avoided if the Federal tax were imposed at the manufacturing level is of doubtful significance. This argument is equivalent to one maintaining that there is no duplication of tax sources in the gasoline tax field because the States tax the distributors while the Federal Government taxes the refineries.

(3) The shift to a general sales tax would aggravate, rather than lessen, the net deflationary effect of the tax structure in the event of a decline in business activity. The high stability of yield of the commodity taxes is advantageous if the primary goal is considered to be the maintenance of a balanced Federal budget, but it is a destabilizing effect from the standpoint of the economy as a whole.

(4) The argument that a shift in the direction of greater reliance upon commodity taxes would stimulate economic development is of doubtful validity. The actual deterring effects of the income taxes upon investment and development are not known, but have certainly not been obvious in recent years. On the other hand, the greater adverse effect which commodity taxes have upon consumption, compared to higher bracket income taxes, is apparent. Any reduction in income taxes which would be politically feasible would require significant reductions in the lower income brackets; it is extremely doubtful if low-bracket income taxes have made adverse effects upon incentives than the excise taxes.

(5) As demonstrated by State and Canadian experience, it is virtually impossible to keep all producers' goods out from the base of the sales tax. Thus some distortion of the choice of methods of production would be inevitable.

(6) The choice of levels of a Federal sales tax encounters a serious dilemma. A tax at the manufacturing level tends to pyramid, at least for substantial periods, and thus to burden the consumer by amounts in excess of the amounts of tax revenue collected. It also creates problems for retailers, such as larger capital requirements, and difficulties arise with respect to the determination of a suitable price base for tax purposes, as shown by Canadian experience. On the other hand, the retail level, the most satisfactory in many respects, does require collection from a relatively large number of small firms.

Revision and reduction in the excise-tax system

The second alternative is the reform of the excise-tax system, and reduction in excise-tax rates. The most objectionable results of the excise-tax system are the products of a relatively few excises. The elimination of the tax on the transportation of property will remove the greatest adverse effect of the present system of the selection of the optimum methods of production and location of industry. This levy likewise has an extremely capricious and regressive distribution of burden; it has no justification on any score, from the standpoint of usually accepted principles of tax-burden distribution. The tax on business machines is equally unjustifiable, although less significant from the standpoint of the magnitudes involved. Abandonment of

the excise tax on the transportation of passengers will eliminate the artificial incentive now given to persons to use their own cars and add to highway congestion, and facilitate development of efficient channels of public passenger transportation, an industry which in general is barely able to cover all costs.

Rate reductions in the various luxury excises will lessen the significance of the discrimination which now arises, and the injury to the industries affected As suggested above, the excises related to highway finance should be coordinated, from the standpoint of height with the Federal expenditures for highway purposes.

Elimination of the most objectionable excises and rate reductions in others will, of course, require a somewhat higher level of income taxes than would otherwise be possible. But consideration of the relative merits of the two forms of tax suggests that the most objectionable excises have effects far worse than those which can be attributed to the income taxes, particularly the lower bracket income-tax rates, and that the case for the luxury excises is not sufficiently strong to warrant retention of them at present rates if income taxes are reduced. Should a depression develop, complete elimination of all luxury excises (and rate reductions in others) should be one of the most effective measures that can be taken, in the field of taxation, to mitigate the decline in economic activity.

CONCLUSION

Review of the present excise tax system in terms of economic effects and equity considerations suggests the following recommendations:

1. Retention of the present taxes upon liquor and tobacco products, with consideration of some rate modifications to lessen illegal sale.

2. Retention of the excises on gasoline and diesel fuel, automobiles, buses and trucks, tires and tubes, and automotive parts as means of financing, at least in part, the proposed expansion in Federal highway expenditures. The yield of these taxes should not exceed the Federal highway expenditures, if they are to be retained permanently as benefit-based levies while luxury excises are eliminated.

3. Immediate elimination of the tax upon the transportation of freight, the most indefensible and injurious element in the present tax structure, and elimination of the tax on passenger transportation, because of its tendency to increase highway congestion. The loss in revenue from the elimination of these two objectionable taxes would be about $640 million annually. This is about 7 percent of excise tax revenue, or about 1 percent of total Federal tax revenue.

4. Reductions in other excises at least comparable to any general income-tax reductions made.

5. Complete elimination of the luxury and miscellaneous excises, should a period of depression arise.

THE PLACE AND ROLE OF CONSUMPTION TAXES IN THE FEDERAL TAX STRUCTURE

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INTRODUCTION

The proper role of consumption taxes in the Federal tax system, and the degree of reliance to be placed on such taxes, cannot be adequately appraised without some preliminary consideration of certain underlying principles, certain facts of fiscal and economic life, and a point of view from which the entire taxing process is to be judged. There has been more emotionalism, and consequently less objectivity, in the recent discussions of excise or consumption taxes than in the analysis and appraisal of any other part of the Federal tax structure. This substitution of heat for light has been particularly conspicuous with the growing emphasis upon the use of the taxing power for purposes other than the provision of public revenue.

Source of taxes

There can be little disagreement regarding the source of the funds that are collected by taxation. All taxes are paid out of income. This is true even if a taxpayer has to borrow to meet a particular tax payment, for the loan is merely a transfer of income from the future to the present. It is true, also, if a taxpayer must sell an asset to obtain funds for tax payment. The buyer must use either his current income, or his saved income, or his pledge of future income by way of a loan. In a fundamental sense, all taxes come from the income of persons, even in the case of business taxes of every sort. Such taxes are either recovered from consumers in the prices charged for goods and services, or they are deducted from the profits that would otherwise be distributable to the several individual owners of the business. Too frequently, the profits of business and the property used in business are regarded as separate, independent sources of taxes and the levies imposed, especially on business income, are allowed to become inordinate in the belief that no one other than the business unit, as such, is affected or concerned.

The methods of taxation

The subject of tax methods is highly controversial, because the choice of methods determines the particular incomes to be levied upon or to be passed over. There is involved, also, the relative severity of burden on particular incomes.

The three methods of taxation correspond to the three major phases of income as an economic phenomenon. This correspondence can be shown in tabular form as follows:

PHASES OF INCOME	METHODS OF TAXATION
1. The getting of income.	1. Income taxes, and the license and privilege taxes on various income-getting activities.
2. The holding of past and present income in "congealed" form as wealth, assets, possessions of different sorts.	2. Property taxes, capital stock taxes, inheritance taxes, etc.
3. The use of income through spending.	3. Sales, excise, and other consumption taxes.

This classification may not provide a neat pigeonhole for every conceivable kind of tax, but it is sufficiently accurate for the present purpose, which is to point up the contrast between the receipt and the application of income and the tax methods that are appropriate to these two aspects of the income flow. From the standpoint of Federal taxation, the receipt and the spending of income are of chief importance. Federal taxation of wealth, property, or assets, per se, would come under the limitations of the direct tax clause and hence is not available as a significant source of Federal revenue. This restriction is evaded in the case of the estate and gift taxes by construing them as taxes on the privilege of transferring property and not on the property as such. A privilege tax is regarded as a form of excise, for which there is express constitutional warrant. Inasmuch as the entire body of law relating to the testamentary or intestate disposition of property, and the entire administration of such disposition through probate, or escheat, is at the State level, it is difficult to discover the basis or derivation of any sanction regarding property ownership or disposition which the Federal Government gives, or is empowered to give, under the Constitution. The absence of any logical basis has not prevented a substantial Federal preemption of estate and gift taxes, but that is another story.

Purposes or Objectives of Taxation

The position taken in this statement is that taxes should be levied and collected only for the support of government. A corollary is that the amount taken should be only what is required for that support. The taxing process is a taking of private income for public purposes, with no intent or obligation to provide benefits or services directly to each taxpayer corresponding to his payment of tax. The benefit rule has only a very limited application which is best exemplified by prices, tolls, and other service charges not commonly regarded as methods of taxation. The plea of using taxation to defray the cost of common or general, rather than specific, benefits, becomes a potent argument for keeping the tax load within the strictest limits of fiscal necessity.

The levy of taxes for nonfiscal purposes is thus ruled out, by definition. These purposes range all the way from objectives that are essentially of a policing character to the socialistic intent to equalize wealth and income through taxation. It is not possible to justify such exercise of the taxing power by any sort of logical rationalization because in every case there is involved some degree of arbitrary control over the actions and the decisions of individuals. The police power does involve control by government over the actions, the property, and even the lives of individuals, but this power extends to fairly definite purposes and its proper exercise is to be performed by appropriate agencies within the limits of well-understood administrative, judicial, and constitutional procedures.

The difficulty is that there has been too much disposition to utilize the taxing power to enforce the objectives of the police power. There are, of course, antisocial ways of getting income and wealth, such as racketeering, preying on the vices and the passions of men through vice rings and gambling, monopoly, and so on. Instead of dealing adequately with such practices by direct means, which is the only way of correcting them at the source, the taxing power is too frequently

relied upon as a corrective. The record contains instances of conviction for income-tax evasion as an apparently satisfactory substitute for prosecution on far more serious charges.

The worst case of control of the economy through taxation is found in the use of tax-rate progression. The ultimate purpose is the equalization of incomes, and eventually of wealth, which represents the accumulated margins of past income. The present writer has discussed on many occasions the errors of doctrine and the disastrous practical consequences involved in this policy and repetition is not necessary here.[1] It is significant that there should be a growing critical attack on the obvious defects of progressive income-tax theory and practice, although there is still insufficient recognition that the harsh, destructive tax-rate scale is the real source of the evil.

It is frequently said that taxation inevitably has an impact on the economy and on the decisions of the individual taxpayers. Therefore, it is contended, it is better to recognize and utilize this impact than to disregard it. This viewpoint overlooks the following:

(*a*) Taxation, as the price for necessary and useful public services, is no more burdensome than other costs. Within the limits of the "useful and necessary" test, the total cost of the public services is less than it would be if each person were to undertake provision of these services for himself; and some of them, such as defense, highways, public order, and security—to name only a few—could not be provided at all without communal action. Taxation becomes onerous when the range of governmental activities is extended beyond the limits of the useful and necessary, or when even the essential public services are conducted on a lavish, imprudent scale.

(*b*) The harmful impact of taxation is produced by the discriminatory and penalty features that tend to be incorporated in the tax structure when objectives other than the provision of the necessary public revenue gain the ascendancy in tax policy.

(*c*) The goal of neutrality in the effects of taxation on the economy and on the individual citizens is best achieved under proportional tax rates. Any departure from this standard by progression, selectivity, or any of the numerous gadgets and devices for the benefit of special groups introduces discriminations which warp and distort the tax structure and thus become the source of the bad effects so often attributed to all taxation as such.

It is submitted that neutrality of economic effect and impact is an essential characteristic of a satisfactory tax system. Each taxpayer would then be in the same relative position, after tax, as he occupied before tax. His economic decisions and his actions, both in the getting and the spending of income, would then be influenced, in the least possible degree, by the fact that a portion of his income had been spent for governmental services.

Uniform, or proportional, taxation requires a broad tax base

The broadest possible tax base in any society is the total income of the people. This is obvious since income is the only source of all taxes.

For administrative as well as practical and political reasons, it would not be feasible or desirable to substitute one tax on total income

[1] Cf. H. L. Lutz, Public Finance, fourth edition, pp. 264–271. Appleton-Century, New York, 1947.

for the variety of taxes which are now used. It is important, however, that the tax load be distributed, through the combination of tax methods employed, as nearly uniformly as possible over the total of income, for these reasons:

(*a*) To make possible the maximum moderation of tax rates at all points;

(*b*) To provide maximum neutralization of the effects of taxation on economic growth; and

(*c*) To eliminate the case, and the pressure, for gadget relief from excessive rates.

A broad tax base requires that the tax load be distributed over income as received and income as spent. Taxable income as now defined by statute is too narrow a base to provide a substantial revenue without imposition of excessive rates. And the policy of relying on the individual income tax to produce a substantial revenue compels the levy of oppressive rates. The statistical data compiled from the tax returns do not reveal the amount of taxable income. My calculations, using limited and inadequate data, show that with estimated personal income of $298.5 billion in 1955, the adjusted gross income in taxable returns would be some $224 billion, and taxable income would be about $123 billion.

The fact that taxable income is only about one-half of the adjusted gross income in taxable returns results from the liberality of the deductions and exemptions allowed. On this relatively limited income-tax base it is necessary to impose high rates in order to secure the high proportion of the Federal revenue that is expected from this tax. The budget projection for the fiscal year 1956 anticipates net receipts of $29,770 million in round figures, out of the individual income tax. This is an average effective tax rate of 24 percent on taxable income.

The total of personal consumptio. expenditures is in marked contrast with the limited total of taxable income. In 1954 this total was $236.5 billion, and for the first half of 1955 it was at an annual rate of $247.6 billion. This contrast points up an important issue which can be stated thus: Is it better for the citizens as individuals and for the economy as a whole to retain the heavy concentration of the tax load on that smaller part of personal income which is defined as "taxable income" or to spread a part of this load over the larger segment of personal income which is not touched by the income tax?

The position taken here is that it is far better to spread the burden over a broad base than to concentrate it on a narrow base. Provision of a broader tax base would require either a material reduction in the allowable exemptions and deductions or the use of taxes that are paid as income is spent, i. e., excise or consumption taxes. For reasons that are so apparent to all as to need no elaboration here, the present writer's view is that the latter course is preferable and should be adopted.

A substantial group advocates the opposite course, namely, the elimination of a large part of the existing excise revenue. Few, if any, of these persons would support compensating for this revenue loss by broadening the taxable income base through lower exemptions and deductions, which means that they would make up the excise revenue loss by the levy of higher rates on the taxable income base as now determined.

In the fiscal year 1955, total excise revenues were approximately $8.9 billion. If this total were to be collected through the individual income tax, a first bracket rate of 27 percent would be required. If it were to be collected from corporations, a combined normal and surtax rate of 77 percent would be necessary. If all excises except the alcoholic beverage and tobacco taxes were repealed, an addition of 3.7 percentage points to the individual income-tax rate would be required, or an addition of 13 percentage points to the corporation income-tax rate would be needed if the revenue loss were to be made up from that tax.

These facts should have a sobering effect on those organizations and individuals that have made the excise taxes a target of emotional attack. They should also lead to objective consideration of the steps that are required to correct the inequalities and other defects of the existing excise system. The one thing that is clear is that if we were to dispense with the excises, or with even as much as half of the present yield, it would be necessary to increase the load on the income taxes or transfer the loss to the deficit. The one course would delay indefinitely any prospect of relief from burdensome, discriminatory income taxation and the other would involve all the dangers of inflation which would, in the end, bear more heavily on the consumers than reasonable excise taxation.

The Case for Excise Taxes

A major point in the case for excise taxes has already been made. It is that the revenue thus obtained prevents as serious overloading of the income taxes as would be necessary otherwise. At any budget level, however, it would be desirable to spread part of the tax load over income as it is spent rather than to concentrate all taxes on income as it is received. The relative stability of excise revenue, by comparison with the income taxes, is well known. In the fiscal years 1930–32 inclusive, the yield of the income taxes declined 56 percent, and that of the limited array of excise taxes then imposed by only 20 percent. The mild economic decline of 1949 caused a drop of corporate profits by $6.6 billion below 1948, and a decrease of $2.1 billion in corporate-tax liability.[2] The excise-tax collections were not affected at all by this brief recession. In fact, the collections increased by a small amount.

Budgetary stability is always important, but it becomes even more so with the current high levels of spending, taxing, and public debt. Complete reliance on the income taxes, which would be the only recourse if there were no excises, would expose the Federal finances to serious fluctuation with every variation in the business and general economic situation. The extreme revenue swings that would be produced by a one-tax revenue system under variable business conditions could not be justified, even by the doctrine of compensatory budget balance over the economic cycle, which is the most undependable of all budget policies. The deficits would be so exaggerated by the deficiencies of such a revenue system as to increase greatly the difficulty of accumulating surpluses sufficient to cover them, and to make such

[2] Economic Report of the President, January 1955, table D-49, p. 189.

a result still more unlikely than it would be under the best of circumstances.

In their own right, excise taxes have many characteristics of a good form of taxation. These characteristics may be briefly enumerated as follows:

1. They permit a perfect application of installment payments. These taxes are paid, in amounts varying from a few pennies to a few dollars, as purchases are made. They conform admirably to the canon of convenience to the taxpayer, for it is always more convenient to discharge an obligation in many small driblets than in lump sums of substantial amount.

2. They permit a perfect application of current taxpayment. When the last purchase of the tax year has been made, the citizen is fully current, so far as his excise taxes are concerned. The income tax is paid currently, to the extent that this can be done through withholding. But not all of the tax is paid in this way. More than 30 percent is paid in quarterly installments and the advertising by banks to solicit personal loans for income-tax payments is eloquent testimony of the difficulties experienced by many taxpayers as the quarterly installments come due.

3. Administrative costs of excise taxes are low. There would be millions of excise-tax payers, however such taxes might be imposed; but there would be a relatively small number of tax returns to be examined, whether the tax were imposed at the manufacturer or the retailer level. Moreover, there would be no vast, complicated, expensive refund procedure such as has developed under the withholding system for income tax.

4. There are no complicated forms to harass the individual citizens, as consumers, no questions of incomplete, erroneous, or false returns, and no opportunity of willful failure to make a return. There is no consumer tax return. Hence there is no question of audit, review, or collection of back tax. These issues do arise for the business firms through which excise taxes are collected, but there will be some kind of business records for examination, however rudimentary these may be in some cases.

5. Excise taxes permit to the taxpayers some discretion with respect to the amount of tax and the time of its payment—that is, the amount of tax is variable according to the volume of purchases and the time when these are made. These decisions are controlled by the individual or the family unit. The tax will vary with the prices of goods bought, and here again there is an element of choice between expensive and moderately priced merchandise. The taxpayer has no discretion whatever in the case of the income tax. All, or at least a part, of this tax is deducted from earnings before the employee gets his pay. The part not withheld is "demanded" by the respective directors of internal revenue to be paid on or before certain dates.

6. An excise-tax system of broad coverage, levied at a uniform rate, is not subject to manipulation through "gadgeteering." There are issues of definition in the fringe area around taxable classes of commodities, but these are diminished as the coverage of the tax is extended. Furthermore, there is no question of loopholes, the discovery and the plugging of which, in the case of the income taxes, provides an extensive and lucrative indoor sport for the tax specialists in private and in public employ, respectively.

The form of excise taxation

It is necessary at this point to set the discussion in terms of what should be, rather than what actually is, as exemplified by present practice. A consistent policy of excise taxation requires that the coverage be universal with respect to the general category of things to be taxed and that the rate of tax be uniform—that is, if the category of things taxable is consumer goods, then all such goods should be taxable. If this category is to include services, then all services in the consumer field should be included.

The array of commodities and services that are now subject to Federal excise cannot be defended on any logical ground. This would be equally true of any selective excise-tax system, for the very process of singling out some goods or services to be taxed, while others are not, unavoidably introduces discrimination, both as among producers and as among consumers. This discrimination is inevitable also when different rates of tax are imposed. A large part of the complaint and dissatisfaction that have been expressed in hearings before the Ways and Means Committee has sprung from the discriminatory features of the present excise taxes. Universality of coverage and uniformity of tax rate would put an end to the discrimination and thus cut the ground from under a major part of the antiexcise argument.

It is sometimes necessary to temper rigid consistency with practical considerations. The design of a sensible, administratively operable system of excise taxation is such an occasion. For example, the taxation of alcoholic beverages and tobacco products at rates separate from those imposed on other commodities has a long record, and this differentiation has become part of our fiscal mores. The practice provides no warrant, however, for excessive rates of tax on these products merely because consumers are willing to pay them.

Another example is food and food products. A majority of the States which levy a retail sales tax do not exempt food, but some States make a distinction between meals served in restaurants and food products sold for offpremise consumption. It is interesting and perhaps significant that an exemption for feeds, fertilizer, and insecticides is much more general than for foods. State policy with respect to food and food products affords no clear guide for the treatment of this class of commodities, but it does afford precedent for either taxing or exempting such goods. Food in some form is one indispensable item in the budget of every person. Its inclusion or its exclusion from a system of excise taxation would not affect the general standard of uniformity and universality, for human beings do not vary greatly in the quantity of food intake required for health and strength. The amount of food actually consumed and its cost will vary widely and the principal determinant is not necessarily the available income. Some persons with large incomes eat sparingly and others with small incomes eat voraciously. An exemption of food and food products, under a general excise tax on consumer goods, would not involve a serious discrimination as among consumers because it would extend to all of them.

It has been urged that an exemption of food and food products is proper because of the relative importance of food costs in the low-income family and individual budgets.[3] This exemption is a conces-

[3] Such an exemption has been recommended in the tax program of the National Association of Manufacturers. Cf. A Tax Program for Economic Growth, 1954, p. 38.

sion to expediency. Although food is a prime necessity for everyone, there are other things that are also deemed by some persons to be important, and for which the expenditure in a given period may be greater than the food bill for the same time. As noted above, a majority of the State sales taxes do not exclude food, and there is nothing in the record of these States nor in that of their experience in taxing food sold at retail, to indicate indifference to the situation of the low-income groups. Moreover, there is nothing that would indicate noteworthy effects on the health or general well-being of the citizens who are now paying sales tax on foods, as against the citizens of those States which do not tax such sales.

In addition to coverage and rates, the question of excise tax form involves also the point of levy. That is, should the tax be imposed at the retail level, or the wholesale level, or at the level of final manufacture. Administrative problems and technical difficulties would arise, regardless of whether the tax were imposed in the form of a retail, or a wholesale, or a manufacturers' level excise. Some of these matters would be more troublesome, and others less troublesome, according to the point of imposition. The present writer's conclusion, which is in accord with the policy of the National Association of Manufacturers, is that, on balance, the manufacturers' level tax would be easier and also less expensive to administer, as a Federal tax, than either of the other forms. The number of manufacturers would be smaller than the number of either wholesalers or retailers. (The term "wholesaler" here includes all middlemen, whether described as jobbers, brokers, commission agents, wholesalers, or any other specific occupational classification between the manufacturer and the retailer.) Furthermore, the records of manufacturers are likely to be in better form than those of the many thousands of small retailers, and some large ones, whose principal sales record is the cash register. The movement of firms into and out of manufacturing is by no means as great, numerically, as is the case with retailing, and the revenue loss from closed, defunct firms that had ceased operations without making a return would be much less in the former than in the latter case.

A consideration of great weight in support of a Federal tax at the point of final manufacture is that it would avoid direct duplication of the retail sales taxes that are now levied in 32 States, and by a substantial number of municipalities. The State is a logical administrative area for a retail sales tax because of the essentially local nature of such sales and the greater effectiveness of State supervision and control. These taxes have become very important to the financial well-being of the States that make use of them, and any action by the Federal Government that would tend to undermine or supplant them through imposition of an overriding Federal tax of the same sort would involve serious financial difficulties for many States. Among other evil consequences, any material shrinkage of sales-tax revenue would lead to greater pressure for additional Federal grants.

It appears almost inevitable that a general Federal tax at the retail level would impair State use of this tax. The Federal tax would be at a different rate which would entail a different set of bracket rates to adjust the tax on small sales to some relation to the full rate. Under the present State taxes, these bracket arrangements differ from State to State, and in each case there would be confusion in computing tax

according to two sets of rules. The paramount Federal tax would be a barrier to any further increase of the State rate, and a deterrent to adoption of the sales tax by States not now using it. The adverse effect could go so far as to induce State repeal in some cases. Nothing would be gained, on the contrary, much would be lost, if the States were driven out of this tax field, or prevented from making adequate use of it for payment of their own governmental costs.

On the other hand, a general excise tax system imposed at the point of final manufacture, would not be a direct, competitive duplication of the State retail sales taxes. About three-fourths of the revenue which the Federal Government now collects as excise taxes is obtained through levies at the final point of manufacture. There is no evidence that such taxes are regarded either by the people or by the State tax administrators, as an encroachment; nor is there evidence that the Federal taxes have interfered with the development of the retail sales tax as a source of State revenue.

Conventional Criticisms of Excise Taxes

The critical attack on excise taxes includes some general points of opposition to the method, and some additional points that are germane only against excises imposed elsewhere than at the retail level. The two major counts against excise taxation in general are (1) the reduction of consumer spending power, and (2) the regressive nature of such taxes.

1. Reduction of spending power

The allegation of diminished spending power is always stated from the viewpoint of the individual taxpayer, and the implication is that an excise tax is the only tax which has this effect. Such is obviously not the case, for any tax reduces the money income of the taxpayer and leaves him with less money to use for any purpose, whether for consumption, or for saving and investment. From the standpoint of the individual, this argument becomes one against all taxation, and not merely a point against excise taxes.

The error comes when the argument is expanded from the particular to the general, and it is concluded that because each individual taxpayer experiences a decline of disposable income because of the excise tax (or any other tax) therefore the total purchasing power of the society is diminished. This erroneous contention ignores the transfer character of taxation, whereby the Government receives and spends the money taken from the people. Public spending transfers tax receipts to other groups—civil servants, contractors, bondholders, beneficiaries and pensioners, and others—and these persons spend that part of private income which was taken from the original income recipients in taxes. In the economy as a whole, the taxing and spending process does not reduce total spending power. It merely shifts part of the total spendable income from the taxpayers to those whose livelihood and income are dependent upon some connection with Government.

The one use of tax revenues that would result in a reduction of money supply and spending power is the application of a surplus revenue to retire bank-held debt. This is a genuine cancellation of existing money, but even so, it does not necessarily cause a permanent

reduction. Retirement of bank-held debt would improve the reserve position of the banking system, and would thus make possible the creation of new bank deposits through the process of loan or investment expansion by the banks. Whether or not such expansion would occur would depend on the need, within the economy, for additional credit accommodation, and on the terms at which the banks would make it available.

2. Regression

In the mathematical sense, a proportional tax, that is, one that is levied at a uniform or proportional rate on the specified tax base, is not regressive.[4] The local property tax, which is levied at a uniform rate on the assessed value of property within a given tax district, may be regressive because of the inability, or the disinclination, of assessors to assess small and large property aggregates in the same relationship to true value. The remedy for this condition is in competent supervision of the assessment process, and in careful review and equalization of assessments. An excise tax levied at a proportional rate is not regressive in this mathematical meaning of the term.

The concept of regression is applied, also, to mean that a given amount of tax involves a larger part of a small income than of a large one. This is obvious, but the same hard fact is also encountered in the whole system of market prices. The cost of any article in the market represents a larger fraction of a small than of a large income. The American people are spending for goods and services in the market places of the country at the rate of more than $210 billion annually. The regressive nature of the price system does not deter them from spending at this rate, nor does it give rise to any open expressions of disapproval of this system. A general Federal excise tax, at a uniform rate, to provide a revenue equal to that now being collected by discriminatory selective rates of excise tax, would be the equivalent of about 2 percent on total consumer spending, or about 5 percent on the classes of goods to be included in a general excise system. In view of the general acceptance of the market price system, which is thoroughly regressive in the sense that this term is now used, the objection to a tax which would constitute so small a fraction of the grand total of consumer spending, on the ground that it is regressive, is a case of swallowing the camel but straining at the gnat.

It is likely that the argument of regression does not stem from the bare facts of the case, for these, as shown above, are hardly sufficient to warrant the fervidity displayed. Rather, these bare bones are used as a skeleton around which is built an array of arguments designed to demonstrate that excise taxes are an instrument of oppression, extortion, and general trampling down of the low-income groups.

At one extreme, the proponents of this viewpoint demand repeal of all excises, with the possible exception of the liquor and tobacco taxes, and, in addition, an increase of personal exemptions for the taxpayer and his dependents. This extreme view can be dismissed at once as wholly unrealistic from the standpoint of the revenue loss involved, and as completely undemocratic in that it would exempt millions of

[4] The word "regression" is not the only one that has been manhandled for ideological reasons. Other examples are the words "liberal" and "democracy," both of which have acquired a current meaning very different from that assigned to them in the 19th century. Prior to the great vogue of the income tax as the "Queen of Taxes," there was no interpretation of regression in any other than its mathematical meaning. The socialistic dialectic has perverted this and other semantically good concepts to the purposes of the totalitarian state.

citizens from payment of virtually all taxes for the support of the National Government. And, as noted above, it would compel indefinite retention of an intolerable burden on such income as would be taxable.

A less extreme position is that excise taxation, if employed at all, should be limited to those classes of consumer goods which would be arbitrarily designated as "luxuries." But the difficulty here is the framing of a definition of "luxury" that would be universally acceptable. The concept of a "luxury" has a twofold origin; it has come, in part, from the reservation of certain things for the use of royalty and aristocracy, as in the case of purple and ermine. It has come in part, also, from the puritanical view that all pleasant things are sinful. This has been revised, in modern times, to say that all pleasant things in life are sinful, fattening, or expensive.

The fact is that today, in our society, there should be neither stigma nor scorn attaching to the way anyone spends such income as may be left to him after paying income taxes. The things that anyone buys and the prices paid for them, are strictly that person's business, and not at all the business of any self-appointed censor who might presume to dictate the course of personal expenditures by penalizing some purchases and favoring others. There are some persons who do not use coffee or tea; others who do not drink alcoholic beverages; still others who do not eat meat; and some, whether by choice or the doctor's orders, who have a salt-free diet. The list of choices could be extended indefinitely. Many persons do not care for television, others may prefer a Ford to a Buick or a wool coat to a fur coat. There is no logical line that can be drawn to distinguish luxury goods from other goods, when all kinds of goods are available in the market, and there are no class or other enforced distinctions that determine who may buy what. The history of American industrial development is a record of a vast array of goods which were expensive when first introduced, and which were steadily reduced in price as the market developed. Many of these were not essential to bare existence, but they have added immensely to comfort and enjoyment, to the amenities of life, and they are part of the great total of national product which, in turn, represents an equally great total of national income and expenditure.

If there were a general excise tax on consumer goods generally, the purchaser of an expensive item would pay more tax than would the purchaser of a less costly item of similar kind, or a substitute item. The big spender is the big excise taxpayer. It is the privilege, and the responsibility, of each individual to determine the disposition of his available income that will afford him the maximum satisfaction, and if he gets this result through the purchase of a more rather than a less expensive car, or garment, or piece of jewelry, or anything else, there should be no relative tax penalty because of some puritanical obsession that some goods are luxuries and should be taxed more heavily than other goods.

The subject of the relation of all taxes—Federal, State, and local—to incomes has been discussed at length in a series of papers in the National Tax Journal and at one meeting of the National Tax Association.[5]

[5] Wide Distribution of Tax Payments by Income Groups, by R. A. Musgrave, J. J. Carroll, L. D. Cook, and L. Frane, National Tax Journal, March 1951, pp. 1–53; Distribution of Tax Burdens in 1948, R. S. Tucker, idem, pp. 269–285; Further Consideration of the Tax Burden, various commentators, National Tax Journal, March 1952, pp. 1–39; and Proceedings of the National Tax Association, 1952, pp. 178–221.

The assumptions and statistical data presented in the papers cited cannot be reviewed here in any detail. However, 1 or 2 points should be mentioned. The first is that the overall regressiveness alleged to exist is magnified as a result of the assumptions made with respect to the income bracket 0 to $1,000. The consequences of underestimating income or overestimating taxes are more serious at this income level because of the small income base to which the taxes are related. Prof. J. A. Pechman says, in his comments on the Musgrave and Tucker papers:[6]

> The significance of the data for the lowest income class should not be overstated, for we know very little about the income and consumption habits of the members of this class and even less about the taxes they pay.

In other words, aside from the income group about which the least is known, there is no regression in the overall tax burden and only a small degree of regression if State and local taxes alone are considered.[7]

This leads to the second point, which is the unrealism of describing and measuring the effect of State and local taxes as if they were similar throughout the country. In fact, these taxes are so diverse, both as to form and as to the relative emphasis on each in different jurisdictions as to require a State by State comparison of taxes with income. For example, there must be wide differences in the relation of taxes to incomes in such States as New Jersey, with neither sales nor income tax, New York, with income tax but no sales tax, Illinois, with sales tax but no income tax, and California, with both income and sales taxes. Likewise, the effect of the property tax must vary according to whether personal property is taxed at general property tax rates, as in Illinois, or is exempted as in New York, or is taxed at classified rates, as in Minnesota.

The statistical device of a general, overall average of diverse but homogeneous factors is useful for many purposes. It is a questionable procedure, however, for leveling off the wide differences in tax methods among the States, particularly when the results are used, with no regard for these differences and the large gaps in the data, to support broad generalizations such as the statement that a considerable progression must be retained in the Federal taxes to offset regression in State and local taxes. In terms of counsel on tax policy, this amounts to saying that an obvious form of tax discrimination must be retained at one point in order to counteract suspected discriminations at other points.

3. Pyramiding of the tax

In addition to the two stock arguments against excise taxation in general, there is the pyramiding argument which is germane only where the tax is imposed at some point other than the retail sale level. Pyramiding means the application of the customary or established percentage markups to the tax as well as to the factory cost of merchandise, if the excise tax is levied at the point of final manufacture. It should be distinguished from additional financing or other costs that might be involved in a manufacturers' excise tax. Any tax causes expenses of compliance, and possibly of financing, and excise taxes are

[6] Proceedings of the National Tax Association, 1952, p. 209.
[7] Cf. idem, p. 185, table 3, in Professor Musgrave's paper.

no exception. Pyramiding goes beyond the recovery of necessary, additional costs in the prices charged to customers, and those who advance this argument are in the position of contending, (1) that markup percentages are relatively fixed and unchanging, and (2) that additional profit will inure to retailers because the retailing profit is realized out of the gross markup, and the application of this fixed markup to the tax will yield some extra profit.

The additional profit to retailers from application of the usual markup to the tax as well as to the factory cost has to be the core of the pyramiding argument. If the price increase to consumers were to be no more than the tax and such extra costs as might be caused by the tax, such as the additional interest, insurance, commissions, and so on, the injury to consumers would be no worse, and no different in kind, in the case of an excise tax than it would be from an increase in any other kind of tax, or from any other increase in cost that is passed along in the prices.

The distributive businesses in this country are intensely competitive and such profits as are realized in them come the hard way, by rendering a quality of service to customers that will build and hold volume. Any attempt to secure extra profit by doing no more than relaying a tax is very unlikely to succeed for long because of the competitive pressure. If prices could be set higher in any retail market than those currently prevailing and still hold sales volume, there would be no reason to wait for an excise tax to provoke the advance. It would be done now.

The contention that percentage markups are so fixed and unchanging as to result in pyramiding by common consent, as it were, disregards the facts of the competitive situation in distribution. Two illustrations may be cited to show the tendency toward flexibility in markups in the struggle for sales volume. One illustration is the growth of the business done by discount houses, despite all of the reasons advanced to show that this kind of operation is deficient in many of the essentials required for good dealer-customer relations. A story in the Wall Street Journal of July 20, 1955, quotes a Chicago department store executive as follows:

> Two years ago we were kidding ourselves that the discount house was a passing thing. We've learned since then that we've got to take a shorter margin just like the discount house in order to survive. We were asleep when discounters were making the point that a $795 list freezer could be sold for $588. Now we treat them like any other good competition. We're a discount house ourselves in many items each day of the week.

The second illustration is the pressure for fair trade legislation. If there were a genuinely united front throughout retailing on the subject of markups, there would be little or no case for either Federal or State legislation designed to hold the line.

Summary and Conclusions

1. All taxes are paid out of income, either as it is received or as it is spent. This means that even the taxes levied on business are eventually borne by persons.

2. Taxes should be levied only for the support of government. When this standard is forsaken, the evils of discrimination, inequity, interference with economic decisions, and restriction of economic

growth emerge, because no one can be wise enough to determine, at each step, what the best next step for the whole economy should be.

3. Taxation for revenue only should assume a neutral effect of taxes, a goal which is best attained under proportional tax rates.

4. Uniform or proportional taxation requires a broad tax base. The broadest possible tax base is the income of the people, and all of this income can be reached only by placing part of the tax load on income as it is spent instead of concentrating all of it on a narrowly defined concept of income as received which is known as "taxable income."

5. Taxes on income as it is spent are commonly known as excise or consumption taxes. There is no defense of the miscellany of excises now imposed by the Federal Government, but a properly designed excise has many characteristics of a good tax, viz:

(*a*) They are a perfect example of installment payment, and of current tax payment; (*b*) administrative costs are low; (*c*) they involve no forms, no reports by the individual consumers, no audit of taxes paid, and no back tax; (*d*) they permit taxpayers some discretion as to the amount of tax and the time of its payment; (*e*) they are not subject to manipulation through "gadgeteering."

6. Consistency would require universal application of the tax to all goods, or to all services if the latter class is to be included. Practical considerations warrant separate tax treatment of alcoholic beverages and tobacco, based on long historical experience; and also for the exemption of food products as being the one commodity which would provide general rather than discriminatory exemption treatment for all persons.

7. The selection of the point of levy—retail, wholesale, or final manufacture—involves consideration of arguments on both sides. Some matters would be more troublesome and others less so, according to the point of imposition. The writer's conclusion is that, on balance, the case is strongest for the manufacturers' excise, although it is possible that the wholesale level would be equally admissible. A Federal retail excise or sales tax should be avoided, both for administrative reasons and to avoid direct duplication of, and conflict with, the sales taxes now collected in some 32 States. Even if the manufacturers' excise were to involve some additional administrative difficulties—which is not conceded here—it would be better policy to endure these than to encroach upon a source of State—and local—revenue which has attained so great importance. The outcome could well be an increase of Federal grants, a result which would be serious for the fiscal independence of the States.

8. The conventional criticisms of excise taxes in general are (*a*) reduction of spending power and (*b*) regression in relation to income. Any tax reduces the income available for spending by the taxpayer, but it does not diminish total spending power in the economy because the Government spends the money taken from the people. The efforts to establish regression in recent discussions have dealt with the overall taxload rather than with excises per se. The results depend on the assumptions used, and at best establish no regression or so little as to provide no case for elimination of excises. None of these studies have dealt with the disastrous consequences of substituting more and heavier taxation of incomes for excises.

9. The objection of pyramiding applies only to excises imposed elsewhere than at the retail level. The inclusion of necessary added costs in the prices to consumers is proper, but this is not pyramiding. In a field of business as intensely competitive as the distribution of goods and services, profits depend on supplying customers with what they want, and when and where they want it. There would be no extra profit in the mere relay of a tax. The growth of discount business reveals the weakness of the old-time rigid percentage markups, and the existence of fair-trade legislation indicates the weakness of the contention that these markups are a necessary "built in" feature of modern retailing.

10. A manufacturers' excise, levied across the board on all end products of manufacture except alcoholic beverages, tobacco, and food products, in substitution for the present discriminatory hodgepodge of excises, would be the soundest solution of the Federal excise-tax problem.

THE IMPACT OF COMMODITY TAXES ON RETAIL TRADE

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Our present method of imposing excise taxes

Every segment of industry opposes our present method of excise taxation. The selection of certain items to be taxed and the exclusion of others from taxation is done without any rhyme or reason. These selective excises at both the retail and manufacturers' level impose severe competitive penalties on the taxed products. The varying rates of tax create further competition between items subject to taxation.

In fact, the 20-percent excise tax at the retail level on furs was largely responsible for the deterioration of the fur industry. Everyone in that industry has suffered. The trapper, the fur farmer, the dresser and dyer, the manufacturer, and the distributor have suffered unemployment, poor business and severe financial losses because furs were capriciously singled out as something to tax. The consumer purchased merchandise manufactured from competing materials not subject to tax, as a substitute for furs. Similar situations exist in the case of most of the other articles subject to our present selective excise tax system. Nothing good can be said for our present method of selective excise taxation.

Why not substitute a broad-based uniform rate system of excise taxes on the end product of manufacture?

There are many reasons against this form of taxation which will be discussed in some detail in this paper.

Before discussing reasons opposing such taxation, it is necessary to understand exactly the effect of such taxation. It is necessary also to analyze and define the meaning of the words "end product."

Representative Mason, of Illinois, introduced H. R. 5694 which was referred to the Committee on Ways and Means April 20, 1955, to provide revenue from an excise tax uniformly applied to the end products of manufacture. This tax is to be applied to the manufacturers' sales price. However, in order to make this method of taxation less bur-

densome on the great mass of the population, certain exclusions were provided.

Food, drugs, seeds, fertilizers, insecticides, fungicides, and defoliants; books, pamphlets, and music in raised print for the blind; religious articles; all are to be exempt from taxation.

All articles taxable under chapters 51 and 52 (alcohol and tobacco) of the Internal Revenue Code are excluded from the provisions of this bill. All articles sold for further manufacture, for export, or for use by the United States, are also excluded from tax. However, for administrative purpose, I presume, in the case of certain manufacturers whose sales of otherwise taxable merchandise are $10,000 or less in any quarter, there is no requirement for the imposition of the tax.

These conditions introduce a considerable degree of selectivity in the imposition of the tax, which establishes precedent for further selectivity under the heat of congressional debate and pressure from interested groups which believe the products they manufacture are entitled to special consideration.

These exclusions in H. R. 5694 are emphasized to point out the vulnerability of excise taxation to the efforts of manufacturing groups to have their products exempted from tax for reasons which honestly seem to these groups to be in the public interest.

The words "end product of manufacture" have very serious implications when the entire pricing structure through the processes of manufacture, wholesaling and ultimate sale to the final consumer is understood.

They mean that the tax would be imposed on the sales price at the manufacturers' level on the brick, stone, plaster, steel, plumbing, heating, electric wiring, electric equipment, and all other components required to construct any manufacturing plant. If such materials are acquired through a middleman, there would undoubtedly be a profit taken on the tax to reimburse the middleman for added ad valorem taxes, insurance, and other costs occasioned because of the excise tax.

Production machinery and tools, all office furniture and equipment, all machine parts and maintenance supplies and all other supplies of whatever character, will be increased in cost at least to the extent of the tax, and probably more, depending on whether the article is secured through a distributor.

The manufacturer will pay higher ad valorem taxes on plant machinery, equipment and supplies, and higher insurance costs on these more costly facilities.

He must recover all these added costs of depreciation, repairs, taxes, insurance and other items of expense by means of an increased sales price for his product, to which must be added the excise tax if the product does not fall within one of the excluded classifications.

It will be argued that competition will prevent the price increase outlined here, but all manufacturers will be faced with similar increased costs of production and will employ similar methods to save themselves from loss of profits to the maximum extent possible.

The wholesaler is faced with similar problems. His plant, equipment, and consumption materials will increase in cost. Higher ad valorem taxes on plant, equipment, and supplies and on an increased cost of inventory, higher insurance costs on all these items, increased depreciation costs and higher costs for repairs and supplies must be

recovered by means of an increased sales price if the wholesaler is to remain in business.

The retailer, the last step in the chain of production and distribution, faces the most serious problems of all. His plant, fixtures, equipment, and consumption materials will increase in cost. Ad valorem taxes and insurance costs on plant, equipment, and supplies will increase, depreciation charges will be larger and higher costs for repairs and supplies must be recovered from the sales price of merchandise.

In addition to these increased costs, the merchant is faced with increased ad valorem taxes on an inventory increased in cost to him because of—

Higher cost of manufacture;

The excise tax;

Higher wholesalers' operating costs;

Increased insurance costs on this increased cost of the inventory;

Greater working-capital requirements and therefore higher interest costs to finance inventory investment;

Substantially higher rental costs based on a percentage of higher sales prices;

Higher compensation to salespeople based on a percentage of a higher sales price; and

Greater hazards of loss in the value of merchandise inventories in time of declining prices because of an excise tax paid for at the time of the purchase of his inventory. Falling prices would not bring any reduction in the tax cost of existing inventories because that tax was paid when the merchandise was purchased.

As has been demonstrated here, the real meaning of taxing the end products of manufacture is to build into each step of the cost of producing and the cost of distributing articles for consumption, a series of increased costs for depreciation, maintenance, repairs, taxes, insurance, interest, rentals, compensation to sales personnel and hazards of loss on unseasonable merchandise and merchandise declining in value because of market conditions. All of these added costs, plus the profit margins on cost taken by the entrepreneur in each step of the process of production and distribution, increase the price to the ultimate consumer much more than the amount of the tax collected and paid to the Government.

What is the purpose motivating the proponents of broad-based uniform rate excise taxes at the manufacturers' level?

To anyone who carefully studies the problem, it is perfectly apparent that the real purpose behind the drive for excise taxation is to secure relief from the present high corporate income tax and to secure reductions in the very high progressive rates of taxation on the higher paid individuals. Both corporate and individual income-tax rates are excessively burdensome. They reduce the after-tax disposable income of both corporation and individual.

Corporation directors have constant concern to balance the division of after-income-tax net earnings between a dividend large enough to give stockholders an adequate return on their investment and earnings to be retained in sufficient amount to meet increasing needs for working capital and new fixed capital requirements.

Individuals in the higher income brackets, the logical source of new investment capital, have but little chance after paying income taxes and meeting living costs, to have funds remaining in sufficient amount to supply risk capital in adequate amount for an expanding economy.

To improve the situation for corporations and higher paid individuals, the proponents of broad-based uniform rate taxation, advocate progressive lowering of income-tax rates on these taxpayers. In order to replace the revenue loss created by these reductions of income-tax rates, the proponents urge the spreading of the tax burden to all the population by means of a broad-based uniform rate excise tax at the manufacturers' level.

It is argued that our Government has placed too great reliance on income taxes as a source of Federal revenues, and that it has relied less on consumption taxes than any other government in the world.

It is argued further, that the enactment of these broad-based excise taxes will be a means of balancing the tax structure and that such balancing process will preserve the Federal revenue if deterioration should come into the economy, and create a decline in profits and wages with a resulting loss of income-tax revenues.

The proponents advocate also that after progressive reductions of income-tax rates have brought the top bracket rates for individuals down to 35 percent and the top tax rates for corporations to 35 percent, there should be constitutional limitation placed on such rates so that they cannot again rise above the 35-percent level. In addition to these limitations on income-tax rates, it is recommended that something should be done to stop estate and gift tax rates where they now are, institute a program of reducing their steeply progressive rates and set constitutional limits for the top brackets for these taxes.

However, when discussing excise taxes on liquor, tobacco, and all other kinds of articles (end product of manufacture), these proponents conclude that constitutional limitation of rates is not needed.

Therefore, it is apparent that proposals for balancing the Federal tax structure are prompted largely by a desire to reduce income-tax rates for corporations, and the highly progressive income-tax rates on the higher-paid individuals, those, counting husband and wife filing a joint return as one individual, reporting incomes subject to tax of $10,000 or more. According to the U. S. News & World Report in 1953, these higher-paid individuals represented 5.34 percent of all individuals reporting taxable income.

In order to supply the revenue lost because of income-tax rate reduction, it is the intent to tax all citizens of the United States for the privilege of consuming the goods and services which create the American standard of living.

But in order to give Congress freedom to increase the Federal revenue, constitutional limitations are not proposed for any of the excise taxes; in fact, it is argued that limitations on such taxes are not needed.

Since 94.66 percent of all those reporting taxable income reported less than $10,000, 74.38 percent of all those reporting taxable income reported less than $5,000 (see sec. (e))—and many millions of others had no taxable income to report—again it is obvious that relatively few taxpayers in the high-income brackets would be benefited by a greater after-tax income at the out-of-pocket cost of the many.

Basic position of retailing on selective excise taxes and on broad-based uniform rate excise taxes on the end product of manufacture

Almost all retailers—and I am a retailer—are unalterably opposed to the present system of selective excise taxes, whether imposed at the manufacturers' or the retail level. I am sure that almost all industry opposes such taxation.

Our present system is capricious and arbitrary both as to item being taxed and rate of taxation. Every industry whose product is being taxed is at a serious competitive disadvantage with those industries whose products are not taxed.

In our American economy the consumer has the right to choose, within the limits of his pocketbook, what shall be purchased and what shall be passed by. When the tax is at the retail level, the customer can determine the amount of penalty involved in the purchase. The fur, jewelry, ladies' handbag, and silverware industries, both producer and distributor, have discovered that the present 10-percent tax at retail is still a serious deterrent to the sale of these products—the customers are continuing to choose to buy something else. When the tax is at the manufacturers' level, the customer does not know the amount or rate of the tax or the effect of tax on price, but the customer does know that the product is high-priced. The distributor is blamed for the high price, and whenever possible the customer avoids the purchase of such products because of price.

Only the advent of the discount house which with very few exceptions furnishes no service and does not guarantee the performance of the product has brought price to the consumer down to reasonable amounts. But the distributor who furnishes services and guarantees his merchandise is experiencing a profitless sales volume from his efforts to prove to his customers he will not be undersold and to avoid the penalty of being just a showroom for the discount house.

The retailer opposes excise taxes at the manufacturers' level for many reasons. The present selective excise taxes at the manufacturers' level create considerable hardship; a broad-based, uniform rate excise tax at the manufacturers' level on the end product of all manufacture will intensify and increase these hardships not only on the retailer but also on the entire economy.

The retailer opposes such taxation because—

1. The cost of his merchandise will be increased—

(*a*) By the manufacturer's excise-tax-caused increased cost for depreciation, taxes, insurance, and repairs on plant, equipment, and consumption supplies and the cost of consumption supplies.

(*b*) By the tax itself imposed on a price sufficiently greater to cover the increased costs plus a margin for profit sufficient to reward the manufacturer for added risk because of higher production costs.

(*c*) By the wholesaler's excise-tax-caused increased costs for depreciation, taxes, insurance, and repairs on plant, equipment, and consumption supplies and the cost of consumption supplies, plus increased costs for insurance, taxes, interest, and sales commission required to carry and sell a most costly inventory. The wholesaler will of necessity be required to secure a price high enough to cover his higher cost of inventory plus higher operating

costs plus a margin sufficient to reward him for the higher risks he will be forced to take because of the added costs.

2. His investment in plant, fixtures, and equipment will increase, and therefore his operating costs for depreciation, taxes, insurance, repairs, and interest on these investments, and on supplies for consumption will increase.

3. The operating costs to carry interest, taxes, and insurance on merchandise will increase because of a more costly inventory.

4. His selling prices must of necessity be increased sufficiently to cover increased cost of inventory, plus the increased operating costs outlined in 2 and 3, plus increased sales commissions plus increased costs of rents both based on percentage of sales, plus enough to protect him from the added risks assumed because of an inflationary spiral a broad-based excise tax at the manufacturers' level will build into every step of the production and distribution of the clothing, furniture, accessories, housing, fuel, electric current, and all other goods and services required by the ultimate consumer to maintain ordinary standards of living for himself and family.

5. In spite of the fact that no tax is proposed on seeds, fertilizer, insecticides, fungicides or defoliants, the farmer's cost for housing, clothing, and other costs of living, barns, farm machinery, fencing, depreciation, repairs, taxes, insurance, and interest will all increase because of this method of taxation.

No tax is proposed on foods. However, food prices will rise because of the farmer's added costs of operation plus the added costs of depreciation, repairs, taxes, interest, and insurance on plant and equipment of the food processors, wholesalers, and retailers.

6. The Department of Labor's BLS Index is the key to many labor contracts and all farm parity prices. All the added costs outlined in the previous paragraphs will be reflected in the BLS Index. As a result the wages of every segment of the population as well as farm parity prices, will rise and add further impetus to the inflationary spiral.

7. Retailers fear price inflation because the many consumers with fixed incomes lose purchasing power with the result that overall consumption is reduced. Reduced consumption backs up into less production and reduced employment in every step of the manufacturing and distributive processes.

8. Falling commodity prices, whether caused by recessions, reduction of excise tax rates by Congress or any other reason, will impose severe hardships on both wholesalers and retailers. These falling prices will not bring with them any reductions in the tax and other costs created by the tax, built into existing inventories because these elements will have been paid for at the time of the purchase of the merchandise.

Retailers in England and Australia have complained very bitterly because of severe losses occasioned by reduction of "purchase taxes" when no provision for floor tax refunds was legislated with the tax reduction.

9. The excise tax is hidden. The many effects of a broad-based, uniform-rate excise tax on the "end product of manufacture" will be so deeply buried in the final retail price that no one will ever be able

to determine the actual impact of the excise tax on the tangible things the ultimate consumer purchases in the retail stores.

But the customer will be acutely conscious of the fact that the price of goods has materially increased. Because the customer will have no basis for understanding the reason for the increased price, because the customer will not know that a taxing device is responsible for a series of pyramiding costs built into the price paid for merchandise, the retailer will carry the onus for profiteering, for unconscientiously increasing the price of goods presumably to the benefit of the retailer and the detriment to the customer.

There have been representations made that the customer is fully aware a tax at the manufacturers' level is imposed on merchandise in Canada where this form of taxation has been in effect for many years. To determine the extent to which this statement is correct, with the permission of a Canadian department store catering to the middle- and lower-income population, I sent one of our executives, equipped with a tape recorder, to interview customers buying in the Canadian store.

We found that 56.2 percent of the customers had no knowledge of any tax, 40 percent had a very vague knowledge but not the slightest idea of the rate of tax, and 3.8 percent had worked in stores, had been exposed to the tax and therefore knew about it. Our executive told the rate of tax to the customers interviewed and then there was grumbling about hidden taxes as the interview progressed.

Our executive interviewed customers in our own store to determine their knowledge of the manufacturers' excise tax on radios, television sets, mechanical refrigerators, photographic cameras, etc., electric light bulbs, fountain pens, etc. He found that 74.5 percent did not know a Federal consumption tax existed and that 83 percent had no idea of the rate of the tax. When he told them the tax rate, there was again grumbling about hidden taxes.

10. There have been representations made that no pyramiding of the tax will affect the retail price, that competition will prevent such pyramiding. So I discussed this problem at some length with my Canadian retailer friend. I was told that full markup was taken on the tax. The Canadian retailer said, "The tax is a part of the cost of our merchandise and we are entitled to our full markup. In addition, when we buy from wholesalers, the tax is included in the price we pay for the item, and we cannot determine its amount. If for no other reason, in order to price our merchandise uniformly, it is necessary to take our markup on the tax when we purchase directly from manufacturers."

11. From these experiences, it is reasonable to conclude that most customers do not and will not know about hidden taxes at the manufacturers' level. It is also reasonable to conclude that American retailers will always of necessity take full markup on the excise tax purchased with the merchandise to be offered for sale.

12. There have been representations made that the corporate (or business) income tax pyramids viciously in the price the ultimate consumer pays for goods and services. This is only a half-truth and dangerous because it is a half-truth.

The final price at the retail counter does include the corporate tax of every organization involved in the chain of production and distri-

bution of the item. In fact, to be exact, it includes the income tax of every individual employed by these organizations because the compensation of these employees had to be paid out of the price received for the product and therefore was a part of the cost of the product.

But the corporate income tax of each of the organizations involved is not absorbed in the final retail price as such. The profit (if any) included in the price at each step in the process is a part of the final retail price. The income tax paid by each organization is a sharing with the Government of the profit resulting from its sales prices after deducting all costs of operation on the Government's terms, just as the income tax of the individual is a sharing of his income with the Government on the Government's terms.

Neither producer nor distributor has any intention of reducing his profit margin if a broad-based, uniform-rate excise tax is enacted and income tax rates are reduced. To do so would defeat the entire purpose of the determined attempt to have this form of excise taxation legislated in order to have lower income-tax rates on corporation and higher income individuals to give them more after-income tax disposable income.

To summarize, the retailer fears and opposes excise taxes because he will be required to pay more for his merchandise inventories, be subjected to higher costs of operation, be subject to increased hazards of inventory loss, and be required to secure a higher selling price for his goods, thereby drying up the purchasing power of a substantial number of his customers.

Where will the impact of broad-based, uniform-rate excise taxes on the end product of manufacture fall? What effect will they have on the buying power of the masses?

Earlier in this paper it has been shown that the goal to be achieved by the enactment of such excise taxes is a shifting of the income-tax burden from corporations and higher income individuals to the great masses of the population. For instance, a corporation earning a before-income tax net income of $100,000, at present tax rates would pay a tax of $46,500. If the normal tax rate should be reduced to 25 percent, the corporation would pay a tax of $41,500 and would have an additional $5,000 of after-tax earnings to use for expansion of the business, increased dividend to stockholders, or any other legitimate purpose. As the corporate-tax rate continues to lower, the after-tax net income will continue to increase and additional amounts will be available for corporate purposes. In exactly like manner, as the income-tax rates for the individual reduce, the after-income tax disposable income of that individual increases and he has added funds to use for investment, recreation, to improve his family's standard of living, or any other legitimate purpose.

However, as long as Federal expenditures remain at present levels, if any program of reducing income-tax rates for corporations and individuals should be instituted, the missing tax revenues must be obtained from other sources. The recommended source is a broad-based, uniform-rate consumption tax imposed at the manufacturers' level.

All consumers will pay this consumption tax plus the pyramiding it will engender. Those high-income earners whose income tax rates

have been reduced sufficiently to increase their after-tax income, will not be materially hurt because of paying the tax plus its added costs, but many low-income individuals will be seriously harmed.

Before discussing this phase of the problem, it must be understood that under the definition of the "end product of manufacture," in addition to a substantially higher price for clothing, furniture, accessories, utilities, food, and other goods and services, the cost of housing will also be more costly because all of the components required for the construction of a home are also end products of manufacture. Therefore they are subject to the tax and all the added costs that the tax engenders.

In addition to the higher costs outlined, when the consumer buys goods and services in 33 States and fifty-odd cities where State and municipal sales taxes are imposed, the sales tax will increase in amount because the price on which it is based has been increased by the tax and the pyramiding it creates.

The United States News & World Report reported earlier this year, that counting a husband and wife filing a joint return as one taxpayer, in 1953 there were—

Taxpayers reporting incomes of less than $5,000	33, 163, 934
Taxpayers reporting incomes of $5,000 to $10,000	9, 037, 730
Making a total of—	
Taxpayers reporting incomes of less than $10,000	42, 201, 664
Taxpayers reporting incomes of $10,000 to $25,000	1, 931, 616
Taxpayers reporting incomes of $25,000 to $50,000	329, 616
Taxpayers reporting incomes of $50,000 to $100,000	93, 346
Taxpayers reporting incomes of $100,000 to $250,000	24, 119
Taxpayers reporting incomes of $250,000 to $500,000	3, 076
Taxpayers reporting incomes of more than $500,000	1, 131
Total	44, 584, 568

David L. Babson & Co. report in their weekly letter of April 4, 1955, that 53 percent of the spending units reported before-tax earnings in 1954 of less than $4,000 and 88 percent of the spending units reported before-tax earnings of less than $7,500.

The Detroit Free Press, issue of August 15, 1955, reported that more than 7,500,000 Americans during June 1955 received benefit checks under social security. There are always hundreds of thousands of individuals for short periods of time who are living on tax-free unemployment compensation benefits. In addition, there are millions of others who are living on interest, dividends, and earnings in insufficient amounts to be subject to income-tax payment.

The 42,201,664 taxpayer units, plus the 7,500,000 receiving social-security payments (not included among taxpayer units), plus the millions of others living on incomes not subject to income tax for one reason or another, are the ones who spend most or all of their income to meet the day-to-day costs of living for their families and themselves. These are the ones who have but little liquid resources to draw on to meet extraordinary family obligations.

These also comprise the great mass of purchasing power which keeps the American economy strong and healthy. These people must be kept open to buy if we wish to keep our farms, mines, factories, and stores producing and distributing an ever-expanding volume of goods and services which will keep a constantly growing labor force gainfully employed.

The average factory worker in February of 1955, according to the Bureau of Labor Statistics, earned $74.93 per week. While there have been increases in wage rates since that time, the figure will serve to illustrate the financial burdens of the lower income workers, the major part of our population.

If this worker is married but has no children, and elects to use the optional tax table, his income tax will be $458. The income tax cuts his disposable income $8.81 per week, giving him $66.12 per week to meet his bills for food, housing, home furnishings, clothing, heat, utilities, and all the other costs required to maintain his standard of living.

In section (*d*) of this paper it has been demonstrated that when the excise tax reaches the final consumer he will be required to pay an increased price for the merchandise purchased, far in excess of the amount of the tax imposed on the specific item being purchased. This is so because the tax on the "end product of all manufacture" builds a series of added costs into every step of the processes of production and distribution, from the farm and mine clear through the final process of sale to the ultimate consumer. Because of these built-in added costs, the effect of the broad-based excise tax at the manufacturers' level will be far more burdensome to these millions of lower income people than the present selective system of excise taxations at the manufacturers' level. To demonstrate the burden the present system places on the consumer, a refrigerator sold by my store for $249.95 at a markup of 31.4 percent on selling price, was subject to an excise tax at the manufacturers' level of $8.16. Had there been no excise tax at the manufacturers' level, the same refrigerator with a markup of 31.5 percent on retail, would have sold for $238.50. The $11.45 difference in price recouped for us the $8.16 excise tax plus the extra ad valorem tax, insurance, rent, sales commissions, and added risk created because we had to invest in the tax when the merchandise was purchased by us. The customer was penalized further:

	Manufacturers' excise tax imposed	Had no excise tax been imposed	Additional amounts paid
Retail price of refrigerator	$249.95	$238.50	$11.45
Michigan State sales tax	7.50	7.15	.35
Total amount paid by customer	257.45	245.65	11.80
Amount of the manufacturers' excise tax			8.16
Amount of the pyramiding on the excise tax			3.64
Total additional paid by customer because of the excise tax			11.80

This pyramiding was all by the retail store. If the proposed "end product of all manufacture" tax legislation is enacted, in addition to the pyramiding by the retail store, there will be pyramiding of costs at each of the mine, farm, manufacturing, and wholesale levels to permit the recovery of the added costs the tax will create at each of these levels.

Our factory worker has $66.12 disposable income per week. Fifty cents to a couple of dollars more for shoes for the man and wife, a

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couple of dollars more for a suit for the husband, something more for a suit or dress for the wife, a little higher payment on the house, a little bit more for each item of food and pretty soon the sum of the increases in prices will equal doing without something desirable for the family well-being.

Is everyone who reads this paper so far removed from the struggle to make ends meet on a limited income, they have forgotten that when the price of any commodity increased, and it had to be purchased, they did without some other desired or needed goods?

The accumulation of things these millions of individuals will be forced to do without will back up into lessened sales and employment in the country's retail and wholesale establishments, lessened sales and employment for the factories which produce the goods, lessened sales and employment for the suppliers of the factories, fewer car loadings for our carriers and ultimately and inevitably the need to construct new factories and stores to meet the requirements of a growing population with an improving standard of living, will cease to exist and will result in a slowing down of the capital goods industries.

The standard of living of these millions of lower income individuals who support the economy of this country will take a backward step. Their standard of living will move toward the lower ones of the populations of most of all other countries of the world where a very large proportion of the national revenue is produced by consumption taxes.

To summarize—the 42,201,664 low income taxpaying units, plus the more than 7,500,000 individuals at this time receiving tax-free social security payments, plus those receiving unemployment compensation benefits, plus the millions living on interest, dividends, and other income in amounts too small to be subject to income tax, will pay more for each item of food, fuel, clothing, home furnishings, housing, utilities, and other goods and services they must buy in order to live, so that the income tax burden can be lightened for corporations and higher income individuals.

These many millions will be less able to buy, with a consequent reduction of their standard of living in order to benefit the relative few.

If the consumer does not or cannot buy, the producer in spite of all his techniques for low-cost production, does not manufacture. Both the manufacturer and the distributor will be forced to reduce the number of people employed, both will earn smaller profits from which to pay income taxes, dividends, and provide for the expansion of plant and equipment. The entire economy will be thrown off stride and will suffer.

The dangers inherent in broad-based excise taxes at uniform rates on the end product of manufacture imposed at the manufacturers' level

If the proposed taxation were to be imposed at the point where the product finally came to rest—let us call it the point of consumption—the tax would still be a component part of the cost of plant, equipment, repair materials and other "expense" of goods and services affecting every step in the process of manufacture and distribution. It would still cause higher costs for depreciation, ad valorem taxes, interest, insurance, repairs, and other business expense materials and services, all of which would of necessity cause higher selling prices in each successive step involved in getting the product to the ultimate consumer.

The tax collected from the individual buying for personal purposes although it will be more because it will be collected on a higher sales price, will not in itself carry additional pyramiding as happened in the instance of the refrigerator described in section (*e*) of this report. The customer would have some knowledge of excise taxes. While the customer would still be subsidizing the corporation and higher paid individuals through the shift from income taxes to consumption taxes, at least there would be some idea of the extra burden he will be carrying, even though the knowledge would be incomplete.

The tax collected at the manufacturers' level—with no necessity for constitutional limits on rates—would be subject to constant political pressure.

Once a broad-based, uniform rate, excise tax on the end product of manufacture is legislated the pressures will begin. Every industry will be able to find countless reasons to prove it is operating under adverse circumstances, and therefore the tax on its products should be reduced or eliminated.

Witness the recent legislation in this country which has removed the excise tax on television sets and components which are not of the entertainment type (H. R. 4394), and which has removed the excise tax on motorcycles (H. R. 5647). Congress has been convinced that for one reason or another relief should be granted in these instances.

To help the depressed cotton-textile industry in England and to give added employment to its workers Prime Minister Eden has removed the purchase tax of 50 percent on many items of cotton goods. Cotton goods in England—for political purposes—now have a competitive advantage over other fabrics. English purchase taxes started at low rates, but now they range from 25 to 75 percent on various products.

Canadian purchase taxes started years ago at a 1-percent rate. Last year in 1954, in spite of the fact that some of the tax rates had been reduced, the range was from 8 to 25 percent on various products.

In Russia, according to Franklyn D. Holtzman's recent book, excise taxes range from 15 to 88 percent of the retail price of the commodity, while the salaried workers and party and governmental dignitaries pay income taxes at rates ranging from 2 to 13 percent (with some of the dignitaries being entirely exempt from income tax), and in addition there is an enforced bond purchase plan of 10 percent.

The same story of inequities and discrimination in purchase tax rates can be shown for every country that uses excise taxes as an important source of revenues.

The taxes are hidden for all these countries. Once the Pandora's box of broad-based hidden excise taxation is opened (legislated) the pressures begin to have the rate adjusted on some products. Arbitrarily some products are deemed luxuries and therefore taxed at higher rates; others are deemed less essential but still not luxuries, so a somewhat lower rate is established; others are deemed necessities and taxed accordingly.

When there is a sudden need for additional governmental revenue the least noticeable way to get it is to raise the excise (purchase) tax rate. Very few of the citizens of the country are aware of the existence of the tax—none have any realization of the rate of tax and its effect on prices. Everyone is painfully aware that commodities are costly and the paycheck is too small to satisfy many desires.

I live in Detroit and am frequently in our neighboring Canadian cities just across the Detroit River. The difference between the standards of living of the ordinary Canadian citizen and our folks in Detroit is very apparent even to the casual observer. One of the factors accounting for this difference is that the widespread high-rate excise (purchase) tax puts the Canadian citizens in a very bad price-income ratio in comparison with the American citizen who is required to buy relatively little merchandise subject to excise taxes at either the retail or manufacturers' level.

It would be difficult to convince me that our legislators will be any less human, any less subject to pressure from their constituents, any less willing to trade the legislator from one section of the country a tax advantage for a product produced there, in order to secure a desirable advantage for his own constituents, once this country legislates broad-based excise taxes.

With no limits proposed on excise taxes it would be difficult to convince me that our legislators will not find it expedient when additional Federal revenues are required, to increase excise-tax rates either selectively or straight across the board--ultimately selectively, in order to avoid the grumbling of the people of their districts against increased income-tax rates.

Increased income-tax rates stand out for all to know about, while increased excise-tax rates are hidden, the onus is removed from the legislator for increasing taxes. The public complains about too high prices instead—and not understanding the cause for increased prices, accuses business of profiteering. The public knows too, that its income will not cover quite so many of the desirable things of life, that it must do without some more of the things it had formerly enjoyed.

Does a manufacturers' excise tax pyramid by the time it reaches the consumer?

There is no necessity to belabor this point because both sections (*b*) and (*d*) of this paper have carefully and clearly analyzed the serious pyramiding created by a broad-based uniform-rate excise tax on the end product of manufacture.

Section (*f*) pointed out that a tax levied at the point where the product came to rest—call it a tax at the retail level—will not pyramid as viciously as a tax levied at the manufacturers' level.

However, either the tax at the retail level or the tax at the manufacturers' level will force the ultimate consumer to pay much more than the amount of the tax in addition to—shall we say—the normal price of the product. Either level of tax creates a series of built-in added costs of the product that must be recouped out of the price paid by the ultimate consumer.

The difference between the impact of consumption taxes and income taxes on the ultimate consumer

Representations have been made that at each income level, the consumer will pay exactly the same amount of tax whether or not broad

based excise taxes at the manufacturers' level become an integral part of the Federal tax structure.

It is true that if the total taxes collected for the country are divided by the number of citizens—regardless of the method of taxation—the average tax will be the same for all citizens.

The degree of pyramiding of an $8.16 tax on a refrigerator was analyzed in section (e). When our public accountants made this analysis, they determined that the accumulated before-income-tax net profit occurring through all steps in the process of converting some iron and copper ore into a refrigerator in the customer's home was approximately $36.18. Tax on this amount at 52 percent amounted to $18.81 and the businesses involved in the creation and sale of the refrigerator had $17.37 left out of which to pay dividends and profits for business expansion. If the income-tax rate were to be cut to 45 percent, the tax would be $16.28 and the after-tax remainder $19.90 or $2.53 more to be used to increase the dividend and still have something more than when the tax was 52 percent for the expansion of the business.

Analogous facts could be developed for the higher paid individual should income-tax rates be reduced. They would have more after-income-tax disposable income to be used for investment or such other purposes deemed appropriate for their purposes.

Industry has no intention of reducing profit margins should income-tax rates be reduced for any reason. Certainly if the proponents of broad based excise taxation should be successful in their endeavor, the reduction of profit margins coincident with the reduction of income-tax rates would defeat their purpose of having more after-tax disposable income, both for corporation and higher paid individual, to be used according to their greatest advantage.

So far as the retail industry is concerned, there is definite proof that income-tax rates have no influence on original markup over cost or on rate of gross profit. The following schedule shows that for the years 1928 through 1954, inclusive, retail store original markups have fluctuated over a very narrow range, and that before-income-tax net profits have been governed by the markdown rate and the expense rate. The schedule shows also that such excise taxes at the manufacturers' level that have been in effect in this country during the last 14 years have had no effect on original markups. The retailer has taken his full margin on such taxes.

Operating data of department stores

	Corporate income-tax rates	Cumulative markon	Mark-downs	Gross margin	Operating expenses
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
1928	12	36.7	6.5	33.2	31.7
1929	11	37.1	6.6	33.5	32.3
1930	12	36.75	7.6	33.3	33.9
1931	12	36.6	8.3	33.1	35.9
1932	13.75	38.85	9.6	33.1	39.5
1933	13.75	37.55	7.1	36.0	38.1
1934	13.75	37.05	6.7	35.6	36.5
1935	13.75	37.25	6.8	35.9	35.9
1936	15	36.9	5.95	36.5	34.9
1937	15	37.6	6.8	36.4	36.0
1938	16.5	37.9	6.75	36.4	37.4
1939	16.5	38.8	5.4	36.9	35.4
1940	24	38.7	5.2	36.95	34.75
1941	[1] 31	39.35	4.35	38.2	33.4
1942	[1] 40	39.65	3.9	38.7	31.2
1943	[1] 40	39.15	3.45	38.4	28.7
1944	[1] 40	38.75	3.5	37.9	27.4
1945	[1] 40	38.6	3.65	37.6	27.85
1946	38	37.85	4.8	35.9	28.1
1947	38	38.2	5.65	35.4	30.1
1948	38	38.2	5.45	35.6	31.1
1949	38	38.2	6.0	35.2	32.5
1950	[1] 42	38.8	5.1	36.5	32.1
1951	[1] 52	38.4	5.85	35.3	33.2
1952	[1] 52	38.4	5.25	35.8	33.5
1953	[1] 52	38.8	5.25	36.3	33.8
1954	52	38.8	5.3	36.35	33.75

[1] Plus excess-profits tax.

Source: Harvard Report.

While I do not know anything about the pricing policies of manufacturing concerns, it would be my opinion that the rate of income tax has little, if any, bearing on their methods of pricing. It is my opinion that the manufacturing concern first, to the best of the ability of its cost-analysis department, determines the cost of producing a given product, and, second, after checking competition, prices the product at highest possible price compatible with competition and the potential market. From that point on I would suspect that there is a constant effort to improve manufacturing processes in order to reduce costs and improve the profit potential for the item.

If there is any profit left after paying all costs of manufacture, selling, and overhead, the Federal Government's share based on current tax rates is determined and paid. The remainder is used to pay dividends and for other corporate purposes.

The same is true for the wholesaler and retailer. So, the income tax is a sharing with the Federal Government of the reward for successful operation of the business. It limits the disposable income of the business. It is not passed on to the ultimate consumer as a tax pyramiding through each step of the process of production and distribution. Each step in the process pays the preceding step's competitively created prices for its product, whether or not that step succeeded in earning a profit.

In contrast, the consumption tax (excise tax) is a specific levy on the right to consume a product, in addition to its price. It is levied and collected irrespective of the fact that profits may or may not have been earned at any one or more of the steps involved in getting the product into the possession of the ultimate consumer.

It must never be forgotten that the production of our farms and mines and factories—although in the intermediate steps it is manifested by railroad equipment, intricate and marvelous automation equipment to produce automobiles and for other manufacture, huge dams, dynamos, or atomic reactors for producing electric current, ships at sea, fine office buildings, or in any other form, is all for the purpose of maintaining and improving the living standards of the citizens of our country. The costs of creating, maintaining, and operating all of these facilities become a part of the price the individual pays for the goods and service he acquires to meet the day-to-day requirements for living and dying.

Any consumption tax levied on top of price, at whatever step of production and distribution it comes to rest, increases the price the great mass of the population must pay in order to live in our complicated and intricately interwoven economy. Unless these many millions of lower income people—88 percent or more of our population, both individually and collectively, are able to buy increasing amounts of goods and services, it will be difficult to keep an ever-growing labor force gainfully employed.

Consumption is the key to the prosperity of the people of this country. It will be meaningless to be able to produce at low cost unless there is ability to consume what is produced. Legislating a method of taxation which will automatically and drastically increase the price the consumer must pay and thereby limit the ability to buy, will not solve the problem of consuming an ever-expanding flow of goods created by a growing labor force with greater productive capacity per man because of improved plants, equipment, and methods.

Consumption taxes if enacted, in my opinion, will be the stumbling block which can slow down the entire economy.

Is the United States system of income taxes on corporate and individual incomes a deterrent to capital formation?

It is entirely true that if there were no income taxes both corporations and individuals would have all of their net incomes available for any purpose deemed desirable. It is also true that the rate of tax applicable to the income of any taxpayer determines the remainder of after-tax net income subject to the taxpayer's disposition.

If broad-based consumption taxes are enacted for the purpose of replacing the revenue lost because of lower income-tax rates, the taxpayers will have a greater proportion of their incomes remaining after income tax. I am convinced, however, there would be less funds available after tax in spite of the fact the remaining after-tax net income would be a greater proportion of the before-tax income. Smaller volumes of business because of reduced ability of consumers to buy caused by tax-created higher prices, will have its inevitable effect on before-tax profits and the salary and dividend incomes of managers and investors.

It is also true that if a company is not profitable, it is unable to build capital from retained earnings and, in addition, no individual is willing to risk his capital to buy its stock. So we are in reality discussing the problems of corporations and unincorporated businesses both large and small which are successfully and profitably marketing their stocks in trade.

Regardless of size, if more capital is available for investment in new and improved or additional plant and equipment and to provide more working capital to carry inventories, receivables, and to finance the cost of enlarging marketing areas, every business management believes it would become increasingly successful. Under such fortuitous conditions every business management believes it could better serve its employees, its creditors, its customers, and its stockholders.

Most business managements are in a hurry. They would like large additions to capital to come into being overnight—just like rubbing Aladdin's lamp. The fact that most business managements are aggressive and impatient is an excellent indication—it is undoubtedly one of the reasons they are successful.

There will be no attempt, in this paper, to minimize the need for capital formation. If American business is to give increasing employment to an expanding labor force in order to serve a rapidly expanding population, it must constantly enlarge its productive and distributive plant. It must constantly search for and install the most modern, the most efficient machinery and methods. All this takes money.

Let us take a look at what has happened to capital formation in the last several years. Then let us attempt to evaluate the happenings of the past with the probabilities of the future.

The company which employes me—a department store—will have invested $75 million between June 1, 1952, and August 1957 in added plant, fixtures, merchandise, and receivables in the metropolitan area in which we are located.

We believe in the growth and future of our country and of our community, so we are willing to assume the business risks involved to create, what we believe, are needed facilities. Our plans are set for additional expansion in our metropolitan area during the 10 years subsequent to 1957. Whether or not the income-tax rates will remain static, increased or lowered had no influence on our decision.

Socony Mobile Oil Co. has announced it will spend $265 million in 1955 for additional facilities, after having made investments of similar amounts in 1954. Revere Copper & Brass has announced it will build a new aluminum plant to produce 60,000 tons of aluminum per year. Anaconda Corp., has just started operation of a new aluminum plant. Ford Motor Co. has just announced that it will build a new 1½-million-square-foot plant to produce Lincoln cars. Diana Stores—a women's ready-to-wear small-store-chain operation—announced that it will open 20 new stores within the next 2 years and that it is negotiating for 10 additional store locations.

These are just a few of the thousands of concerns that are aggressively building for tomorrow's needs. Their plans are turning into realities and are not being deterred by present income-tax rates.

The financial pages are constantly reporting the offering of rights to existing stockholders to buy additional shares on the basis of one share for "every so many" held and later reporting that the rights were exercised. These rights were exercised by individuals who were subject to the high income-tax rates. The Wall Street Journal recently reported that investors had absorbed $2.5 billion in new stock issues in the first 3 months of this year.

The source of new capital to be used for risk purposes is well understood by every one, nevertheless, at the risk of being redundant, I will name them again:

For individuals:

The remainder from gross income after paying income taxes, meeting all costs of living, recreation, and the payment of all fixed obligations.

For corporations:

The remainder from before-income-tax net income, after the payment of income taxes and dividends (retained earnings);

Funds created by amortization, depletion, and depreciation of fixed assets;

Additional capital stock sold to present stockholders and others;

Borrowed money—retired out of depreciation of new fixed assets acquired, if borrowed for plant expansion, or out of added earnings if borrowed to finance increased inventories and receivables;

Risk capital and/or borrowed money obtained from pension funds, insurance companies, foundations, and union treasuries. (I have no great enthusiasm for unions to own stock in business corporations—but such investments in substantial amounts are made by unions.)

The proponents of a substitution of expanded revenues from excise taxes for a reduction in revenues from income taxes argue that there is not enough retained earnings from corporate net income, plus depreciation, amortization, or depletion of fixed assets to provide funds in adequate amount for the business expansion required to service tomorrow's rapidly expanding population.

The Hanover National Bank in its December 15, 1953, letter reported:

> For the period 1946 to 1952, both inclusive, the excess of total revenue over all expenditures of corporations, including taxes and dividends, amounted to $76.4 billions. The growth of corporate savings also contributed to increase corporate net working capital from $51.6 billion at the end of 1945 to $88.2 billion at the end of June 1953.

Alexander Hamilton Institute reports in its July 16, 1955, letter that—

> according to the Securities and Exchange Commission, net working capital of corporations during first 3 months of 1955 showed an increase of $2,300 million over the preceding quarter's total, or the best quarterly gain reported since 1950.

The Securities and Exchange Commission reports that the stockholders' equity for all corporations increased from $62,747 million at the end of the first quarter in 1947 to $116,591 million at the end of the first quarter in 1955. An increase of $53,824 million in a period of 8 years is a truly impressive performance.

It must be remembered that this information is for listed companies only. The source of the Hanover Bank's statistics and the source of the Securities and Exchange information must be from published statements of companies listed on the exchanges. These statistics cannot take into account the showing of the thousands of corporations, large and small, whose stock is closely held and whose statements are carefully guarded.

Let's take a look at the record of capital formation for a few companies whose balance sheets are in my files.

Common-stock holders equity only

	1945	1954	Increase
American Home Products	$31,153,691	$77,121,217	$45,967,526
Ex-Cell-O Corp.	11,685,809	30,141,471	27,455,662
Monroe Auto Equipment (1947)	1,966,388	4,309,637	2,343,249
International Shoe Co. (pay out almost all of earnings)	80,312,893	97,108,960	16,796,067
Canteen Co. (1950)	5,457,212	8,358,610	2,901,398
Hunt Foods	4,644,218	23,903,173	19,258,955
Geo. W. Helme Co., tobacco, snuff (policy of full payout)	15,626,000	15,687,000	61,000
Reliance Electric & Engineering	2,390,347	13,686,126	11,295,779
Pittsburgh Forgings Co	4,557,182	13,634,924	9,077,742
Pure Oil Co.	107,634,298	284,398,285	176,763,987
Minneapolis Honeywell Regulator	23,195,049	82,009,880	58,814,831
Celanese Corporation of America	62,442,444	172,316,434	109,873,990
Philip Morris (1948)	70,513,000	146,160,000	75,647,000
National Dairy Co	112,865,000	268,418,000	155,553,000
Rockland Light & Power	15,626,023	18,878,861	3,252,838
Mueller Brass Co. (1950)	15,267,055	22,528,439	7,261,384
Fruehauf Trailer Co. (1948)	33,463,817	53,986,056	20,522,239
Allegheny Ludlum Steel	31,785,206	63,804,450	32,019,244
National Distillers Products	76,758,000	253,635,000	176,877,000
Dayton Power & Light	42,745,000	59,547,000	16,802,000
Gardner Denver Co.	8,160,252	19,358,452	11,198,200
Magnavox Co.	1,597,963	11,550,282	9,952,319
National Gypsum Co.	17,778,067	81,659,795	63,881,728
Woodall Industries	2,489,427	7,634,212	5,144,785
Burroughs Corp. (1950)	56,780,356	74,410,268	17,629,912
Commercial Solvents Corp	23,618,000	37,462,000	13,844,000
General Acceptance Corp.	3,466,000	10,582,000	7,116,000
Associates Investment Co.	21,889,767	78,689,490	56,799,723
Total	885,868,464	2,039,980,022	1,154,111,558

I believe you cannot help but agree that an increase in stockholders equity of $1,154,111,558 from $885,868,464 to $2,039,980,022 for the above few listed companies is an impressive performance. These statistics and the report of the Securities and Exchange Commission on the growth of stockholders' equity, do not bear out the theory of capital being destroyed at its source. This growth represents a retention of earnings after dividend payout in a period of less than 10 years because for some companies the statistics did not go back that far. To it must be added the growth produced from long-term borrowed capital, retired principally out of depreciation of the facility acquired. We must not overlook the fact that some of the companies listed here have the statistical representation of retained earnings at a figure lower than the actual facts, because of the chargeoff of new plant on an accelerated basis granted by the Government in order to get agreement for a greater than normal expansion of plant facilities.

The impressive growth of capital in the period from January 1, 1945, until the end of the first quarter of 1955, in spite of the fact that excess-profits taxes were imposed in 5 of the 10 years, argues that capital growth during the next 10 years should at least equal and has every probability of substantially exceeding the record of the 1945–54 period. The growth during the decade beginning with 1955 is commencing from a substantially higher base than that which existed at the end of 1944. After income-tax earnings during the next decade, with a substantially higher capital investment to produce them, should permit the payment of larger dividends than have been paid in the last several years, and still leave greater "retained" earnings with which to build increased, more efficient plant, and acquire the most modern equipment and tools in order to give gainful employment to a growing population.

If conditions permit a very desirable, greatly needed reduction in income-tax rates, for either or both corporation and individual, the formation of new capital should be still further accelerated.

Summary

The weight of the evidence seems to point to the following conclusions:

1. Consumption taxes will have the effect of building substantially higher costs of producing the product purchased by the ultimate consumer, in addition to the tax specifically imposed on the product.
2. These costs will pyramid in the price the consumer must pay.
3. The consumer's ability to buy will be lessened because of higher prices, the standard of living will lower.
4. The burden of consumption taxation will fall largely on the 42,201,664 taxpaying units reporting incomes of less than $10,000 plus the 7,500,000 individuals receiving social-security payments, plus those living on interest, dividends, wages, and other income in insufficient amount to be subject to income taxes.
5. All these people described in 4 will lose the right of choice to the extent of the increase in price paid, as to how their income shall be spent.
6. While it is unquestionably true that all corporations would like to accelerate the speed of capital formation, and increase dividend payments, the available evidence shows that a truly remarkable growth has occurred in common-stock holders equity. The evidence does not indicate that corporate and individual income taxes have destroyed capital at its source. The evidence indicates that capital growth in the next decade will be far greater than in the past decade. If conditions permit reductions in either or both corporate and individual income-tax rates, future growth of capital should satisfy the most impatient of the Nation's entrepreneurs.

On the basis of this evidence, it seems highly questionable to substitute a system of excise (consumption) taxes for a lowering of income-tax rates on corporations and higher paid individuals.

7. While it is true that all tax revenue enters the stream of spending—that spending does not necessarily benefit the low-income consumers. I do not believe that excise taxes in America could or would ever reach the drastic extremes they have reached in Russia. The Russian situation, however, where hidden consumption taxes range from 15 to 88 percent of the retail prices, shows clearly how such taxation has deteriorated the standard of living of the ordinary Russian citizen and robbed him of the right to use his income to meet the requirements of living for himself and family. The funds raised by this taxation are used to build a huge war potential. They do nothing to improve the lot of those who are taxed and who have no voice in the spending.
8. Excise taxes are inflationary. They will increase the cost of living—increase the BLS cost-of-living index, influence wage rates, and increase parity prices for agricultural products.
9. The American labor force is growing rapidly. More efficient production machinery (automation) and improved methods are constantly increasing the productivity of labor. The growing labor force, producing at a constantly improving production per man, must be kept gainfully employed.

10. The only answer to America's ability to produce is the ability to consume the products produced. The genius of our engineers and managers to produce an ever-increasing flow of goods per man-day with an ever-increasing labor force will be of little importance if the American citizen, individually and collectively, is unable to consume these products. Limiting the ability to buy by tax-created higher prices is not the answer to our problem. Business in our free-enterprise economy always produces a series of chain reactions. If the customer buying for personal consumption cannot or will not buy, the producer does not manufacture, employment declines in all the processes of production and distribution of both capital and consumer goods, lower profits are earned—less wages will be paid, governmental revenues will decline—everyone will suffer. If we look back to the thirties, particularly the early thirties, we will be able to see the effect on the entire economy resulting from a drying up of the ability to buy of the consumer purchasing for personal consumption.

11. The present discriminatory selective excises should be repealed at the earliest possible time and that repeal should end any further consideration of excise taxes in the Federal tax structure.

ECONOMIC IMPACT OF THE FEDERAL EXCISE AND SALES TAX SYSTEM—A CASE STUDY

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Introduction

Although the writer is concerned here chiefly with the impact and economic effects of a specific tax—the 20-percent cabaret tax—a statement of more general views on commodity taxation in tax policy for steady growth is in order.

We are well aware in this country of the importance of production and of the extent to which increases in the efficiency of production have been a basis for economic growth. But the application of power, the division of labor, and the concept of interchangeable parts could be no more than theories of production without the background, not just of a mass market, but of an expanding mass market. Mass markets did not exist when the industrial revolution began. Today our mass markets are expanding, and distribution and marketing have become increasingly dynamic in nature. The importance of distribution and marketing, to the producer and to the ultimate consumer, is more generally recognized. The functions of marketing are more carefully studied.

As our population has increased, and the nature of our society has become more complex, an increasing number of marketing functions have become necessary to the efficient distribution of the country's production. Along with rising efficiency in output, there have been marked increases in the efficiency with which individual marketing functions are executed. At the same time, the number of marketing functions, and their importance in serving the needs of producers on the one hand, and of an expanding mass market on the other, has increased tremendously. Costs of distribution tend to rise as these functions multiply and become more complex.

An expanding home market is also very necessary if we are to avoid a later problem of chronic unemployment. The Nation has at its disposal many new technical means of further increasing the efficiency of production. Current and prospective rates of investment indicate that these means are and will be utilized. We can look forward to a further reduction of man-hours of employment per unit of output. We can expect a shorter workweek and increased leisure. If employment of a growing labor force is to be maintained, however, it will require steadily increasing consumption in the home market, and an expansion of job opportunities in distribution and service industries.

Need for sustained consumption

One of the major balances to be achieved in taxation is that between encouraging or hindering investment on the one hand, or consumption on the other. As a premise to the comments that follow, an opinion will be expressed that, at the present stage of economic development and international affairs, it should be a prime consideration in present tax policy to maintain and encourage consumption.

This does not imply by any means that investment should be discouraged. A sustained level of investment is essential to an expanding economy. It is through such investment that increases in production, and in productivity, are achieved; and it is on such increases that a rising standard of living in this country has been constructed. Such increases, however, must be accompanied by an expansion of the domestic market for consumption products.

The postwar economy has been characterized by the following trends:

1. Business investment, as measured by outlays for plant and equipment, has been at high levels during the entire postwar period, and suffered only a moderate decline during the last recession in business activity. Estimates of current investment and investment prospects are favorable.

2. Consumer investment, including outlays for autos, other durable goods, and new housing, has shown an even more sustained advance.

3. Consumption expenditures, measured by consumer spending for nondurable goods and services, have shown somewhat smaller fluctuations, and provided an extremely important stabilizing influence during the recent business recession. Despite this favorable showing for consumer expenditures for nondurable goods, however, we find many of the industries supplying these needs operating at a level well below rated capacity. Consumers' goods, with the exception of a few durable goods, seem at the moment to be more in need of an expanding market than they do of added incentives for new investment to plant and equipment.

The tabulation on the following page has a bearing on these points.

Choices in taxation

Any tax, obviously, will have to be paid ultimately by the consumer. The tax on corporations is reflected in prices of goods produced. The tax on individual income withdraws a corresponding amount of income from consumer expenditures. A sales or excise tax has the effect of increasing costs to the consumer. Nevertheless, although both income and excise and sales taxes are taxes that tended to limit consumption, there is a substantial difference in their effects.

Business investment, consumer investment, and consumption expenditures [1]

[In billions of dollars]

	Consumer spending for—			Business spending for new plant and equipment
	Durable goods	Nondurable goods	Services	
1951:				
1st quarter	30.6	111.1	68.3	23.7
2d quarter	26.0	109.1	69.3	25.5
3d quarter	26.2	110.5	70.7	26.5
4th quarter	25.8	113.5	72.2	26.6
1952:				
1st quarter	25.6	114.2	73.6	27.1
2d quarter	26.8	114.9	74.8	26.6
3d quarter	25.2	116.8	76.3	25.7
4th quarter	29.0	118.2	78.0	26.7
1953:				
1st quarter	30.2	118.7	79.6	27.8
2d quarter	30.6	119.7	81.1	28.1
3d quarter	30.5	118.8	82.7	28.8
4th quarter	28.0	118.6	83.8	28.5
1954:				
1st quarter	28.3	119.2	84.7	27.5
2d quarter	29.0	120.4	85.7	26.9
3d quarter	29.4	121.5	87.0	26.8
4th quarter	30.4	122.5	88.1	26.2
1955:				
1st quarter	34.4	122.4	89.0	26.5
2d quarter	35.1	125.3	90.2	27.2
3d quarter				[2] 29.0
4th quarter				[2] 29.7

[1] Quarterly figures, seasonally adjusted, annual rates.
[2] Estimate.

The personal income tax is felt openly by everyone to whom it applies. Excise taxes on the other hand are concealed. In personal income taxes, the idea of progressive taxation, with heavier levies on high income brackets and lighter levies on low brackets, is an accepted principle. In excise taxes, the problem of progressiveness is less easily solved. If excise taxes are to be progressive, it is necessary to distinguish between necessities and nonnecessities. This might be attempted by differentiating between the products to which an excise tax is applied, exempting some or allowing differential rates depending on the product; or it might involve a distinction by price line, rating products sold below a certain price as necessary and essential and those sold at a higher price as being less essential. Such distinctions, however, are difficult. It is the writer's belief—

1. That income taxes are more desirable than excise taxes, in the sense that their effects can be more easily appraised and that a progressive principle of taxation is easier to apply on a practical basis; and

2. That to the extent to which excise taxes are used they should be selective, with rates on individual commodities subject to much more careful study and consideration than they have been in the past. The present excise tax structure originated, in the main, as an emergency action, and should be thoroughly overhauled.

In the debate between the relative desirability of personal income taxes as against excise taxes, there is the added factor that the income-tax law can easily be adapted to take care of special situations. Personal exemptions allow for a varying number of children in the taxpayer's family. Deductions for medical expenses help the taxpayer

meet unusual demands of this sort. No such special treatment is possible under an excise-tax structure.

It is sometimes argued that the United States obtains less revenue from excise taxes, relatively, than any other country in the world. This is usually presented as a point in favor of reduced income taxes and a broader excise-tax base. It could be just as easily argued, however, that other countries, all of which have lower living standards than the United States, should reduce their excise tax structure and follow the pattern of the United States in depending more on progressive income taxes, and less on excise and sales taxes. Moreover, in many of these other countries, it has been necessary to limit consumption in the domestic market. This is exactly contrary to the objective in the United States, which is to maintain and expand both the productive and distributive phases of the economy.

Commodity taxation should avoid pyramiding

Excise taxes represent a tax on consumption and distribution. To the extent to which excise taxes are to be used at all, they should be applied as closely as possible to the point of ultimate sale. Otherwise every successive processor will, in his purchases of raw materials, semifinished products, and finished items, be buying a tax as well as the commodity. Both direct and indirect costs, such as insurance, inventory reserves, etc., will be increased and will tend to pyramid.

We must remember that marketing and distribution today substantially outweigh production, in terms of employment, and that marketing and distribution costs are greater, for most products, than production costs. Even in 1929, the first year in which a Government agency studied distribution as a segment of the national economy, nearly 59 percent of the combined cost of producing and distributing commodities were costs of marketing. To place a hidden tax on consumption, particularly a tax that would pyramid distribution costs, can hardly serve the purpose of an expanding home market.

Case Study of the 20 Percent Cabaret Tax

This tax is typical of "emergency" taxes, which may have a defensible purpose at the time when they are applied, but which are allowed to remain on the statute books indefinitely without further study or consideration of their effects. It has this much in common with other "emergency" taxes, but its effects have been unique in their impact on a culturally important occupational group—musicians:

1. Since 1943, the last year in which this tax rate was 5 percent, the man-hours of employment available to musicians in establishments subject to this tax have declined in excess of 50 percent.
2. These job losses for musicians in places subject to the 20-percent cabaret tax exceeded all other job losses since 1929, including those which were the result of technological change.
3. These establishments subject to the 20-percent cabaret tax today provide almost as many man-days of employment as all other sources of employment combined.
4. Under existing interpretation and administration of this 20-percent cabaret tax, the loss of employment for musicians in these establishments is being accelerated.

Others besides musicians have been affected by this tax—the proprietors of these establishments; entertainers; waiters, waitresses, and other types of service or kitchen help. The economic hardship imposed on musicians, however, is magnified in importance by the position of musicians in the Nation's cultural life.

Music is a major element of the Nation's cultural life, and to have music we must have musicians. To have fine music, we must have fine musicians. And to have fine musicians, we must have economic conditions under which musicians of all kinds will be able to support themselves and their families at the activity for which they are trained and talented.

The musician holds the same relation to the Nation's cultural health as the farmer holds to the Nation's economic health. When the farmer was depressed by economic changes, the Nation, through the Federal Government, gave him help, and still does. But in a period during which the musician has been depressed by technological changes, his economic position has been further impaired by this 20-percent tax on music, dancing, and entertainment.

Our symphony orchestras have survived, and even grown, despite a constant and harrowing shortage of funds. But they will not be able to survive a shortage of musicians having the highest degrees of skill, which they are already beginning to encounter. And as the economic opportunity for musicians of all kinds dwindles, this shortage will become greater.

We were able to understand 30 years ago that an economic depression on the farms would bring on an economic depression for the Nation. We should be able to understand now that an economic depression among musicians will lead to a cultural depression for the Nation.

ECONOMIC STUDY OF IMPACT OF 20-PERCENT CABARET TAX

The conclusions expressed in the previous section, and the further conclusions and documentation presented in following sections, are based on extensive fieldwork conducted by Research Company of America, and an economic analysis by the writer and his associate, Dr. Robert C. Shook.

A pilot study in five cities, Boston, Detroit, Denver, Minneapolis, and Memphis, was financed by the American Federation of Musicians. On the basis of this study, it was believed by the research agencies that a more extensive survey would support the conclusions:

1. That establishments subject to this 20-percent cabaret tax are more important sources of employment for musicians, and that job loss in these establishments since 1943 had been much heavier than has been recognized;
2. That elimination of the 20-percent cabaret tax would lead to a very substantial increase in employment of musicians, entertainers, waiters, waitresses, and other service and kitchen help; and
3. That loss of tax revenue to the Treasury through elimination of this tax would be offset by increased income-tax payments.

It was therefore recommended by the research agencies that the pilot study be extended on a nationwide basis, and that the analysis

and estimates based on this extended investigation be submitted to the appropriate congressional committees for their consideration.

This extended investigation involved:

A. Fieldwork in 33 cities

Including the five cities listed above, these cities are—

Atlanta	Galveston	New York
Baltimore	Indianapolis	Omaha
Boston	Los Angeles	Phoenix
Buffalo	Louisville	Pittsburgh
Chicago	Memphis	Portland
Cleveland	Miami	Providence
Dallas	Milwaukee	St. Louis
Denver	Minneapolis	San Francisco
Des Moines	Newark	Seattle
Detroit	New Haven	Tulsa
Fort Worth	New Orleans	Washington, D. C.

This fieldwork involved 1,401 personal interviews with proprietors of establishments which are subject to the 20-percent cabaret tax, or which had been subject to the tax sometime in the interval between 1941 and 1954, inclusive. These interviews required 3,500 hours of interviewers' time and 15,000 miles of travel.

Of the establishments subject to the tax in 1954, 560 reported fully on the amount of cabaret tax paid, and on their employment of musicians. Total cabaret taxpayments reported by these establishments amounted to $9,068,390, or 23.3 percent of the total tax collected in the continental United States in that year.

An additional 227 establishments reported fully on their employment of musicians in 1954, but would not disclose their individual cabaret taxpayments. There is, however, a close relationship between the man-days per year during which musicians are employed, and the amount of the cabaret taxpayment. On the basis of this relationship, it is estimated that these additional establishments paid approximately $3,357,687 in cabaret tax in 1954, or 8.6 percent of the total cabaret tax collected in that year.

B. An employment and earnings questionnaire to individual musicians

This mailing consisted of 23,289 questionnaires, of which 3,547 were returned, the rate of response being 15.2 percent.

C. A questionnaire to membership of the licensed beverage association

This questionnaire related to the tax and employment position of the member establishments of this association. It involved a mailing of 30,540, from which 3,825 returns were received, a response of 12.5 percent.

D. A questionnaire to the secretaries of local A. F. of M. unions

This questionnaire related to the current employment of the local membership, distinguishing between establishments subject to the 20-percent tax and other establishments, as well as other occupations. Responses were received from 83 local unions, having a total membership of 105,648 musicians, or 41.2 percent of the national membership.

Most of the actual estimates made here and elsewhere are based on the fieldwork described in *A*, above, on the information obtained by trained interviewers, working under the direction of qualified super-

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visors. Much of the information obtained from the mail questionnaires described in *B* to *D* above, however, served to confirm and support these estimates, and to provide additional valuable information on many aspects of cabaret-tax policies; on the adjustments the establishments subject to this tax have made, and are still making; and on the position of musicians and other employees in such establishments.

DISTRIBUTION OF TAXPAYING ESTABLISHMENTS, BY SIZE OF TAXPAYMENT

No information is available from official sources about the distribution by size of cabaret taxpayments, or even about the number of establishments that paid the cabaret tax in 1954. Such a distribution, however, is very valuable in any analysis of the impact of this tax, or of what the effect will be on payments to the Treasury if this tax is eliminated. In the course of this present fieldwork and analysis, therefore, it was necessary for us to construct such a distribution. This is shown on the following page.

This distribution is based on information collected in the fieldwork and from supervisors relating to taxpayments and estimated size of sample for establishments of different size. Confidence in its general reliability is strengthened by the fact that:

(1) Estimates of the employment of musicians, in which this distribution is used, are consistent with similar estimates derived from two other sources:

(*a*) reports from individual musicians; and
(*b*) reports from local unions.

TABLE I.—*Estimated distribution of cabaret tax payments, by size of payment, 1954*

Size of payment	Establishments			Cabaret-tax payments (in thousands of dollars)		
	Number	Percent	Cumulative	Amount	Percent	Cumulative
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Under $1,000	9,790	63.3	63.3	3,885	10.0	10.0
$1,000 to $1,499	2,283	14.8	78.1	2,612	6.8	16.8
$1,500 to $2,499	1,173	7.6	85.7	2,191	5.6	22.4
$2,500 to $4,999	846	5.5	91.2	3,038	7.8	30.2
$5,000 to $9,999	678	4.4	94.6	4,540	11.6	41.8
$10,000 to $14,999	254	1.6	97.2	2,894	7.4	49.2
$15,000 to $24,999	226	1.5	98.7	4,013	10.4	59.6
$25,000 to $49,999	133	.9	99.6	4,542	11.7	71.3
$50,000 and over	90	.6	100.2	11,187	28.7	100.0
Total	15,473	100.0		38,962	100.0	

(2) When weighting factors derived from this distribution are applied to a sampling of establishments subject to the 20-percent cabaret tax on both 1946 and 1954, the indicated decline in taxable time in these establishments, combined with previously reported information about hotels, provides a consistent explanation of the loss in cabaret tax revenue between 1946 (when revenue was $71.6 million) and 1954 (when revenue was $39.0 million).

EFFECT OF CABARET TAX REPEAL OF TAX REVENUE

It was possible to obtain from 358 establishments a statement of the amount of their current cabaret taxpayments, and a careful estimate of the amount by which their income taxpayments will be increased if the 20 percent cabaret tax is eliminated. These establishments paid a total cabaret tax of $5.3 million, or 13.6 percent of the 1954 collections. A comparison of these amounts is shown on the following page.

TABLE II.—*Comparison of cabaret tax payments and estimated increase in income-tax payments if cabaret tax is eliminated*

Size of cabaret tax payment	Number of establishments	Cabaret tax payments (thousands of dollars)	Estimated increase in income-tax payments (thousands of dollars)	Ratio (4)/(3)
(1)	(2)	(3)	(4)	(5)
Under $1,000	82	42.4	87.5	2.06
$1,000 to $1,499	38	44.7	69.9	1.56
$1,500 to $2,499	32	61.8	88.6	1.43
$2,500 to $4,999	57	200.0	225.4	1.13
$5,000 to $9,999	52	348.5	273.9	.79
$10,000 to $14,999	22	255.7	300.6	1.18
$15,000 to $24,999	32	872.8	369.8	.42
$25,000 to $49,999	19	659.4	367.6	.56
$50,000 and over	24	2,858.8	1,096.3	.38
Total	358	5,344.1		

When the ratios shown in column (5) of table II are applied to the distribution shown in table I, the following results are obtained:

TABLE III.—*Estimated effect on Federal revenue if 20 percent cabaret tax is repealed*

Size of cabaret tax payments	Total cabaret tax payments	Estimated increase in income-tax payments	Balance
(1)	(2)	(3)	(4)
	Thousands of dollars	*Thousands of dollars*	*Thousands of dollars*
Under $1,000	3,885	8,003	+4,118
$1,000 to $1,499	2,642	4,122	+1,480
$1,500 to $2,499	2,191	3,133	+942
$2,500 to $4,999	3,038	3,432	+394
$5,000 to $9,999	4,540	3,587	−953
$10,000 to $14,999	2,894	3,415	+521
$15,000 to $24,999	4,043	1,698	−2,345
$25,000 to $49,999	4,542	2,544	−1,998
$50,000 and over	11,187	4,251	−6,936
Total	38,962	34,185	−4,777

Derivation: Col. (2) is col. 5, table I; col. (3) is obtained by multiplying the entries of col. (2) by the corresponding ratios in col. (5), table II, in col. (4), plus indicates a gain to the Treasury and minus indicates a loss.

It will be noted:

(1) That the deficit in tax collections estimated in table III, if the cabaret tax is repealed, is a gross deficit. If the cost of administration and collection is eliminated, the net deficit, of course, will be smaller;

(2) No allowance whatsoever has been made for the increase in personal income to musicians, entertainers, waiters, waitresses, and other service and kitchen help from establishments now subject to the 20-percent cabaret tax. The increase in such employment, however, would involve a substantial number of individuals, as indicated in a later section, and the increase in their personal income-tax payments should be more than enough to cover the small net deficit to the Treasury if the 20-percent cabaret tax is repealed.

Present Employment of Musicians in 20-Percent Places

The 560 establishments reporting the size of their cabaret-tax payments and the man-days per year of employment they provide for musicians, were arranged according to the size of their cabaret-tax payments. For each of these groups, man-days per dollar of tax-payment was computed. These ratios were then applied to the distribution of table I to obtain the estimate of present employment of musicians in the 20-percent tax establishments shown in the table on the following page:

Table IV.—*Estimated employment of musicians in establishments subject to the 20-percent tax*

Size of cabaret tax payment	Total cabaret tax payments	Man days per year of employment, per dollar of cabaret tax	Total man days
(1)	(2)	(3)	(4)
	Thousands		*Thousands*
Under $1,000	$3,885	0.71	2,758
$1,000 to $1,499	2,642	.46	1,213
$1,500 to $2,499	2,191	.31	676
$2,500 to $4,999	3,038	.23	688
$5,000 to $9,999	4,510	.13	586
$10,000 to $14,999	2,891	.09	274
$15,000 to $24,999	4,043	.07	266
$25,000 to $49,999	4,512	.05	229
$50,000 and over	11,187	.03	298
Total	38,962		6,985

Derivation: Col. (2) is col. (5), table I; col. (3) is based on 560 establishments reporting total cabaret tax payments of $9,668,390 in 1954; col. (4) is obtained by multiplying entries in col. (2) by the corresponding entries in col. (3).

PAST EMPLOYMENT OF MUSICIANS IN 20-PERCENT PLACES

A total of 159 establishments, paying almost $4.5 million in cabaret tax in 1954, were able to provide comparisons between employment conditions in 1943, when the tax was only 5 percent, and in 1954, when

the tax rate was 20 percent. This comparison is shown in the following table:

TABLE V.—*Changes in entertainment policy, 1943 to 1954, 159 establishments*

	1943 (1)	1954 (2)	Percent change (3)	If tax eliminated (4)
Average days per week	5.29	3.93	−25.7	5.48
Average hours per day (estimated)			−20.0	
Average number of musicians	5.43	3.98	−26.7	5.58
Loss to Government in taxable time			−40.6	
Loss to musicians in man-hours			−56.5	
Number of establishments		159		
Cabaret tax payments		[1] $4,450,945		

[1] Of which $412,600 is estimated on the basis of man-days.

There were another 105 establishments which could provide information, or had a peak year in their business in the calendar years 1945–47, overlapping the 1946 period when cabaret tax collections were at their peak. Their changes in employment policy since that time are shown in the following table:

TABLE VI.—*Changes in entertainment policy, 1946 to 1954, 105 establishments*

	1945–47 (1)	1954 (2)	Percent change (3)	If tax eliminated (4)
Average days per week	4.45	3.72	−16.5	5.22
Average hours per day (estimated)			−10.0	
Average number of musicians	4.68	2.93	−37.4	4.67
Loss to Government in taxable time			−24.9	
Loss to musicians in man-hours			−53.0	
Number of establishments		105		
Cabaret tax payments		$1,054,335		

In both of these tables, the shortening of average hours per day is estimated on the basis of information outside the samples which provided information on average days per week and average number of musicians employed.

A comparison of these tabulations suggests that establishments subject to the cabaret tax acted quickly when the rate was increased on April 1, 1944, to 30 percent to reduce their taxable time. It suggests, however, that further reductions have taken place in taxable time since 1946.

The indicated decline in the average number of musicians employed was greater from 1946 to 1954 than it was from 1943 to 1954. In other words, during the early period, when establishments were making drastic changes in the amount of entertainment time they provided their patrons, there was an effort to maintain the quality of music and entertainment and the number of musicians. In the latter part of the period, from 1946 on, this apparently became impossible and a drastic reduction in the number of musicians, and in the quality and cost of music and entertainment, became necessary.

Tax receipts in calendar 1946 amounted to $71.6 million. The indicated decline in taxable time of 25 percent would account for a loss of $17.9 million.

In addition to this loss, however, allowance must be made for the outright closing of some of the larger and more prominent places which, though small in number, were among the heavy cabaret taxpayers. For example, the American Hotel Association testified in 1953 that 450 entertainment rooms in hotels had been closed during the preceding 6 years. This alone would account for the remainder of the tax loss.

Other factors that have affected total taxable receipts in these establishments have been—

(1) The consistently rising trend of prices; and

(2) Variations in the amount of consumer spending in these establishments per taxable hour, after allowance is made for the rising prices.

The sharp decline in the average number of musicians employed suggests strongly that consumer spending per taxable hour between 1946 and 1954, if it increased at all, did not increase as much as the rise in prices of food and beverages.

FUTURE EMPLOYMENT OF MUSICIANS

Both the samples discussed in the preceding section indicate that there will be a sharp increase in the man-hours of employment available to musicians in establishments now subject to the 20-percent cabaret tax if this tax is repealed.

Supervisors and interviewers were warned that proprietors might be overoptimistic about the beneficial results if the 20-percent tax were repealed. Every effort was made to encourage conservative and reasonable estimates. Even though the estimates made by the proprietors themselves might naturally be inclined toward an optimistic bias, there are other reasons for believing that elimination of this tax would lead to a very sharp increase in the hours of dancing and entertainment, and in the average number of musicians employed.

With regard to hours, establishments in both samples indicated that they would like to increase hours back to or even somewhat above earlier levels. It is believable that there would be a very rapid and substantial expansion in the number of hours. Proprietors of these establishments have an investment in entertainment facilities, and a great limitation on the use of these facilities for entertainment purposes has occurred during the period when the cabaret tax was at the high rate of 20 percent. A lengthening of hours would represent no more than a natural attempt to obtain a bigger return on their investment in these facilities.

In indicating that there would be a substantial increase in the average number of musicians employed, as well as in the hours of entertainment and dancing, these proprietors merely expressed in figures what they stated in words many times to interviewers—that the decrease in the number of musicians represents a financial necessity and that it had created a vicious circle of declining business.

EMPLOYMENT PROSPECTS FOR OTHER TYPES OF EMPLOYEES

Establishments now subject to the 20-percent tax will increase their employment of entertainers, waiters, and waitresses, and other service and kitchen help if the tax is eliminated.

The following estimates of increased employment for these other types of personnel are based on the 560 establishments that reported both cabaret tax and employment of musicians.

Increased employment for these other types of personnel, with the exception of entertainers, shows less of a variation dependent on the size of present cabaret-tax payments. It is more closely related to the total volume of food and beverage business in the establishment, since most of these establishments have reduced taxable time to a minimum. Totals obtained from this sample, based on establishments paying $9,068,390 in cabaret tax were, therefore, enlarged proportionately in line with total cabaret-tax payments in 1954.

TABLE VII.—*Estimated increase in employment of nonmusical personnel if 20 percent cabaret tax is repealed*

	Present	Additional	Percent increase
Entertainers (other than musicians)	3,416	3,210	94
Waiters and waitresses	14,164	6,951	49
Kitchen help	8,284	3,493	42
Service help	5,169	2,863	55
Others	3,621	1,920	53
Total	34,654	18,437	53

XII. CORPORATE INCOME TAXATION

EFFECT OF THE CORPORATE INCOME TAX ON CORPORATE FINANCING

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Let me confess at the outset that, with the limited information available on this subject, I have been unable to appraise or measure the effect of the corporate income tax on corporate financing. I doubt that this can be done without extensive research encompassing many different industries and representative case histories throughout the country.

Many of us are familiar with individual instances from which certain conclusions can be drawn, but the aggregate or composite effect is something else again. Therefore, I shall confine myself largely to entering in the record some background material. Then I shall comment on certain phases of the problem which I believe are not subject to any great argument.

First, let us look at the volume of corporate financing over the past 20 years as divided among bonds, preferred stocks, and common stocks. We find that the total, excluding issues of investment trusts, trading and holding companies, amounted to about $100 billion, of which bonds represented $80 billion (or 80 percent) and common stocks just over $10 billion (of 10.6 percent). This is a startling comparison and indicates that there is certainly something wrong with the picture. In the relatively favorable postwar II period, for example, our corporations have sold an average of only about $1 billion worth annually in common stocks.

Corporate securities issued for cash

[In millions of dollars]

	Bonds	Preferred stocks	Common stocks		Bonds	Preferred stocks	Common stocks
1935	$2,225	$86	$22	1946	$4,882	$1,127	$891
1936	4,029	271	272	1947	5,036	762	779
1937	1,619	406	285	1948	5,973	492	614
1938	2,044	86	25	1949	4,891	425	736
1939	1,980	98	87	1950	4,920	631	811
1940	2,386	183	108	1951	5,690	838	1,212
1941	2,390	167	110	1952	7,601	564	1,369
1942	916	112	34	1953	7,083	488	1,326
1943	990	124	56	1954	7,534	816	1,213
1944	2,669	369	163				
1945	4,855	758	397	20-year total	79,713	8,803	10,510

Source: Securities and Exchange Commission.

Percentage distribution of corporate securities issued for cash

	Bonds	Preferred stocks	Common stocks		Bonds	Preferred stocks	Common stocks
1935	95.4	3.7	0.9	1946	70.8	16.3	12.9
1936	88.1	5.9	6.0	1947	76.6	11.6	11.8
1937	70.1	17.6	12.3	1948	84.4	6.9	8.7
1938	94.8	4.0	1.2	1949	80.8	7.0	12.2
1939	91.5	4.5	4.0	1950	77.3	9.9	12.8
1940	89.1	6.9	4.0	1951	73.5	10.8	15.7
1941	89.6	6.3	4.1	1952	79.7	5.9	14.4
1942	86.3	10.5	3.2	1953	79.6	5.5	14.9
1943	84.6	10.6	4.8	1954	78.8	8.5	12.7
1944	83.4	11.5	5.1				
1945	80.8	12.6	6.6	20 year total	80.5	8.9	10.6

If we go back to the period of the 1920's, when the corporate income tax ranged between 10 percent and 13½ percent, we find that the record is not too different. In the 11 years from 1920 to 1930, inclusive, corporate security issues totaled $52 billion, of which about $36 billion consisted of bond issues.

It is true that bond issues represented only 67.7 percent of the total but there were other factors at work including much higher interest rates. Actually in only one year (namely, 1929) did bond issues represent less than 50 percent of corporate securities offered for cash.

The safest conclusion to be drawn is that taxation is only one of several factors affecting corporate financing. Other factors, such as depressions, wars, and money rates, may be equally or even more important much of the time. In other words, the relatively small difference in financing methods during recent years in comparison with the period of the 1920's may be more attributable to low interest rates than to anything else.

The so-called excess profits tax, which imposed a ceiling on net earnings, was, of course, a definitely determinable factor during the periods when it was in operation. This undoubtedly was responsible, in large part, for the anemic condition of common stock financing during the war but, in all fairness, it cannot be regarded as pertinent to this discussion.

Corporate securities issued for cash

[In millions of dollars]

	Bond issues	Preferred and common stocks	Percent of total in bonds	Percent of total in stocks
1920	$1,895	$1,071	63.9	36.1
1921	2,112	279	88.3	11.7
1922	2,419	621	79.7	20.3
1923	2,497	736	77.2	22.8
1924	2,973	866	77.4	22.6
1925	3,424	1,299	72.5	27.5
1926	3,967	1,262	75.9	24.1
1927	5,460	1,684	76.4	23.6
1928	4,090	2,937	58.2	41.8
1929	2,987	4,826	38.2	61.8
1930	3,785	1,455	72.2	27.8
Total	35,639	17,038	67.7	32.3

Source: Commercial & Financial Chronical

There are two other elements in the equation which are of vast importance and deserving of mention, although not perhaps scheduled for exploration at this time. I refer, of course, to the two principal forms of internal financing which do not involve a contribution of new money. These are—

(*a*) Retained earnings.

(*b*) Depreciation reserves.

The retained earnings of corporations in recent years have ranged from a high of $13 billion in 1948 to a low of $7 billion in 1954. Depreciation charges alone totaled more than $13 billion in 1954. Obviously, such huge cash accumulations as these influence importantly the matter of corporate financing.

Another factor of growing importance is the issuance of term loans by banks and insurance companies to business enterprises. Made for periods which may run as long as 5 or 10 years, such loans often obviate the necessity for actual securities issues, either bonds or stocks. They also, as a general rule, provide more flexibility and less redtape than security flotations.

Retained earnings and depreciation charges of corporations

[In millions of dollars]

	Retained earnings	Depreciation charges		Retained earnings	Depreciation charges
1945	$3,000	$6,100	1950	$12,900	$8,100
1946	7,700	4,400	1951	9,000	9,400
1947	11,700	5,500	1952	7,100	10,700
1948	13,000	6,500	1953	7,700	12,000
1949	8,400	7,400	1954	7,000	13,400

Source: U. S. Department of Commerce.

Two Specific Suggestions

Regardless of what general conclusions are reached at these hearings, there are two matters which I feel should have the immediate attention of the Congress. They are:

1. Tax relief for small businesses, which everyone is in favor of but which no one does anything about.
2. The menace of tax-exempt organizations, including cooperatives, mutual associations, educational and charitable foundations, and pension funds.

From time immemorial it has been quite generally agreed that small-business organizations, especially struggling new ones, should be given a type of tax treatment that would permit them to get some fat on their bones so that the first ill wind that comes along does not blow them away. This is relatively noncontroversial. Both political parties are in favor of it, labor is in favor of it, and, needless to say, business is in favor of it. The mortality rate of small businesses is fantastic and tragic.

It would seem to me a fairly simple matter to provide a graduated scale of taxation for small businesses that would accomplish the desired purpose without much loss in revenue. There would probably be no loss of revenue if we take into account the greater stability of employment and business activity that would result.

The following is a simple and logical way of taxing small businesses. I suppose the chief objection to it will be that it is simple and easily understood.

Graduated scale of corporate income taxation:
- 10 percent on first $25,000 of net income.
- 20 percent on second $25,000 of net income.
- 30 percent on third $25,000 of net income.
- 40 percent on fourth $25,000 of net income.
- 50 percent on all net income above $100,000.

I have used a tax rate of 50 percent on net income above $100,000 just as a round figure and perhaps on the subconscious theory that the least Congress can do is to reduce the corporate tax rate from 52 percent to 50 percent. This would be easier to calculate and would have the psychological advantage of putting us on a 50-50 basis with the Government as far as earnings are concerned.

Regarding tax-exempt organizations, this is a colossus which will ultimately destroy our private enterprise economy. It is something that must be faced immediately while there is yet time to do so politically. When corporate tax rates were low, efficient businesses could offset the disadvantage but, with a tax rate of 50 percent or above, even inefficient and incompetent organizations can operate to the detriment of fully taxed organizations.

There is no justification whatsoever for tax favoritism of the kind that now exists. Pension funds, as well as educational and charitable foundations, are favored enough as it is when the money is funneled into them in the first place. They do not need any further advantage or incentive. They are already getting too big for the good of the general economy.

We must stop looking at this situation as a sacred cow. Even educational and charitable foundations have no right to operate tax free when they engage in business competition with enterprises that are taxed. I see no point in mincing words about it. It is becoming a scandalous racket.

Personally, I believe that, so long as we have an income tax, all income should be taxed.

THE PLACE OF TAX LOSS POSITIONS IN CORPORATE ACQUISITIONS

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SCOPE

My purpose is to describe some of the law affecting transfers between taxpayers of net operating loss carryovers, with particular reference to those aspects which affect business decision about mergers and other corporate acquisitions. While I have seen no economic or statistical studies in point, I have concluded, both from my view of the law and my own experience, that tax losses, transferred or otherwise, play a negligible part in the merger movement as a whole. Finally, I have briefly suggested reforming the policy of the law on loss transfers. I have not, however, attempted to explore the tendency of my proposal for or against economic concentration. The reason is, of

course, that I believe the tax law is properly concerned only with making each taxpayer's contribution to the tax base correspond with the economic results of what he does. Our antitrust policy belongs elsewhere.

THE STATUTORY PROVISIONS

The basic provision for the net operating loss deduction is section 172 of the Internal Revenue Code of 1954. It allows a corporation which has a net operating loss in any year to carry back that loss against the taxable income of each of the 2 taxable years preceding the year of the loss and to carry the loss over to each of the 5 years after the year of the loss. Before the Revenue Act of 1932, a 2-year carryover of losses had been allowed. In the Revenue Act of 1932 the carryover was reduced to 1 year, and in the National Industrial Recovery Act the provision was eliminated. The 1939 revenue bill restored the 2-year carryover. The Ways and Means Committee then stated in connection with the NIRA amendments:

> As a result of the elimination of this carryover, a business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital-goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carryover will greatly aid business and stimulate new enterprises.[1]

Section 153 of the 1942 bill allowed the 2-year carryback for the first time. Subsequent acts have expanded the provision to the present 8-year overall averaging period.

Section 269: The intent test

Just 4 years after the reintroduction of net operating loss carryovers, Congress first expressed a policy against transfers of loss carryovers and other tax attributes in section 269.[2] It deprives transferees of the benefit of a beneficial tax attribute where the acquisition of corporate stock or property with which it was connected was primarily motivated by a desire to get the carryover or other benefit.

When considering the desirability of restrictions on operating loss carryovers, it is well to be reminded of the original context of section 269. It was enacted in 1943 when the most significant transferable corporate tax attribute, from the point of view of revenue, was the excess-profits-tax credit. That was a device for establishing what part of a corporation's current profits were attributable to war. It is different from the net loss carryover which is intended to permit recoupment of past losses. The reasons for limiting wartime transfers of such credits are therefore not necessarily applicable to the loss carryover.

Section 269 has not worked well. The courts have been reluctant to find the prohibited motivation in the cases which the Government has brought before them. The problem of enforcement is common to most legislation which makes tax consequences turn upon subjective intention. With section 269, the judges had not only to probe states of mind, but also to select dominant motives from the several purposes which generally lie behind the acquisitions covered by the

[1] C. B. 1939-2,510.
[2] Sec. 129, I. R. C. 1939.

section. In case after case the courts found enough legitimate business purpose to set aside the application of section 269.[3] Moreover, the scope of section 269 has never been entirely clear because of the outstanding question as to whether it could deprive a continuing corporate entity of its own tax attributes.[4]

It is true, of course, that section 269 has had a certain effect in terrorem. Despite its technical faults and erratic operation, it did stand as a warning that carryovers were not freely transferable. But it is also true that when section 269 was substantially the only limitation on transfers of tax attributes, many acquisitions took place in which the transfer of a tax position was a significant feature.

1954 code limitations

The 1954 code is intended to provide some of the certainty which section 269 lacked in the specific limitations on transfers of carryovers of section 382. The draftsmen also attempted to shore up section 269 itself with an amendment which does not merit close analysis at this moment. Subsection 269 (c) presumes the existence of the condemned intention which will often operate in precisely those cases where such intention is not present, and I think the courts will be forced to ignore it.

It is difficult to provide a concise statement of the present law regarding transfers of tax loss carryovers. The uncertainties of the pre-1954 law have been carried into the new code. Moreover, we now have a complex set of new provisions with ambiguities of their own. The following, therefore, must be understood as merely an outline of an intricate set of rules which is likely to plague us for years to come:

(*a*) Section 381 of the 1954 code liberalized the former law by providing that loss carryovers pass to successor corporations in tax-free reorganizations. Before, if a corporation with a tax loss disappeared in a merger, the carryover frequently disappeared as well, depending upon the form of the reorganization.[5]

(*b*) The liberality of section 381 is restricted by section 382 (b). If the stockholders of the loss corporation own, after a reorganization, less than a 20-percent interest in the corporation which is to use the carryover, the carryover will be disallowed in whole or in part, depending upon the ratio of their interest to 20 percent.

(*c*) Where stock of a corporation changes hands through purchase to the extent of 50-percentage points of the total amount outstanding, that corporation's carryover will be disallowed in full unless the corporation conducted some business prior to the purchase and continues to carry it on for up to 2 years thereafter.

(*d*) The relationship of the intent test in section 269 to the foregoing is not altogether clear. Upon the ordinary rules of statutory interpretation, it would seem that the limitations found in section 382 preempt the field in the case of stock purchases or reorganizations to which they are applicable. The committee reports suggest a different view: That the application of section 269 is foreclosed in stock purchases or reorganizations only where the invocation of section 382 results in the disallowance of some or all of a tax loss carryover.[6]

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[3] See e. g., *WAGE*, 19 T. C. 249; *Berland's*, 16 T. C. 182.
[4] See *Alprosa Watch*, 11 T. C. 240.
[5] See *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435.
[6] S. Rept. No. 1622, 83d Cong., 2d sess., p. 284.

A third possibility, which is hard to justify under the committee report, is that section 269 operates concurrently with section 382.

In considering whether a loss carryover can or cannot be transferred in a particular transaction, we are faced with a bewildering pattern of interwoven rules. The taxpayer must be concerned with how his motives will be characterized and the extent to which he must carry on the enterprise acquired or be able to show a business purpose for the acquisition. Depending upon which of several statutory provisions affects the carryover, the penalties vary. Sometimes the carryover is struck down automatically, in toto (sec. 382 (a)); sometimes a specific percentage is disallowed (sec. 382 (b)), and under section 269 (c) the Commissioner is authorized to dispose of the carryover in whole or in part on an equitable basis. Finally, for the purpose of applying these various tests and penalties, the code deals with at least four different degrees of change of interest.

Four kinds of transfers

As noted above, section 381 allows a transfer of carryovers between corporations merely upon satisfying the requirements with respect to tax-free corporate acquisitions. The subjective intent test of section 269, however, applies to acquisitions of corporate stock or property which result in a shift of "control." For this purpose "control" is defined as the ownership of 50 percent of the voting stock or 50 percent of the value of the stock of a corporation. It is apparent that under section 269 a condemned transfer may occur where a very small shift in ownership occurs as a result of a purchase or reorganization, provided that the new people move across the 50-percent mark. A transfer for the purpose of section 382 (a) occurs only where a stock purchase actually involves 50 full percentage points of the outstanding stock of the loss corporation. Finally, in section 382 (b), which limits the transfer of carryovers in reorganization, the critical point is the retention by owners of the loss corporation of 20 percent interest in the corporation which acquires the carryover. Thus, in the case of stock purchase, the carryover can survive a sale of 100 percent of the stock; in a merger if the stockholders of the loss corporation terminate their interest, the whole carryover disappears automatically.

Continuity of business test

The discrepancy in the continuity of interest rule between purchases under section 382 (a) and reorganizations under section 382 (b) is made more apparent when one considers that in both types of acquisitions some continuity of the loss corporation's business is required. In a merger, it is unlikely that the business purpose requirement underlying reorganizations could be satisfied if the acquiring company entered into the transaction with a plan of abandoning or disposing of the business acquired.[7] It is true that the two business continuation rules are not perfectly congruent. The express formula of section 382 (a) may apparently be satisfied by continuing the business after purchase for as short a period as a year and a day, and in no event must it be continued for more than 2 calendar years.[8] A require-

[7] *Standard Realization*, 10 T. C. 708.

[8] Under sec. 382 (a) the business of the purchased corporation need only be continued during the taxable year ending after the date of purchase of stock, and the next taxable year thereafter.

ment that no plan to abandon the business be adopted within the "freeze" period has been omitted. On the other hand, the business purpose requirement affecting the validity of a reorganization might not be satisfied if a plan to abandon the acquired business was part of the plan of reorganization, even if actual abandonment were deferred for more than the 2-taxable-year period set forth with respect to purchases under section 382 (a). A reorganization would not be invalidated if part of the acquired business were discontinued, as long as some substantial operation survived. The purchase rule is more rigorous on this point. It would seem that substantially all the business acquired must be carried on after the stock purchase during the stated period. The differences in respect to continuity of activity tend to balance out, leaving no very good reason for a different continuity of stockholder interest rule.

Stock for stock reorganizations

The transferability of a loss carryover is subject to still another set of rules if, instead of merging the loss corporation into a profitable company, or purchasing its stock, it is acquired as a subsidiary by a tax-free exchange of its stock for that of another corporation. In such case, the subsidiary's carryover is not subject to the 20 percent continuing interest rule of section 382. The former stockholders of the loss company may have a much smaller interest in the acquiring company without imperiling the carryover. Of course, the acquisition is subject to the motivation test of section 269. But this can probably be satisfied if the business purpose for the transaction qualifies the reorganization as tax-free in the first place. The actual results in these cases may well conform to the policy of sections 381 and 382, but that will be coincidental.

The most obvious fault of this entire group of restrictions is that the effect of the statute is unpredicatable. This is partly due to the complexity and ambiguity of the relationships of several provisions themselves, and partly due to the nature of the tests applied, since to a great extent the survival of the carryover will depend on characterization of subjective intentions and purposes.

Secondly, it is apparent that differences in the form of acquisitions which are economically insubstantial can profoundly affect the transfer of a carryover. The reason is, of course, that the restrictions are not founded on one clear policy. The philosophy of the statute is divided: The restrictive provisions stigmatize as abuses the very transfers which the basic provisions, sections 172 and 381, recognize, expressly or impliedly, to be normal dealings with the carryover and consistent with its purposes.

Stock sellouts and mergers: What can be done

Despite the rigor and uncertainty of the limitations on transfers of carryovers, there are important situations in which the availability of a carryover may influence or facilitate corporate expansion.

The first is the sale of stock of a loss corporation where the buyers are willing to carry on its business for at least the period provided in section 382. (It is well to emphasize the seriousness of this condition. The continuation of a losing operation will certainly be unattractive to many buyers.) It is clear that the buyers may add whatever business they like to the acquired operation in order to utilize the loss

without thereby jeopardizing its deductibility.[9] It is this last feature which is particularly pertinent to the question of corporate expansion. The loss corporation is temporarily a tax-exempt organization. The tax exemption may provide a source of funds to pay for the acquisition of profitable business. The situation is exemplified by the following item which appeared in the Wall Street Journal for May 19, 1953:

> Chesapeake Industries, Inc., with nine diversified subsidiaries, has a large tax umbrella which W. C. MacMillan, Jr., president, displayed for a group of security analysts yesterday.
>
> Mr. MacMillan said the company's tax carryovers of losses in the past years add up to nearly $8 million, good through 1955, and added, "We're going to use the entire $8 million." He stated Chesapeake purchased Vandewater Paper yesterday, jobber of quality paper located in New York, and asserted "we're still looking for other sellers to bring under the umbrella."
>
> He explained the company's habit was to offer the seller 2 years prospective pre-tax earnings on which they would have to pay only capital gains.

It must be borne in mind that a transferred tax loss is only a special instance of that kind of expansion. The general case is that in which a loss corporation, without undergoing a change in ownership, goes out to buy new sources of income. In the latter case, there is, however, no requirement of the continuation of any business conducted before the acquisition program.

A second important type of corporate acquisition in which carryovers may figure is merger. In these cases the code requires that the stockholders of the loss corporation retain an interest in the acquiring company which is to use the carryover which amounts to at least 20 percent of the value of common stock of the surviving company. In many cases, of course, a continuing interest of that size will not satisfy the business requirements of the transaction.

Apparently the recent merger between the American Woolen Co. and Textron involved some of these considerations.[10] Regarding that transaction, the Wall Street Journal reported on January 7, 1955:

> The bulky, 88-page statement [proxy] also disclosed that the new firm, to be known as Textron American, Inc., will have a combined tax loss of about $30 million which can be used to offset Federal taxes on future earnings. About $200,000 of this total offset will expire by 1956, if not used by then, $14,350,000 in 1957, and $15 million in 1958.

And again on January 20:

> [among] advantages of the merger, Mr. Little said, * * * "More importantly, it would contribute about 30 million that could be used to offset future income taxes, * * *.
>
> "With American Woolen's estimated loss of about $7 million on disposal of plants the total losses would reach around $37 million," he declared. "This would permit us to build about $13 a share of additional net worth behind the combined company's common stock, without paying income taxes. And that would result in a book value for this stock of about $37 a share, up from $23.45 it would have when the merger became effective."

Since in a tax-free merger the consideration paid is in corporate stock of one of the parties, the carryover is not required as a base for the accumulation of funds to pay for the acquisition. If the acquiring corporation is profitable, a merger of this kind may provide a practical way for the owners of the loss corporation to retain a stake

[9] See the conference report on the Internal Revenue Code of 1954, p. 40.
[10] See The Stormiest Merger Yet, Fortune, April 1955.

in the business and recoup. Typically their own corporation is deficient in resources of money or management to go forward. So the future availability of the carryover tends to encourage merger. However, the motives affecting transactions of this kind tend to be rather complex, especially where large corporations are concerned. The existence of an available tax-loss carryover may be an element without which an acquisition would not be undertaken, but other business aspects of the transaction may be similarly critical. It is almost impossible in most cases to isolate the carryover as the single, dominant factor. In this respect the tax law is consistent with business considerations.

For the merger to qualify as one in which the carryover survives not only must the technical formalities of the reorganization provision of the Internal Revenue Code be satisfied but the transaction must be consistent with the principal underlying assumptions of those provisions: The reorganization must have substantial economic consequences which are independent of the tax results.

Limited duration of loss carryovers

When considering the use of carryovers (transferred and otherwise) in corporate expansion, it is well to keep in mind their limited duration. The loss arising in a particular taxable year can be carried over for 5 full years thereafter. But the aggregate loss carryover available to a company at any particular moment will frequently consist of amounts attributable to several past years, so that parts of the total carryover will have to be used, if at all, in the first, second, etc., year. The 5-year maximum limit, together with these annual reductions, imposes a very exacting time schedule on anyone who proposes to base an expansion program on tax savings which come from the use of a loss carryover.

Shell corporations

To pass for a moment from what can be done to what cannot, I think the law is now quite clear with respect to transfers of carryovers involving shell corporations, that is to say, companies whose only asset is the tax-loss position. The carryover cannot be delivered in connection with the sale of the stock of such a company, for it is implicit in section 382 (a) that some actual business must have been carried on prior to the sale in order to meet the business-continuation test. Furthermore, if such a corporation were merged into a profitable company, the tax attributes of the disappearing company would not be carried over because there would have been no acquisition of assets as required by section 381. Those rules are, I think, quite neutral with respect to the expansion question. The acquisition of a shell corporation simply does not constitute economic concentration. It is true that an acquired carryover may constitute a useful, if limited, asset in undertaking an expansion program. But that is not particularly a problem arising from transferred losses. A tax position may be used in the same way without having been transferred, if the persons in control of the corporation have the will and power to do so.

The ability of a corporation to do things with its own tax-loss carryover brings to mind a kind of transfer which is very real in the business sense, but which the code does not consider a transfer at all.

A publicly held corporation can often be controlled by the owners of a relatively small fraction of its outstanding stock. Where such a company has experienced losses sufficient to make its carryover interesting, the necessary stock to acquire control can often be bought cheaply. Control of the corporation and the carryover can be shifted without a sale of the 50 percentage points referred to in section 382 (a) or an accumulation of the majority control referred to in section 269. Where transfers of this kind are opposed by management (who are frequently vulnerable in a loss corporation), we have what is invidiously termed a "raid."[11] It is significant that a successful transfer of this kind is just not recognized by the Internal Revenue Code as an occasion for limiting net loss carryovers. This is true even though the business community sees it as a transfer of the most dramatic kind and even though the outsiders may have their minds exclusively on the utilization of the tax position so acquired for expansion by corporate acquisitions or otherwise. In such a situation, however, the public investors who incurred the losses will persumably share in the recoupment through the use of the carryover.

Carrybacks and corporate acquisitions

In considering the effect of the net loss deduction on economic concentration, the right to carry back losses I think stands somewhat apart. Since the existence of the loss and the payment of taxes in the 2 years prior thereto are determined when the question becomes material, the right to carry back the loss is essentially a cash item in the hands of the company which incurred the loss and would be dealt with as such in the case of a transfer by sale or reorganization. The law (sec. 381) is quite clear, for example, that a loss in the hands of a merged company may not be carried back against the taxes paid by an acquiring company. I think it is true, however, that the carryback right tends against economic concentration by promoting the independent survival of corporations in financial difficulties. In furtherance of this purpose, the code provides for quick refunds of prior taxes as soon as the subsequent loss appears in the income-tax returns of the corporation so that financial recoupment is prompt even though subject to later audit.[12]

Built-in losses

The net loss deduction so far discussed is concerned only with losses which have been realized. I would like to touch briefly on the so-called built-in loss which has a somewhat similar relationship to the corporate acquisition question. This is the situation of a corporation which owns assets the cost of which is high in relation to present value. If the owners of such a company sell those assets, the sale itself produces a loss which can be deducted or carried over against new profitable business which they acquire for the company.

On the other hand, if they merge with a profitable company, the latter will have the benefit of depreciation or loss deductions based on the former owner's tax basis in such assets which may be in excess of the value of the consideration (in stock) paid for their acquisition. While, technically, the intent test of section 269 would apply to such a merger, it would in all likelihood be ignored if the surviving com-

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[11] See How Managements Get Tipped Over, Fortune, October 1955
[12] Sec. 6411, I. R. C., 1954.

pany intended to use any substantial part of the assets acquired in its business. A net operating loss carryover produced by such a sale of high-basis assets, whether in the hands of the original corporate owner or a successor after merger, is generally more attractive than a previously accumulated carryover position because it all is useful for a full 5-taxable-year period after the sale.

There are limitations on transfers of assets with built-in losses but these are far less rigorous and more certain in effect than those affecting the carryover itself. Accordingly, the existence of high-basis assets in the hands of a prospective seller probably figures more significantly than realized losses which have become carryovers in decisions about corporate acquisitions.

A proposal

As to the future, I think it is clear that a radical revision of the law on transfers of tax loss carryovers is desirable. This would be true if we were only troubled by the existing uncertain and erratic effect of the legal restrictions on such transfers that we now have. But the real problem is inherent in the whole policy of restricting such transfers at all. I believe such restrictions to be inconsistent with the basic carryover principle. I would propose that we consider a revision of the code which eliminates interference with free trade in tax loss carryovers.

The carryover provisions are good tax legislation because they have the effect of equating taxable income with the real economic results of an enterprise. It seems obvious to everyone that we have achieved a fair distribution of the tax burden if a corporation which loses $50 in 1 year and makes $100 in the next pays the same tax as the corporation which makes $25 in each of the same 2 years. I think it is the rightness of the averaging principle which has caused Congress to extend the carryover and carryback period from time to time, and to eliminate, in the 1954 code, artificial limitations on the survival of losses in corporate reorganizations. If the principle of recoupment is sound, I suggest that the tax law need not be concerned whether the interests which suffered the loss recoup by selling it or recoup by going forward themselves. In any event, someone will have to carry on business at a profit for the loss to produce a tax benefit.

What about the position of the buyer of the loss? Will the Government be subsidizing him at the expense of other taxpayers by relieving him of taxes on income to the extent of the loss acquired? It seems not. If losses were freely transferable, I suggest that buyers would have to pay a price which reflected the value of the tax benefit acquired. He would have an investment in the acquired tax position. That investment would come from after-tax funds on hand at the time of purchase. Or it would come from the money saved by the use of the carryover. In either event other taxpayers would not have paid for his acquisition. Of course, no one would pay dollar for dollar for the tax benefit acquired. There would then be no reason to buy it. The discount will reflect the relative willingness or ability of the buyer and seller to risk going forward with business to absorb the loss. There may be a profit to the buyer from his assumption of the business risk. The situation is to be contrasted with the present situation where the successful buyer of a tax loss gets an enormous return primarily for having risked the uncertain hazards of the tax law.

It may be objected that I have bottomed this argument on too broad an interpretation of the policy of the carryover provisions. I have suggested that they are intended to provide economic recoupment for the taxpayer who suffered the loss, and that restricted transferability of the tax position is inconsistent with that intention. To hold otherwise, it would be necessary to find that the carryover provisions are intended to assist recoupment of the losses of a particular enterprise only out of the profits of that enterprise. The law might be that way, but it is not. The owners of a corporation with a tax loss are wholly free to abandon the business in which the loss was suffered and buy, enlarge, or invent any other business to produce profits to absorb the carryover. If they have not abandoned all activity, moreover, they can sell the stock of the corporation, severing all relationship with it, and the loss will be available to the buyers if they are willing to continue the remaining activity for a limited period. The code neither presupposes nor requires any continuing link between the investors in a corporation and the business which it conducts for the survival of tax loss carryovers.

I can imagine a carryover provision which restricted the utilization of the loss to the activity which produced it in the hands of the same investors who suffered it. Or the utilization of the carryover might be limited to the profits of the same activity which produced the loss, in whatever hands the activity was carried on. (This would resemble the position of the present regulations on the place of acquired loss carryovers in groups of corporations making consolidated income-tax returns: the carryover attributable to a new member of a group (whether it became a member by purchase of its stock or tax-free exchange) is usable against the income of the group only to the extent of the income contributed by the new member after it joins the group.) These suggestions present serious problems of drafting and definition. But, mainly, they depart from the basic principle of income averaging of the present carryover provision. It would return generally to the unsatisfactory, arbitrary annual accounting for corporate income. It would unfairly allow recoupment of losses only to the taxpayer who chose a business which ultimately became profitable. Those who discovered that a particular line of endeavor in which losses were suffered was not worth carrying on would be held not to merit having their taxable income reflect their economic income. It is hard to see the fairness of such a rule. Perhaps that is why we do not have it now. It is true that the transfer question would thereby be eliminated, but we have that question because transfers of carryovers are implicit in the allowance of the economic carryover under section 172. It is because the principle of that section is sound that a lifting of the restrictions on carryovers appears to me to be logically required.

I cannot conclude without recognizing the revenue implications of my suggestion. In a prosperous period, providing for the survival of a larger volume of carryovers than is possible under present law may not create a serious loss of revenue. It seems to me that the rate structure ought to take into account the volume of losses which are expected to occur and be used against taxable income, whether transferred or otherwise. In a depression period, however, free trade in tax losses could create a dangerous situation. Many corporations may have losses, and their owners may have little faith in their ability

to earn profits against which to use them in the near future. Such losses would then become available to the few corporations with income, and very likely at distress prices. There may then be a great reduction in taxable corporate income, with a serious problem for the tax collector. With that in mind, perhaps logic must give way to necessity. The limitation on transfers which ought to be kept, if the revenues require it, is, I think that affecting shell corporations. The reason is that that limitation imposes the least burden on transactions having normal business characteristics and consequences. The extent to which further limitations ought to be imposed depends on the requirements of the revenue, not the rationale of carryovers.

THE IMPACT OF FEDERAL INCOME TAXES UPON CORPORATE AND INTERCORPORATE FINANCIAL REARRANGEMENTS

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The vigor of the present-day corporate merger movement, its relatively prolonged life, as well as the trend generally toward more frequent financial readjustments,[1] would seem to indicate not only the existence of a high level of economic activity but in addition the presence of a favorable Federal income taxing climate. Moreover, in a period such as the present one of sustained high tax rates focused at both the corporation and its shareholders, it seems equally unlikely that the variety of corporate rearrangements could flourish as they have without affirmative stimuli in some significant form from within the framework of the Federal income taxing structure.

This paper will seek to evaluate the foregoing impressions by reference to the nature of the tax effects created by these corporate transactions, primarily from the standpoint of those portions of the statutory taxing provisions in which the various intra- and inter-corporate financial and capitalization adjustments are reflected.[2] As pertinent, the relationship of other elements of public policy or related statutes, such as problems involving monopoly generally, will also be considered.

There are involved three basic categories of transactions:

I. Corporate rearrangements which are, or are akin to, corporate distributions to shareholders—stock splits, stock dividends, recapitalizations, corporate separations and corporate partial liquidations.

II. Corporate readjustments which expand the corporate enterprise—mergers and acquisitions.

III. Transactions which reflect the cycle of corporate existence—corporate organizations and liquidations.

It is to be emphasized that the grouping above bears no relationship to the actual physical structure of the Internal Revenue Code. That statute reflects the described transactions with varying degrees of specification, ranging from total omission[3] to almost meaningless

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[1] See Report on Corporate Mergers and Acquisitions, Federal Trade Commission, May 1955, pp. 1–18.

[2] See Internal Revenue Code of 1954, subch. C, secs. 301–395 (except where stated otherwise, all references to sections are to the Internal Revenue Code of 1954).

[3] See, for example, the definition of "recapitalization," sec. 368 (a) (1) (E).

redundance.[4] Its language in fact has been written in the light of a lengthy and voluminous history of judicial and administrative interpretation and encrustation. This, together with the inherent involved nature of the transactions in question makes these provisions "* * * proverbially the most complicated in the revenue laws:"[5] the above classification has accordingly been chosen in terms of substantive economic effect and without regard to statutory order. Each category will be discussed from the standpoint of its financial and tax mechanics; the tax policy considerations underlying these mechanics will be treated in terms of their relationship generally to the economic or other factors motivating and implementing the transactions.

1. Corporate rearrangements which are, or are akin to, corporate distributions to shareholders—stock splits, stock dividends, recapitalizations, corporate separations, and corporate partial liquidations

The instant transactions involve a readjustment of the capital structure of a single corporation. The degree of readjustment extends from mere alteration of the number of shares outstanding, as represented by the so-called stock split, to ultimate physical division of the corporate enterprise, as may occur in a corporate separation. Except in the case of partial liquidations the common denominator is the fact that if properly arranged under the statute, each, within limits, may be accomplished without any immediate tax effects to the recipient shareholder.[6] Moreover, the new interest received may be disposed of by the shareholder, again within limits, at capital-gains rates.

Stock splits involve no change in the amount of capitalization of the corporation, but represent merely a further subdivision of that capitalization through a reduction in the amount allocable to each share. There never has been serious suggestion that these should be taxable upon receipt. Notwithstanding, there is considerable corporate level interest, and constant effecting of these transactions since they tend to increase marketability of shares. It should be noted, however, that while no tax is imposed upon receipt of new shares in a stock split, the basis of the old shares is divided among all of the new received.[7]

Stock dividends represent a far more troublesome area of treatment under the taxing statute and accompanying court decisions. In this instance, although no tax is imposed at the time of receipt,[8] surplus of the corporation is in fact capitalized. At the same time, absent special taxing rules to the contrary, stock so received may be disposed of in the same manner as his underlying shares, normally at capital gains[9] as distinguished from dividend rates. If the stock received is nonvoting, in no instance is the amount of the shareholder's managerial control over the corporate entity affected. This situation, the so-called preferred stock bailout,[10] seems in many respects to con-

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[4] See, for example, sec. 358 (e).

[5] See Peterson, Subchapter C of the Internal Revenue Code of 1954 Corporate Distributions and Adjustments, Notre Dame Lawyer, 1955, p. 617.

[6] See, for example, sec. 305 (a) excluding stock dividends from the gross income of the recipient.

[7] See sec. 307 (a).

[8] Id., sec. 305 (a).

[9] Unless the shareholder were deemed to be a dealer in shares, the stock would constitute a capital asset in his hands. See sec. 1221.

[10] See S. Rept. No. 1622, 83d Cong., 2d sess., p. 46.

stitute an example of a corporate capitalization adjustment stimulated basically by the taxing statute. Dealt gingerly with by the courts,[11] the administrative authorities sought to limit the scope of the transaction, oftentimes termed a "device," by providing in terrorem restrictions upon later disposition of the preferred stock dividend.[12] Most recently, the 1954 revenue statute has specifically attacked the problem by permitting receipt of the stock without immediate tax effect, but by seeking to insure, in a defined class of cases, that its later disposition for cash or its equivalent will be taxed generally in the same manner as if such cash had been received in lieu of stock at the time of the dividend.[13] While this provision may serve to narrow the amount of interest on the part of taxpayers and their advisers in effecting preferred stock dividends, the very fact that a specific provision of the law treats this question, and that there are limitations on its application enabling taxpayers to avoid its impact under certain circumstances, would seem to insure a continuation of interest in this area.[14]

The foregoing is, of course, merely one part of a much larger problem concerning the tax treatment of stock dividends generally. Although the Congress at one time sought to tax their receipt,[15] such a provision was stricken as unconstitutional in a landmark decision.[16] This rule has never been changed, to the extent at least that the proportionate interest of a shareholder in the corporation is not changed by reason of the dividend.[17] Although there has been some interest in seeking review of this construction in the past, the Supreme Court has thus far refused to alter its views.[18] Currently, the Congress has rendered most of these problems moot by enunciating a position under which all stock dividends of whatever nature and irrespective of resulting proportionality would, subject to relatively narrow exceptions, be treated as nontaxable upon receipt.[19]

Underlying the above treatment is a tax policy belief that the consummation of shifts in the equity capital structure of a corporation as represented by stock dividends is not an appropriate occasion upon which to exact the dividend tax.[20] Secondarily is the view that such a position will eliminate from this area certain purely technical tax considerations unrelated to matters of business judgment.[21] A shareholder receiving such a dividend is perfectly free to dispose of the distributed stock in the same manner and with the same tax effects as if he had originally sold his underlying stock. The only exception has been previously noted where the stock so received by way of a dividend was other than common; in that case the special so-called preferred-stock bailout dividend treatment becomes operative upon disposition.[22]

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[11] See *Chamberlin v. Commissioner* (207 F. 2d 462).

[12] See Darrell, Recent Developments in Nontaxable Reorganizations and Stock Dividends, 61 Harv. L. Rev. 958 (1948).

[13] See generally sec. 306.

[14] See sec. 306 (b).

[15] See R. A. 1916, sec. 10.

[16] See *Eisner v. Macomber* (252 U. S. 189 (1920)).

[17] See, for example, *Koshland v. Helvering* (298 U. S. 441 (1936)).

[18] See *Helvering v. Griffiths* (318 U. S. 371 (1943)).

[19] See sec. 305 for the general rule. For the exceptions to that rule see sec. 305 (b). These involve stock dividends issued subject to an option to receive cash, or stock dividends issued in lieu of current dividends in arrears.

[20] See S. Rept. No. 1622, supra, p. 44.

[21] Id., at p. 241.

[22] See sec. 306.

It seems quite obvious that the extremely wide latitude given a corporation to "market" a part of its surplus through a stock dividend distribution, always available within limits under the taxing statute, will now serve even more than before to stimulate such transactions. Interestingly enough, the restrictions now placed upon the disposition of nonmanagerial (preferred) stock serve to underscore the lack of such restrictions in the case of dispositions of voting common stock received through a dividend.[23] In terms of economic substance, in the case of a shareholder of a publicly held corporation holding only a minute fraction of the outstanding shares, it is difficult to perceive the distinction between the receipt and sale of common stock or preferred stock initially received as a dividend. While in the former case, receipt of common, the sale of such stock technically reduces the shareholder's managerial control, his interest in the corporation may have been so negligible before receipt of the dividend that it is not in any way affected by later sale of the stock so received. In any event, interest in this opportunity to shareholders in receiving common-stock dividends will certainly not be diminished by the present form of the taxing statute. At the same time the management of publicly held corporation seems entirely free to declare such dividends as the economic needs of their business dictate.

Recapitalizations—financial readjustments which may involve both the debt and equity structure of the corporation—partake of some of the characteristics of both "reorganizations" and dividend distributions. Mechanically a corporate recapitalization involves the surrender of stock (or securities) in a corporation in exchange for new stock (and possibly new securities) of that corporation. No new capital is injected into the corporate enterprise. Normally, although not always, all of the shareholders and security holders participate in the recapitalization exchange and all of the shares held by them will be surrendered as part of the transaction.

The statutory specification concerning this transaction is sparse. All that is expressed is that a "recapitalization" may be accomplished without generating immediate tax provided the other "reorganization" requirements are complied with.[24] Such a rule accordingly leaves considerable leeway to the corporation. If the recapitalization is sought to be effected during insolvency, further freedom is afforded.[25] Notwithstanding the economic similarity of a recapitalization to a stock or other form of dividend, no special correlation of these transactions with dividends generally was provided in the Internal Revenue Code.[26] The recent tax law changes have recognized this to some extent so that if the effect of a recapitalization is the same as that of a preferred stock dividend,[27] or a dividend in bonds,[28] ordinary income treatment is provided. In other respects, however, a corporation is enabled to alter completely the managerial relationship of the shareholders or

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[23] See sec. 306 (c) which specifically exempts from the classification of "Section 306 stock" stock which is "common stock issued with respect to common stock." Where a corporate reorganization, etc., appears, no "common stock," however received, constitutes section 306 stock." See sec. 306 (c) (1) (B).

[24] See generally secs. 354 and 368.

[25] See sec. 371.

[26] See, however, H. R. 8300, sec. 306 (House bill) which was intended to provide such correlation.

[27] See sec. 306 (c) (1) (B).

[28] See sec. 356 (d).

otherwise to readjust its capital structure for reasons of "business purpose" without tax hindrance.[29]

Those readjustments which, to the minds of many, most nearly approach dividend equivalence, involve the distribution to shareholders of stock and securities of a controlled corporation.[30] Variously termed by tax technicians as "spin-offs," [31] "split-offs," [32] and "split-ups," [33] depending upon the details involved, these transactions permit one corporation to divide its business into two or more segments, to incorporate those segments and to distribute stock of that corporation to its shareholders. Such a transaction has been available to corporations (although with differing degrees of facility) since the 1920's.[34] The statute in its present form comes to grips with the problem involved more carefully than before and articulates with considerable detail the mechanics to be followed. These include a requirement that the stock of the corporation which is distributed must have been "controlled" [35] by the parent corporation and that both corporations have been engaged in the "active conduct of a trade or business" for a period of 5 years preceding the distribution.[36] Exactly what factors, when taken together, constitute a trade or business for purposes of this provision of the statute is currently the subject of considerable discussion.

In general, an effort is being made by the administrative authorities to devise tests for determination of a "business" which will prevent the use of this provision as a vehicle for the tax-free distribution of cash equivalence but at the same time to permit such separations to occur in narrow areas. Suffice it to say, the practical problems involved are enormous.[37]

Although the statute contains a general admonition to the effect that the transaction must not have the effect of a "device" for distributing corporate surplus,[38] the actual application of this provision is somewhat less than clear. Administratively, restrictions may be placed upon a subsequent sale [39] of the stock of the new corporation or of the liquidation of any of the corporations.[40]

It is well to observe that one of the announced reasons for enact-

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[29] All "reorganizations" must meet a test of "business purpose" first enunciated (in connection with a corporate division) *Gregory* v. *Helvering* (293 U. S. 465 (1935)).

[30] See generally sec. 355.

[31] A distribution of stock without an accompanying exchange by the recipient shareholder.

[32] A distribution of stock, where the recipient shareholder exchanges a part of his underlying shares.

[33] A distribution of stock where all of the shares are exchanged for new stock by the recipient shareholder.

[34] See, for example, R. A. 1924, sec. 203 (c). This provision which would have permitted "spin-offs" as well as "split-ups" and "split-offs," was deleted in the Revenue Act of 1934. From that time until 1951 "spin-offs" were not available. See IRC 1939, sec. 112 (b) (11) which again permitted "spin-offs." The 1954 code, in sec. 355, treats all technical forms of the transactions similarly without regard to internal mechanics.

[35] The term "control" involves 80 percent stock ownership. See sec. 368 (c).

[36] See sec. 355 (b) (2).

[37] See tentative Treasury Regulations under sec. 355. A corporation may not incorporate its investment portfolio or the real estate upon which its business may have been conducted. A vertically integrated manufacturing concern may not incorporate one of its component divisions and distribute that with tax impunity. On the other hand, where a corporation engages in two distinct functions, preferably somewhat dissimilar ones, and each of these separately derive taxable income, a separation of that corporation may be effected.

[38] See sec. 355 (a) (1) (B). This language purportedly writes into the statutes the so-called business-purpose test.

[39] See id., which states that the mere fact of a subsequent sale is not determinative of a tax avoidance purpose unless prior negotiation occurred.

[40] Althought the statute does not refer to "liquidations" as distinguised from "sales," a liquidation technically is a sale, and it is likely that the Treasury will insist upon a representation that no liquidation be contemplated at the time of the corporate separation. Were the rule otherwise, taxpayers would be enabled to effect a "Gregory" disposition.

ment of the corporate division statute in its current form was to permit the separation of the assets of a corporation between divergent shareholders where such division is required pursuant to an antitrust decree.[41] Apparently, although it is nowhere expressed, the effect of this is to treat the penalties resulting from the economic fact of division as sufficient to compensate for the wrong sought to be corrected by the antitrust decree. It is doubtful if such a result has been fully considered in terms of its broader antitrust implications.[42]

Finally there must be mentioned the relationship of partial liquidations to corporate distributions generally. Mechanically such a transaction involves a redemption of a part of the shareholders' stock in exchange for corporate assets (or the proceeds of their sale). In such case, if the "partial liquidation" definition has been complied with, a sale of the stock is deemed to have occurred with capital gains treatment normally resulting.[43] In order to effect a partial liquidation however, the corporation must alter considerably some portion of its corporate level activity. Thus, if the corporation carries on two or more businesses, one of these may be distributed in kind to shareholders, or one be sold and the proceeds distributed.[44] Similarly, whether or not two or more such businesses exist, if the corporation materially reduces the scope of its activities, i. e., if it effects a "corporate contraction" and thereby obtains excess working capital, such may be treated as a partial liquidation distribution.[45]

Sometimes a partial liquidation may be caused by reason of events beyond the corporation's control, such as in those cases where a fire destroys an insured part of the corporate facilities. In lieu of rehabilitating the destroyed facilities, the insurance proceeds may be partially liquidated.[46]

In each of these instances, a portion of the corporate assets, otherwise referable to surplus (with inherent dividend potential) may be distributed at an immediate tax price midway between the no cost of a dividend and ordinary income levy of a cash (or its equivalent) dividend. The rationale of this distinction may be explained in part by the fact that the partially liquidated assets have been removed from "corporate solution" in part, thereby requiring imposition of some tax, but that in addition certain extraordinary corporate level activities have occurred justifying a preferential taxing rate. Unfortunately the application of this provision is plagued by certain purely technical difficulties, involving in part the lack of some explicit correlation with corporate separation generally. The provision in its intended form gives to the corporation an additional opportunity of divesting itself of part of its net worth at a calculated, relatively minimal, tax cost to shareholders.

In this area in general, interest in effecting changes in the corporate capital structure through recapitalization, etc., will remain intense so

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[41] See S. Rept. No. 1622, supra, at pp. 266-267.

[42] It is also doubtful that the full income-tax implications of this transaction have been considered. Since in any of these instances of "non pro rata" divisions, the reality of the transaction is a sale between shareholders (each obtaining different portions of the old corporation), no question of dividend equivalence is involved. The issue in these cases is one of deferred tax or capital-gains tax, but not of ordinary income. Possibly special rules for "non pro rata" split-up should be considered for inclusion in the statute.

[43] See sec. 331 (a) (2).

[44] Sec. 346 (b).

[45] Sec. 346 (a).

[46] See S. Rept. No. 1622, 83d Cong., 2d sess., p. 262.

long as it is possible, to any extent, to retain corporate earnings at a maximum price of the corporate rate and to defer additional dividend tax upon shareholders until such time as cash or its equivalent has been distributed. Removal of this divergence in treatment, for example, through a broader current credit for dividends received, would, it would seem, mitigate some of the pressures to effect these readjustments artificially. On the other hand, these corporate rearrangements, including recapitalizations and stock splits effected for reasons solely relating to better marketability of public issues, etc., may well continue to develop in terms of the economic and business realities of the moment without special regard to tax implications. Stated otherwise, the basic problems here may well involve the inability of the technical framework of the statute to cope with the inherent differences between the publicly held management-controlled corporation and the incorporated family enterprise.

II. Corporate readjustments which expand the corporate enterprise mergers and acquisitions

In many respects the mechanical means whereby corporate mergers and consolidations may be effected are the most complex of all of the corporate rearrangement provisions and the resulting tax attributes most widely varied.[47] Generally stated, these transactions involve a union of two or more corporate entities pursuant to State statute (i. e., the so-called statutory merger or consolidation)[48] or merely by force of intercorporate action, i. e. the nonstatutory "practical mergers."

Practical mergers take 1 of 2 forms, viz, "stock for stock"[49] or "assets for stock"[50] exchanges. In the former case, one corporation acquires a controlling interest in the stock of another, the shareholders of the absorbed corporation receiving in exchange for their shares stock in the acquiring entity. No transfer of assets occurs within any of the corporations, parties to this transaction, and the relationship of those corporations after the transaction becomes that of parent and subsidiary.

Statutory mergers and consolidation and "assets for stock" acquisition involve generally two steps. A transfer of assets first occurs from the disappearing to the acquiring corporation in exchange for stock of the acquiring corporation.[51] At that stage the sole assets of the disappearing corporation are stock of its transferee. The second stage of the transaction contemplates an exchange by the shareholders of the absorbed corporation of their old stock for new stock of the surviving entity.[52] Each of these steps results in no taxable gain or deductible loss if the exchange occurs as part of a "reorganization."[53]

As in the case of recapitalization adjustments, the nature of the acts involved (the exchange of property for stock by a corporation and the exchange of stock for stock by a shareholder) may generally under broader taxing principles constitute a tax-generating event.[54] For

[47] See generally, subch. C, pt. III, secs. 354–368.
[48] See sec. 368 (a) (1) (A).
[49] See sec. 368 (a) (1) (B).
[50] See sec. 368 (a) (1) (C).
[51] This is specifically treated as tax free under sec. 361. Some question exists as to whether a corporate level transfer occurs in a statutory merger, the theory being that there is corporate union by virtue of the authority of the laws of a sovereign jurisdiction.
[52] This exchange is tax free under sec. 354.
[53] See sec. 368 generally.
[54] See sec. 1002.

this reason it would seem that the very fact that the statute has for years carved out an exception provided the exchanges occur in connection with a "reorganization," is certain to provide its own impetus toward consummation. Other motivating factors may of course also be present. For example, the absence of a ready market for the stock of a closely held enterprise together with the immediate imposition of tax, should such a sale be effected for cash or its equivalent, could well impel the shareholders to seek a so-called tax free acquisition. Indeed, such a desire is often heightened by the fact that under the present taxing code, should the sellers hold the stock so acquired until death, no income tax whatsoever may become payable.[55]

On the other hand, the fact that a suitable acquiring corporation cannot be found which is willing to take part on a "tax free" basis, may not necessarily stifle the merger. And many occur in precisely such a "tax paid" fashion.[56]

The consequences in those instances are nevertheless normally capital gains.

The corporate procedures under which the merger transactions were effected had, to a large extent, been fully developed to a high degree of sophistication far in advance of any specific treatment in the Federal income taxing statute.[57] In the absence of specific statutory characterization in the early versions of the Income Tax Act, the tax effects of the various financial adjustments were determined by the courts in terms of general principles. And the conflicting decisions seem to provide little useful precedent.[58]

Not until 1918 did the Congress specifically carve out of the income-tax laws its first primitive exception to the rule of taxation for exchanges in connection with reorganizations.[59] At that time the country had already experienced its first major merger wave.[60] As the years passed, a statutory pattern developed which sought to draw a line between mergers in which the parties exchanged stock interests for items representing cash equivalence and those in which the new interests received represented substituted evidence of corporate ownership modified only by reason of the merger.[61] In the former case, a "sale" was deemed to have occurred justifying imposition of tax; in the latter case, the transaction was not deemed sufficiently "closed" to constitute a taxable event.[62] In a somewhat similar vein, the courts also developed an additional rule to the effect that if the interest of the parties in the merged entity was a proprietorship, one evidenced by stock, but was nevertheless so small in relationship to total stock

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[55] See sec. 1014.

[56] See Butters et al., Effects of Taxation on Corporate Mergers (Boston, 1951), pp. 178, 232.

[57] See id., at p. 1, et seq.

[58] See, for example, *Marr* v. *U. S.* (268 U. S. 536 (1925)) and cases therein cited. Apparently one of the tests of taxability depended upon whether the shareholders of any of the corporations parties to the transaction received stock of a corporation newly incorporated in a different State. See also for a general discussion of these problems, Paul, Studies in Federal Taxation, Third Series (1940), pp. 3–42.

[59] See Revenue Act of 1918, sec. 202 (b).

[60] This occurred in the 1890's with the formation of the so-called trusts.

[61] More carefully developed reorganization provisions appeared in revenue acts succeeding that of 1918. See Revenue Act of 1921, sec. 202 (c), Revenue Act of 1924, sec. 203 (d), and Revenue Act of 1934, sec. 112 (g). The 1924 act is the nucleus upon which the present merger provisions have been based. The 1934 act represented the form in which they were cast until the 1954 code revision.

[62] This represents the judicially developed "continuity of interest" doctrine. For example, if stock is surrendered in a merger for bonds and cash leaving the exchanging shareholder no equity interest whatsoever in the surviving entity, a "sale" has occurred. *LeTulle* v. *Scofield* (308 U. S. 415).

ownership in the merged entity to prevent the continuance of any effective ownership, in such case the transaction amounted to a taxable sale.[63] Such a "relative size" doctrine has, however, never been actually articulated in the taxing statute; and recent attempts to do so failed after considerable public outcry.[64]

An additional condition both expressed and implied in the Internal Revenue Code requires as a basis for nontaxable merger that the fusion represent the entirety of the entities involved. If the acquiring corporation does not obtain "substantially all" [65] of the assets of the disappearing corporation the transaction may constitute a taxable event.

Overall, an additional and ambiguous requirement pervades the application of the merger laws. This requires that independently of tax considerations, there must be an independent "business purpose" for the transaction.[66]

It must be borne in mind, of course, that oftentimes a taxable result is sought for by the taxpayer. This would occur in any situation in which a deductible loss would result from an exchange, and for this reason the Treasury Department in 1934, the Congress ultimately agreeing, refused to abolish the so-called tax-free reorganization provisions from the statute because of the possible adverse effect of an agglomeration of losses upon the revenues.[67]

As between those mergers which may or may not tend to stultify economic competition, the taxing statute seems almost to operate at cross purposes with the spirit of the antitrust laws. Under the Internal Revenue Code the merger movements of the late 19th century which saw the formation of the so-called monopolistic trust would constitute classic examples of appropriate preservation of continuity of interest justifying no immediate imposition of tax. On the other hand, the acquisition of a small operating business by a larger enterprise pointed toward in current studies of merger trends as "nonevil" transactions may be viewed to some extent with disfavor because the shareholders of the disappearing company see such a small continuing interest in the acquiring corporation as to barely satisfy a continuance of their prior ownership.[68]

In periods of declining prices, where full taxation of realized losses would give rise to deductions, the nonrecognition of loss features

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[63] See *Helvering* v. *Minnesota Tea Co.* (296 U. S. 378 (1935)) "And we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation."

[64] See H. R. 8300, sec. 359 (House bill), which would have prohibited mergers between companies unless their relative size was 4 to 1. This provision was stricken after considerable discussion before the Senate Finance Committee. See hearings on H. R. 8300, Senate Finance Committee, 83d Cong., 2d sess., vol. 1.

[65] See sec. 368 (a) (1) (C), sec. 368 (a) (1) (B). In the latter case it is necessary that "control" be acquired (or have been acquired prior to the transaction).

[66] See *Gregory* v. *Helvering* (293 U. S. 465 (1935)). This case involves corporate divisions and therefore based on its facts would seem to have little relationship to merger situations. Nevertheless the courts have applied the Gregory doctrine to strike any reorganization transaction the effect of which is a tax-manufactured sham.

[67] In 1933 the subcommittee of the Ways and Means Committee studied the entire question of the propriety of tax-free treatment for corporate mergers. The recommendation of this committee was that such tax free provisions should be abolished from the statute. See report Ways and Means Subcommittee, 73d Cong., 2d sess., December 4, 1933. The recommendation of this subcommittee was opposed by the Treasury because of a fear that the depression-incurred losses would become deductible. The Congress continued the tax-free reorganization provisions with considerable redrafting. See Revenue Act of 1934 sec. 112 (g).

[68] See Butters et al., supra, et seq. It is here pointed out that the difference between the existing merger movement and the earlier one is the preponderance of small firms among the acquisition by large companies. As a result the authors conclude that the mergers do not basically effect concentration in industry.

of the present merger rules would inhibit those transactions whereas economic reasons may compel retrenchment through consolidation.

In general, it may be stated that the taxing statute's preoccupation with the problem of whether a sale has in fact occurred, that is whether the transaction is sufficiently closed, to provide a readily identifiable event upon which to base a tax has little genuine relationship with the economic and sociological implications resulting from the union of two or more corporations. Where the tax laws treat a transaction as most unlike a sale, i. e., where the enterprises to be joined are identical in nature and relatively similar in size, the antitrust statutes view the same transaction (at least as respects large corporations in similar businesses), as one providing the most fertile climate for a tendency to monopoly to germinate.

III. Transactions which reflect the cycle of corporate existence—corporate organizations and liquidations

There are also specially characterized within the income-taxing structure those tax effects which result from transactions involving the actual mechanics of the corporate cycle of existence, i. e., the organization and liquidation of the corporate enterprise.[69]

For approximately a quarter of a century,[70] the statute has provided for mandatory nonrecognition of both gain and loss where persons transfer property to a newly organized corporation in return for its stock and "securities," provided the stock is received (in an amount which grants "control" to the transferors).[71] Such a rule is intended to prevent the creation of fictitious losses through the mere fact of incorporation. At the same time, persons having the depreciable property may not contribute these to a corporation which they control, pay the price of a capital gains tax and thereby obtain a new, and higher, basis for depreciation, deductible in full against ordinary income.[72]

Recent changes in the revenue laws have underscored completely this basic policy, viz, that incorporation of unincorporated assets (whether or not a going concern) should remain a totally tax-free event.[73] Once such assets are transferred to the corporate entity, however, different results obtain. At that stage the assets so transferred become "locked" in corporate "solution" and may not be retrieved without tax-generating consequences. Thus, if prior to their distribution, the corporation has developed earnings, the amount of that surplus must be taxed at dividend rates before the stock investment can be recouped.[74] Other less burdensome alternatives (produc-

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[69] This area is treated generally in the code in subch. C, pt. II, secs. 331–346.

[70] See Revenue Act of 1921, sec. 202 (c) (3).

[71] The present provision is sec. 351. "Control" as defined in sec. 368 (c) requires 80 percent stock ownership.

[72] See in this connection sec. 1239 which treats gain on the sale of assets to a controlled corporation as short-term capital gain under certain circumstances.

[73] The 1954 code in sec. 351 eliminated the so-called proportionate interest test. Under this test in prior law it was necessary that the stock and securities received by the transferors be substantially in proportion to the assets transferred to the corporation. The application of the test created a great many difficulties of interpretation. The policy of the new statute is to treat every new corporation transfer as a tax-free event. If in fact disproportion results then, the transferors are to be taxed separately inter sese. See S. Rept. 1622, supra, pp. 264–265. This section is, however, not without its own difficulties.

[74] The rule of dividend taxation before investment recovery applies only to returns on stockholding. It does not apply to satisfaction of bond indebtedness. For this reason there is considerable interest upon the initial incorporation of a business of making the capitalization as "thin" as possible. Taxpayer enthusiasm for heavily weighted debt-to-equity capitalization is further heightened by the fact that interest payments on the bonded indebtedness are deductible, whereas dividends on stock are not.

ing capital-gains consequences on the total of the investment) may result in those instances where it can be found economically feasible to sell the stock, cause the corporation to redeem a portion of it under certain circumstances,[75] or cause a liquidation of the corporation.

Mechanically a corporate liquidation involves as usual merely an exchange of stock for the assets (or the proceeds of their sale). If all of the assets are exchanged, the transaction may be termed to be in "complete" liquidation.[76] If only part of the stock is exchanged for part of the assets, the transaction may be viewed as in "partial" liquidation.[77] Both types of liquidations may involve situations in which the assets withdrawn are used to carry on the same business as heretofore in noncorporate form. In such instances, the shareholder is entitled to withdraw assets referable to earned surplus of the corporation containing a dividend tax potential at the price of a capital-gains tax. Additional special rules modify this result somewhat where, for example, the corporation to be completely liquidated is the wholly owned, or substantially wholly owned, subsidiary of its parent shareholder. In that case the liquidation may occur with colorless effect to both parties to the liquidation, i. e., no gain or loss of any sort is recognized, and the assets are received by the parent shareholder at the basis at which they were held by liquidated corporation.[78]

Another special rule is available where the corporation's major assets are property which has appreciated in value, and where the corporate earnings are minimal. There the liquidation may occur in substance without tax on the amount of appreciation.[79]

Quite obviously the problems of liquidating the corporate enterprise are more nearly those of the moderate to small shareholder-controlled corporation. Here the opportunities are greatest for arrangement of circumstances to mitigate the impact of the dividend tax on corporate distribution with the lesser capital-gain levy on liquidation. Problems in this area are most acute where the purchase and sale of a business is involved.[80] In recent years, entirely too much effort has been devoted both by the tax practitioner to developing, and the Congress to combating, devices which artificially seek to take advantage of the capital-gains consequences resulting upon a corporate liquidation in whole or in part. The first step toward a realistic approach to the problems involved in a business transfer was taken in 1954.[81] It is to be hoped efforts in this direction will continue in the future.

The past history of corporate liquidations contains substantial evidence of a tendency to treat transfer in liquidation as dividend distributions, rather than sales.[82] Possibly the tax policy pendulum will

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[75] The entire subject of stock redemption which may involve capital-gains consequences depending upon the facts not treated in this paper. See sec. 302.

[76] See sec. 331 (a) (1).

[77] See sec. 331 (a) (2) and sec. 346.

[78] See sec. 332.

[79] See sec. 333. The actual application of this section is somewhat detailed, involving an election on the part of the various shareholders. The assets are taken by the shareholders at a basis equal to the cost of the shareholders' stock increased by any gain recognized on the transaction. The gain is recognized with respect to certain liquid assets. Ordinary income tax may occur, as respects that portion of the gain not in excess of the shareholders' ratable share of the corporation's earnings. See sec. 333 (c).

[80] See in this connection sec. 337.

[81] Id. sec. 337, however, does not settle all of the problems involved in purchase and sale of a business. The taxpayer is still forced to observe needless formality. The technical difficulties in this are considerable. There is also needed more careful statutory correlation between the application of sec. 346 dealing with partial liquidations and sec. 355 dealing with corporate separation generally.

[82] As late as 1921 distributions and liquidations were treated as a dividend to the extent of corporate earnings. See Revenue Act of 1921, sec. 201 (c).

shift once again. Such a likelihood seems properly remote. On the other hand, it seems essential ultimately, that legislation on an overall basis be produced which will eradicate to the fullest extent possible the wide differentiation between the taxation of ordinary and liquidation distributions.

Although generalizations serve little, if any, useful purpose in an area such as this, involving a multitude of economically varied and technically complex transactions, this may nevertheless be stated:

Over the years, the taxing statute has evolved a pattern for taxability for corporate financial rearrangements which operates independently of, and sometimes almost at variance with, the application with other regulatory provisions of public policy. Special consideration should be given to the relationship of the taxing statute to those laws.

To the extent possible this relationship should be made harmonious. At the very least, there should, perhaps, be fuller awareness of more of the non-tax implications when the taxing laws are framed. For example, the question of whether an acquisition effected between two companies of totally disparate size is in reality a taxable sale, may present consideration suggesting an affirmative answer from the standpoint of closed transactions principles of taxation. On the other hand, a different question is presented when the same problem is viewed from the perspective of public policy generally. Possibly from this standpoint such acquisitions (enabling larger companies to diversify and owners of smaller businesses to obtain a marketable substitute for their stock) should be favored. But the battleground for determination is certainly not (as it was in 1954) the Internal Revenue Code.

An additional problem concerns the multiplicity of avenues for effecting a particular desired corporate management result, and the differing tax consequences produced dependent upon the route chosen. Thus, under the present statute, stock dividends are treated somewhat differently from a transaction technically termed a "recapitalization"; more latitude is afforded the merger of two or more corporate entities in those cases where it is possible to effect the transaction pursuant to State statute than otherwise; a partial liquidation and corporate separation are treated differently in important aspects; there are doubtless other such situations. While complete symmetry may never be achieved in every respect, it would seem that a major tax policy goal, in its technical aspects at least, should include objectives directed at narrowing the gap between substance and form. This should not be merely a perennially pious hope. The areas of anomaly are well known. Their removal requires only a willingness to abandon familiar language patterns.

A review of the previously discussed groupings of corporate rearrangement procedures indicates that much of the impetus directed toward artificially generated tax devices stems from the wide tax rate differentials characterizing the various transactional forms. So long as the dividend tax is more burdensome than the rates imposed upon capital gains—or so long as a corporate distribution may take either of such forms (and indeed may be effected in stock without any immediate tax effects whatsoever)—pressures for tax framing will remain acute. A partial solution could be achieved through elimination, or at least reduction of the rate differentials when applied to all corporate emanations having the form of corporate distribution.

The obvious technical and other difficulties involved in the foregoing, suggest that perhaps the most realistic approach ultimately is for the taxing statute to frankly recognize the distinctive nature of a private corporation, and to develop special and uniform rates characterizing a shareholder's relationship with that entity. This would have the additional effect of unfettering public corporations from many of the restrictions now affecting their activities. It is fully understood that the technical problems involved first in defining fairly the nature of such a corporation and thereafter in producing workable rules are enormous. Moreover, memory is still fresh of the misunderstood charges of small-business discrimination which resulted when the House of Representatives in 1954 sought to give effect to this distinction even in very limited form. On the other hand, if the evolution of the taxing statute is to keep pace with that of the economy itself, the time for such a first attempt has surely now arrived.

EFFECT OF THE CORPORATE INCOME TAX ON MANAGEMENT POLICIES

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I. SCOPE OF INQUIRY

It is abundantly clear—at least to a tax practitioner—that with tax rates at current levels, the provisions of the Federal income-tax law exert a significant influence on corporate management policies. The degree to which executive judgment is affected, that is, made different from what it would be in the absence of the corporate income tax, will, of course, vary with time, environment—psychological as well as physical—industry, and the individual corporation and its management personnel. But it is plain that in certain areas, at least, corporate action or inaction will be influenced to a substantial extent—in some cases to a compelling extent—by the tax consequences of such action or inaction. Where management and ownership of the corporation are the same, tax considerations will usually assume a greater importance than where management and stock ownership are disparate. Where a corporation is publicly owned, tax considerations may be pushed to the background by other factors such as management-stockholder relationships or public relations generally. However, even in such companies, management policies are affected to some degree by the provisions of the Federal income-tax law.

Potentially the topic is extremely broad, covering such matters as the extent to which the character of corporate financing is dictated by tax consequences, i. e., how much of the original or additional capital shall be represented by debt (bonds) and how much by preferred or common stock; the extent to which wage policies and price policies are shaped by the tax law; the extent to which corporate combinations (mergers, consolidations, etc.) and corporate divisions (spin-offs and splitups) are impelled by the tax law; and in the case of privately owned corporations, whether the business shall be carried on in corporate form at all. Most of these matters will be the subject of other papers in the series.. At any rate, they are outside the scope of the present paper which will be confined to two major headings: (1) the

effect on management policy of the penalty tax[1] on corporations which improperly accumulate their earnings, i. e., in order to save their shareholders from the imposition of the individual tax on such earnings; and (2) the effect of the ordinary tax on corporate expenditures for such items as advertising and sales promotion, expense accounts, capital asset acquisitions, research and development expenditures, employee benefits (sick benefits, life insurance, pension, and profit-sharing plans), and charitable contributions. Some of these expenditures are to be covered in detail by other papers. Here they will be considered largely in the aggregate.

II. The Penalty Tax on Unreasonable Accumulation of Corporate Profits

1. FUNCTION OF THE TAX

In any income-tax system which imposes higher rates of tax on individuals than on corporations, a provision to prevent, or at least to discourage, the use of the corporate entity as a means of avoiding the higher individual rates is virtually indispensable. Unhampered by such a provision, the industrialist or investor in the high surtax brackets will obviously find it advantageous to incorporate his business or form a corporation to hold his investments. By interposing the corporate entity between his income and himself and accumulating in the corporation whatever part of its income is not required for his personal needs or desires, he will be able to escape the surtax on the amount accumulated.[2]

The acuteness of the need for a deterrent varies according to the spread between the rate of tax on corporate income and the top rate applicable to individual dividend income. The maximum spread under current law is 57 percent, that is, the difference between the lowest corporate rate of 30 percent (applicable to the first $25,000 of a corporation's taxable income) and the highest individual rate applicable to dividend income, 87 percent.[3] As to corporate income taxable at the 52 percent rate, the maximum spread is 35 percent, enough to present an important problem: how may the revenue be safeguarded without at the same time interfering with legitimate corporate expansion and protection against the proverbial rainy day? That the Government revenue would be significantly greater if there were no barrier between corporate earnings and individual tax rates may not be doubted.[4]

Congress recognized the problem from the very beginning of the modern income-tax era and every income-tax law since the 16th amendment to the Constitution (1913) has contained some provisions designed to prevent the utilization of corporations as a means of escaping

[1] Sec. 531 of the 1954 Internal Revenue Code. All statutory references herein are to the 1954 code unless otherwise indicated.

[2] Rudick, Section 102 and Personal Holding Company Provisions of the Internal Revenue Code, 49 Yale L. J. 171 (1939).

[3] The top individual tax rate is 91 percent. However, a credit of 4 percent is allowed with respect to dividend income (sec. 34).

[4] In 1954 corporations distributed $9.9 billion in dividends as against earnings for that year after taxes of $17.8 billion, a ratio of about 56 percent. Projected figures for 1955, based upon the first quarter of this year show earnings after taxes to be $20.3 billion as against distributions of $10 billion, or a ratio of about 50 percent (Council of Economic Advisers Report on Economic Indicators, p. 24 (June 1955)). In 1933 a former chairman of a House Ways and Means Committee estimated that the Government had lost over $1 billion in tax as a result of not taxing the shareholders on their proportionate shares of the corporations' undistributed earnings (Green, The Theory and Practice of Modern Taxation (1933), 140). This estimate was undoubtedly very conservative.

individual tax. The present Internal Revenue Code contains, as did its predecessor, multiple provisions designed to this end.[5]

2. HISTORY OF THE TAX ON IMPROPER ACCUMULATIONS OF SURPLUS

A brief statement of the background of the taxing provisions should be helpful to an understanding of the problems generated by the penalty tax.[6] As indicated above, the income-tax law has from the outset (1913) contained a penalty section applicable to the income of corporations formed or availed of for the purpose of preventing the imposition of the surtax on their shareholders through the medium of accumulating their earnings instead of distributing them. However, the acts passed from 1913 to 1918 did not impose any penalty on the corporation itself; instead the shareholders of a corporation guilty of harboring the condemned purpose were taxed on their pro rata shares of the company's earnings. In 1920 doubts about the constitutionality of this method of applying the penalty were roused by the Supreme Court's decision in *Eisner* v. *Macomber*,[7] and in 1921, Congress, apprehensive that the penalty section as it then stood might be invalid,[8] abandoned the scheme of taxing the shareholders and began with the law of that year to impose a penalty tax against the corporation. The validity of the original method of imposing the penalty tax on the shareholders rather than against the corporation was never directly tested in the courts.[9]

From 1921 to 1939 various amendments were made to eliminate defects in the 1921 act by strengthening the section and increasing the penalty. The most important of these amendments occurred in 1934 and 1937 when separate classifications were established for "personal holding companies" and "foreign personal holding companies." A company falling in the first of these categories was subjected to a prohibitively high penalty surtax on its undistributed income,[10] regardless of the motive for nondistribution, thus effectively forcing distributions of income by such companies to shareholders; while in the case of a company falling in the second category; that is, a personal holding corporation organized under the law of a foreign country but owned to a major extent by American citizens or residents, such citizens or residents were taxed on the undistributed income of the corporation.[11]

Even with these amendments, the section was not a particularly efficient instrument. This was demonstrated when the undistributed profits tax enacted in 1936 unleashed an unprecedented flood of divi-

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[5] There are now logically grouped in subchapter C of the income tax chapter of the code.

[6] A somewhat more extensive history of the statutory provisions up to 1939 is given in Rudick, note 2, supra, p. 173 et seq.

[7] 252 U. S. 189 (1920). In *Collector* v. *Hubbard*, 79 U. S. 102 (1871), the Supreme Court had held valid a provision in one of the Civil War Income Tax Acts which required the shareholders of a corporation to include in taxable income their proportionate shares of the corporation's income, whether distributed or not. In holding that the income tax on a stock dividend of common on common was unconstitutional, the majority in the Macomber case declared that the Hubbard case was overruled by *Pollack* v. *Farmers Loan & Trust Co.*, 158 U. S. 601 (1895), thus intimating that a tax on the shareholders' respective shares of the undistributed earnings of the corporation prior to dividend declaration was not an income tax but a property tax and so invalid unless apportioned according to population. The Hubbard case, however, is perhaps still good law. See Rudick, op. cit. supra, note 2, pp. 210–211.

[8] See H. Rept. 350, 67th Cong., 1st sess., 13 (1921); S. Rept. 275, 67th Cong., 1st sess. 16–17 (1921).

[9] Rudick, op. cit. supra, note 2, p. 174.

[10] By what is now sec. 541.

[11] By what is now sec. 551.

dends.[12] The undistributed profits tax of 1936 was highly unpopular among businessmen—to this day it is anathema to most of them—and it was soon repealed. Parenthetically, I venture to suggest that if the undistributed profits tax had supplanted the corporation income tax instead of merely complementing it, and had been at a moderate flat rate, its fate might well have been different.

During the 15 years from 1939 to 1954, only a few amendments to the penalty tax on improper accumulations of surplus were enacted, none of them of any great significance to the present discussion with the exception of the provision which removed a net long-term capital gain (less the tax thereon) from the measure of the tax.[13] Apart from reductions in the rate of the tax, this was the first move in the direction of mitigating the threat of the penalty. The second such move came last year.

The Revenue Code of 1954, in response to the urgings of various business and professional groups, made a number of important changes in the statute, described below, which may have weakened—this will not be disclosed until the courts construe the new provisions—the position of the tax collector in his effort to prevent the use of the corporation as a shield against individual tax.[14]

The present provisions are thus the crystallization of 40 years of effort to prevent the utilization of corporations as a devise to escape individual taxes.[15]

3. DESCRIPTION OF THE CURRENT STATUTE (1954 CODE, SECS. 531–537)

The ultimate test of liability remains what it has always been, namely, the existence of a purpose to avoid the income tax with respect to the shareholders[16] by permitting the earnings to accumulate instead of being distributed.[17] The rate of tax also remains as it was: 27½ percent of the first $100,000, 38½ percent of the remaining taxable income which measures the tax, but the measure of tax has been changed. Up to 1954, the tax, if it applied at all, was measured, speaking generally, by the entire undistributed income of the taxable year exclusive of a net long-term capital gain.[18] Under the 1954 Code, the measure of the tax, now called accumulated taxable income,[19] is constricted to the amount which remains after deducting a credit[20]

[12] Dividend distributions by corporations having net income in 1936 and 1937, the 2 years during which the undistributed profits tax was in full effect, amounted to $7,179 million and $7,308 million, respectively, as compared with $3,822 million and $4,631 million, respectively, for 1934 and 1935, and $4,780 million and $5,562 million, respectively, for 1938 and 1939. U. S. Treasury Department, Statistics of Income for 1939, pt. 2, p. 15 (1939).

[13] Revenue Act of 1951, sec. 315 (a).

[14] The Senate Finance Committee deleted a provision in the House bill which would have exempted from the application of sec. 531 publicly held corporations. A publicly held corporation was defined as one with at least 1,500 stockholders, no more than 10 percent of the stock of which was owned at the close of the taxable year directly or indirectly by any one individual. In applying this 10 percent tax, the family attribution rules and constructive ownership rules applicable to personal holding companies were to be applied.

[15] The penalty tax is applicable to foreign as well as domestic corporations under certain circumstances.

[16] "[O]r the shareholders of any other corporation." The alternative clause is to cover situations where another company, e. g., a parent company, is interposed between the taxpayer corporation and the ultimate shareholders.

[17] Sec. 531 (a). As indicated above, the tax does not apply to personal holding companies and foreign personal holding companies nor does it apply, of course, to corporations exempt from income tax. Sec. 532 (b). Certain exempt organizations which improperly accumulate earnings may lose their exempt status. Sec. 504.

[18] In the words of the statute, "The excess of net long-term capital gain over the short-term capital loss." Until 1951, a net long-term capital gain was also included in the income which measured the penalty tax. See note 13, supra.

[19] The accumulated taxable income consists of taxable income after adjustment as provided by sec. 535. The principal adjustments are allowances for nondeductible income taxes, a net capital loss and charitable contributions in excess of the 5 percent limit of sec. 170 (b) (2), and the disallowance of loss carryovers and carrybacks.

[20] Sec. 535 (c).

equal, in the case of a company which is not a mere investment or holding company, to such part of the earnings of the taxable year as is retained for the reasonable needs of the business, and this credit can never be less than the excess of $60,000 over the accumulated earnings at the beginning of the taxable year. In other words, an operating company is permitted to accumulate an aggregate of $60,000 in earnings—not $60,000 per annum—without running afoul of the tax.[21] Under another provision which is new in the 1954 Code, in computing the accumulated taxable income of the taxable year (as well as the accumulated earnings at the beginning of the next taxable year), a dividend distribution made on or before the 15th day of the third month following the close of a taxable year is counted as if it had been made on the last day of such taxable year.[22] Under still another provision which is new in the 1954 Code, the meaning of "income accumulated for the reasonable needs of the business" is amplified by providing that the term "reasonable needs of the business" includes "the reasonably anticipated needs of the business." [23]

A mere holding or investment company is also allowed under the new law a minimum aggregate accumulation of $60,000, but for some reason is not allowed any credit beyond this even though it may justifiably argue that income beyond this would be for the reasonable needs of the business. Thus, once such a company reaches an accumulation of $60,000 and is found to have cherished the nocent purpose, it will incur the penalty on all of its accumulated income even though an accumulation of part would have been reasonable.

As indicated above, the statute depends for its application upon the existence of a proscribed purpose, namely, accumulation in order to save the shareholders from individual tax. Whenever the interdicted purpose is found to be present—and it need not be the dominant purpose—the company becomes liable to the penalty tax except that under the new code, if it is an operating company, such part of the accumulation as is considered reasonable for the needs of the business is not subject to the tax. Purpose is, of course, subjective. It exists only in the mind and since no one has discovered any generally accepted method of looking into people's minds to see what lies therein, Congress has come to the aid of the Commissioner with certain statutory presumptions. The first of these is that if the company is a mere holding or investment company,[24] that fact alone is prima facie evidence of the purpose to avoid the income tax with respect to the shareholders.[25] On the other hand, if it is an operating company, no prima facie presumption exists unless it is found that the earnings have been permitted to accumulate beyond the reasonable needs of the business, in which case that fact is determinative of the prohibited purpose "unless the corporation by the [26] preponderance of the evidence shall prove to the contrary," so that under the new code, as well as under the old, the existence of any unreasonable accumulation puts the company to the burden of proving a complete absence of the condemned purpose—the task of proving a negative is often insuperable—

[21] Sec. 1551 would block a corporation which sought to divide itself into many corporations for the purpose of obtaining multiple $60,000 accumulated earnings credits.

[22] Sec. 563 (a); sec. 535 (c) (4).

[23] Sec. 537.

[24] The meaning of a mere holding or investment company is amplified by Treasury regulations. T. R. 118, sec. 39.102-2 (c). See also Rudick, op. cit., supra, note 2, p. 185.

[25] Sec. 533 (b).

[26] The 1954 Code here deleted the word "clear" which was contained in the prior statute. Whether this deletion will produce any real change in meaning remains to be seen.

but under the new code, the tax is imposed not on the entire accumulation, but only on that part which is found to be unreasonable.

Another important change has been made with respect to the reasonableness of the accumulation. Ordinarily, in any litigated tax controversy, the burden of proving that the Treasury is wrong rests upon the taxpayer.[27] The new code provides in effect that where the Commissioner of Internal Revenue has asserted a deficiency under section 531 and the company institutes a proceeding in the Tax Court[28] appealing from such deficiency, the burden of proving that the asserted deficiency is justified shifts to the Government under certain circumstances: If before the mailing of the notice of deficiency the Government sends by registered mail a notification informing the company that a deficiency has been proposed under section 531 and if within a period of time to be prescribed by regulations (but not less than 30 days after the mailing of the notification) the corporation submits a statement of the grounds (together with facts sufficient to show the basis thereof) on which the corporation relies to establish that all or part of the earnings have not been permitted to be accumulated beyond the reasonable needs of the business, the Government must assume the burden with respect to the grounds thus set forth by the taxpayer.[29] If the Treasury fails to send out such a notification, the burden of proof is on the Government regardless of whether the taxpayer furnishes a statement as to its grounds for accumulation.[30] This new rule was originally made applicable only to taxable years covered by the new code[31] but has this year been broadened to include years covered by earlier statutes.[32] The effect of the new rules on corporations charged with harboring the prohibited purpose remains to be seen. This point is discussed below.

4. IMPACT OF THE PENALTY TAX ON MANAGEMENT POLICIES

Here we come to the nub of the inquiry with respect to section 531. The questions to be considered are: (*a*) How effective is the tax in achieving its avowed purpose? (*b*) Does it really impel corporate managements to declare dividends which they otherwise would not declare, and if so, how bad is this for the economy? (Does the section prevent the growth of small corporations or otherwise prevent companies from growing as they otherwise might, or does it impel distributions which leave companies in such a precarious position that they cannot survive a period of adversity?) (*c*) Does it stimulate the acquisition of small businesses by larger ones whether by merger or by sale and thus tend to concentrate business enterprise? (*d*) Does the tax otherwise warp the judgment of management personnel? In all of these areas, the approach must largely be a subjective one—statistics, where available, are not of much help in answering such questions. In other words, I speak principally from my own experience and observation, which may be different from that of other practitioners or students of the problem.[33]

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[27] The most notable exception is where the Government charges fraud.
[28] In a suit in a district court or the Court of Claims, this new rule would not apply.
[29] Sec. 534.
[30] Ibid. A special rule is provided where there is a jeopardy assessment. Sec. 534 (d).
[31] Sec. 534 (e).
[32] Public Law 367 (1955), secs. 4, 5. In the case of earlier years the new rule applies only to proceedings tried on the merits after the date of enactment of the 1955 amendment (August 11).
[33] For the reactions of a number of other practitioners and economists, see Economic Effects of Section 102, published by the Tax Institute, Princeton, N. J. (1951).

(a) *How effective is the provision?*

It is obvious that the penalty tax does not produce much revenue. For the period 1940 through the first half of 1950, only 919 deficiencies totaling $14,255,000 were assessed under section 102, as compared with a total number of deficiency assessments against corporations for this period of 786,415 totaling $4,375,699,000.[34] From 1913 to January 1, 1950, only 101 cases had been litigated under the predecessor sections.[35] Of these, 45 cases were decided in favor of, and 53 cases adversely to the Government. However, while numerically more cases have been decided against the Government, the Government has not fared too badly in this litigation since the cases decided in its favor represented 67 percent of the total proposed tax in the litigated cases.[36]

The fact that the tax does not produce revenue is not of itself significant: it was not primarily designed to raise money but to deter tax avoidance and it has to a considerable, but probably not to a sufficient, extent achieved this purpose. There can be no doubt that the fear of imposition of the penalty tax has spurred the payment of many dividends that would otherwise not have been declared. The dividend impetus has been confined principally to companies in which management holds the majority of the stock and a significant minority is held by outsiders. Here the possible application of the penalty carries a double threat, namely, the tax itself—although that may not be too painful to the majority where the tax on the dividends distributed to them would exceed their pro rata portion of the penalty—and personal liability as directors for the unnecessarily incurred penalty tax. (The personal liability would be enforced by a minority stockholders' derivative suit.) The latter threat was highlighted a number of years ago by an action brought against the directors of Trico Products Corp. for recovery of the penalty tax which the Government successfully asserted against that corporation.

Trico, which is a fairly well known company manufacturing automobile windshield wipers and other devices, is a company whose stock is traded in over the counter. At the time of the penalty tax proceeding, it had several thousand stockholders; but one small group, most of whom were directors, owned a majority of the stock. The company had piled up a huge accumulation of earnings and had a very strong liquid position.[37] The company was twice defeated in its efforts to combat the Government's charge of improper accumulation, once in the Tax Court [38] and again in the district court [39]—for a later year. After the decisions of the lower courts were affirmed by the appellate court,[40] a minority stockholders' suit was instituted to compel the directors to restore to the corporation the penalty tax which together with interest amounted to over $7 million. Apparently the directors and their counsel must have been fearful of the outcome of this suit for they settled by paying the corporation $2,390,000,

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[34] The Taxation of Corporate Surplus Accumulations, Study Prepared for the Joint Committee on the Economic Report, 82d Cong., 2d sess. (1952), p. 109, table 15.

[35] Ibid., at pp. 154–156.

[36] Ibid., at p. 155.

[37] In 1942 its accumulated surplus was $22,822,210; the amount invested in operating assets was $11,629,186; the amount invested in Government obligations was $15,286,930; and the amount invested in stocks of other corporations was $2,611,929. Ibid., at p. 87.

[38] *Trico Products Corporation*, 46 BTA 346 (1942).

[39] *Trico Products Corporation* v. *McGowan*, 67 F. Supp. 311 (W. D. N. Y. 1946).

[40] The Tax Court decision, involving the years 1934 and 1935, was affirmed in *Trico Products Corporation* v. *Commissioner*, 137 F. 2d 134 (2d Cir. 1943). The district court decision, involving the years 1936 and 1937, was affirmed in *Trico Products Corporation* v. *McGowan*, 169 F. 2d 343 (2d Cir. 1948).

and agreeing to the declaration of an extra dividend of $5.50 per share.[41]

The Trico decision and settlement struck terror into the hearts of the managers of companies similarly situated and probably precipitated the payment of many dividends that might otherwise have been skipped. It also apparently—and in my judgment unnecessarily—intimidated the directors of a number of corporations which were truly publicly owned corporations, that is, where the management group were primarily managers rather than proprietors. So far as I know, the Treasury has never asserted, much less litigated, the imposition of the penalty tax on corporations where a majority of the stock is held by persons who have no direct or indirect control over the declaration of dividends.[42] Another area in which section 531 and its earlier counterparts has had some effect consists of small companies with an obvious surplus of working capital, owned by a few stockholders whose tax brackets do not go much above 50 percent. Here the amount to be lost if the penalty is imposed is so large in comparison with what may be gained if it is not imposed that the excess earnings are often distributed. However, the companies in this category, even through the number of them may be sizable, do not loom large in their aggregate importance to the economy.

On the other hand, there is an area in which the penalty tax is frankly flouted. This occurs where a company is privately owned, that is, where all the stock is owned by 1 or 2 families, and the income is very substantial. As indicated above, in the discussion of the Trico case, there are situations where the payment of the penalty tax by the corporation will leave its owners better off financially than if they had distributed the income. This occurs where the individual stockholders are in a substantial higher tax bracket than the 38½-percent maximum penalty tax, and since the 38-percent individual bracket is reached at a taxable income of $20,000 for a married couple and $10,000 for an unmarried individual, it is obvious that there are many corporations which will fall into this category. Even where the stockholders contemplate an ultimate sale of their stock or a liquidation of the corporation, they will still often be better off by having the corporation pay the penalty than they would if the earnings were distributed. Thus, assume a company with a net income after income tax of $400,000 owned by a single stockholder whose taxable income sans dividends from his corporation amounts to $50,000. If we assume that the sole stockholder claims the benefits of income splitting and that his wife has no income, his individual income-tax bill, if he received a dividend distribution of $400,000, would be increased by $322,840, leaving him with a net of $77,160. If he deliberately attracts the imposition of the penalty tax, the corporation will pay $143,000 (plus perhaps some deductible interest), leaving the corporation with $257,000 so that in the aggregate, he is $179,840 better off than if the

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[41] Op. cit. supra. n. 33, at p. 89.

[42] Available data show that in the case of 93 percent of the deficiency assessments imposed under sec. 102 of the 1939 code for the taxable years 1938–48, the ownership of the assessed corporations is highly concentrated with 79 percent of the corporations having less than 5 shareholders, 14 percent of the corporations having 5 to 10 shareholders, 3 percent of the corporations having 10 to 15 shareholders, 2 percent of the corporations having 15 to 25 shareholders, 0.8 percent of the corporations having 25 to 50 shareholders per corporation, and 0.4 percent of the corporations having 50 to 100 shareholders per corporation. The Taxation of Corporation Surplus Accumulations, op. cit., supra, n. 33 at p. 115.

corporation had distributed the income. If he later sells his stock or liquidates the corporation, the $257,000 left in the company may be subjected to a 25-percent capital-gains tax but even so, he will be substantially ahead.

If the owner paid out 70 percent of the $400,000 as a dividend, he would probably save the company from the imposition of the tax because of a rule of thumb which the Treasury once adopted[43] and which revenue agents still seem to follow to the effect that if a company pays out at least 70 percent of its distributable income, the penalty tax will ordinarily not be asserted. Theoretically, any accumulation may be sufficient to attract the tax but there is no reported case of an operating company being attacked where it distributed as much as 70 percent of its distributable income. However, even a 70-percent distribution, on the facts assumed above, would leave the stockholder worse off financially than if he made no distribution. If the company distributed $280,000, the individual tax thereon would amount to $219,140. This would leave the stockholder with $60,860 in his individual pocket and $120,000 in his corporate pocket. But this would still be less than the increase in his equity of $257,000 if he made no distribution and incurred the penalty tax.

For companies like this, there will be a point of optimum distribution, that is, a distribution which is just enough to prevent the imposition of the penalty but which will not increase the stockholder's individual tax by more than the amount of the penalty which would otherwise be imposed. Thus, if a distribution of 40 percent, or $160,000 would be enough to forestall the penalty (while the distribution of less would incur the tax), it becomes advisable to distribute this much: the individual tax would be increased by $116,840 while the amount of the penalty saved would be $143,000. The trick in situations of this kind, and it is an extremely difficult one, is to correctly divine what the Treasury and the courts will find to be an unreasonable accumulation. If it is known to the administrators and the judges that the corporation and its advisers engaged in such a guessing game, they will probably find the corporation guilty of nurturing the condemned purpose and will impose the tax, although only on the amount of income not distributed.

From the foregoing, it may be noted that while the tax is effective in forcing dividend distributions by certain corporations, it is not an efficient instrument in stimulating distributions by other corporations—probably more numerous than the first group—at which the penalty was aimed. The inefficiency could be easily cured by increasing the rate of the penalty tax—from 1924 to 1934 it was 50 percent and this in the face of lower individual rates of tax—but this would aggravate whatever undesirable economic impacts the tax has on other corporations.

At this point, I would like to interject my personal opinion that the rates of tax on individual incomes above $20,000 are too high for the economic good of the country and that it would be better if the 50 percent bracket were set at a point not lower than $200,000. Incomes above $200,000 are so uncommon that whatever rates are imposed, the effect on the economy as a whole is not too significant. Hence if it were felt that to make a 20-percent rate palatable for low-income re-

[43] T. D. 4914, 1939-2 Cum. Bull. 108 (1939).

cipients, the rates must soar to quasiconfiscatory levels, relatively little damage is done if such rates are made applicable only to the highest incomes, say $200,000 or more. But when rates from 50 to 87 percent are imposed on incomes between $32,000 and $200,000 (for married couples), the point of diminishing returns has probably been passed as to such taxpayers, not so much because they quit work to go fishing—I do not believe there is a truly significant amount of holiday taking as the result of the extremely high rates—but because the persons in the brackets mentioned constitute to an important extent the driving force of the economy. By this I mean that the individuals in this group—at least those whose principal source of income is earnings—possess, to a far greater degree than average, the imagination, industry, and initiative which are essential to the maintenance of a stable and growing economy. They are the ones who, if they could, would be prepared to start new ventures and supply risk capital; and if they are unable to accumulate capital out of their earnings,[44] they are prevented from striking out on their own or otherwise utilizing their talents fully. If the rates in the higher brackets were lowered, the need for the penalty tax would be lessened but would not disappear.

(*b*) *Does the tax really impel corporate managements to declare dividends which they otherwise would not declare and if so, what deleterious effects does it have on the economy?*

Speaking broadly, this question is complementary to the previous one. To the extent that the provision is effective, it clearly causes the declaration of dividends that would otherwise not be paid. But if we are talking about corporations with current income and surplus funds not needed for the business, that is its very purpose. Moreover, I think it would be conceded by even those who call for the abolition of the tax that, to the extent the provision does impel distributions of unneeded funds, it is not merely an effective tax avoidance deterrent but also an economic stimulant in that so far as minority shareholders are concerned, it increases the flow of spendable income and thus stimulates buying. In a boom period this may be bad, but in a sluggish period it will be good. It is my personal opinion that the amount of dividends which are distributed under the threat of section 102 which could otherwise be advantageously used in the business is very limited indeed and that the critics of the tax have overplayed the plight of corporations which have distributed more than they should.

It is said by some of these critics that the tax prevents the growth of small business, whatever small business may mean. Under the 1954 code, every corporation is allowed to accumulate $60,000 of distributable income free from the threat of the tax. If this is an indication of what is meant by small business for the purpose of the present question, the relief provision permitting a $60,000 free accumulation will not accomplish very much except perhaps psychologically. So far as I know, the Treasury has never attacked an accumulation of $60,000 except by a personal service corporation where capital is virtually unessential. I know of no small corporation the growth of which was hampered by the fear of the penalty section. This is not

[44] It is evident that equity capital is being supplied to a growing extent by institutional investors and that the ratio of private investment to total investment is declining. Factors Affecting the Stock Market, report of the Senate Committee on Banking and Currency, S. Rept. No. 1280, 84th Cong., 1st sess., 95, table 4 (1955).

to say that there are none. As I stated earlier, the question has to be approached solely on the basis of the commentator's personal experience and observation. There is a good deal of ignorance and unwarranted fear of section 531 and although I do not personally know any, it is reasonable to believe that there must be a sizable number of owners of small corporations who have heard of the penalty section and who have, without proper advice, distributed dividends[45] that they might otherwise have profitably employed in the business. For such businessmen, the provision of the 1954 code permitting the $60,000 free accumulation will perhaps serve some purpose. However, it is hard for me to believe that there are enough of these situations to have any pronounced or important effect on the economy as a whole.

Passing from "small businesses" to larger businesses, to what extent has section 531 and its earlier counterparts prevented legitimate corporate expansion? So far as large publicly owned corporations are concerned, the importance of the section as an economic factor can be dismissed. The managers of large corporations are sophisticated enough taxwise to know that they are immune from worry about the section. With rare exceptions, they want to pay as high dividends as they feel they safely can, bearing in mind contemplated expansion and other business requirements, and they know that if they improperly accumulate the income, they will be brought to task by the stockholders perhaps faster than by the Government.[46]

After the Trico decision, some managements of publicly owned companies became concerned not because they had any real doubt about the propriety of the income accumulation but because of the possibility of personal liability in the remote event of their company being attacked under the section, but I do not believe there was any significant increase in dividend distributions because of this feeling. In recent years, most of our large corporations have increased their distributions to stockholders but there is no evidence that the increase has been influenced in any way by the threat of section 531. It has doubtless been due to greater earnings.

In the case of companies which are neither large nor small—these are relative terms which can vary widely depending upon the context in which they are used—it has again been my personal experience and observation that the penalty section has not prevented legitimate expansion. There are some situations in which the penalty has had the opposite effect, that it, it has spurred expansion, sometimes in the same line and at other times in a related and in a few instances unrelated lines. It has been asserted that some of this expansion has been premature or unwise and probably that is so, but the amount of such premature or unwise expansion cannot be very great. New investment in totally unrelated lines has been very limited because it is thought by some that investment in a brand new field may indicate

[45] Or, rather, the tax on such dividends since the amount of the dividend after reduction by the tax could be loaned to or reinvested in the corporation.

[46] The decision in *Kales* v. *Woodworth* (32 F. 2d 37 (6th Cir. 1929)) provides an interesting case in point. Here, the stockholders of the Ford Motor Co. successfully sued to restrain the corporation from using its accumulated surplus of almost $112 million, for plant expansion and to require the distribution as dividends of 50 percent of the cash surplus. The taxpayer stockholders received the dividend in 1919, but contended unsuccessfully that the dividend was taxable in 1916, alleging inter alia that the undivided profits of the corporation were taxable to the stockholders, under the then applicable provision requiring that the stockholders be taxed on their share of the corporation's undivided profits which were accumulated for the purpose of avoiding tax. While the taxpayer was not successful in including the dividend in the earlier year for tax purposes, the stockholders were successful in having the courts require the declaration of a dividend.

the presence of the prohibited purpose. In any event, a company which uses its cash to expand, whether the expansion be in the form of new plant or increased volume requiring larger inventories and customers' balances, is not subject to successful attack under section 531. Although my conclusion is empirical, rarely if ever has the legitimate expansion of the corporation been prevented because of section 531.

Another charge leveled at the provision by its critics is that accumulations necessary for long-range development, e. g., construction of new plant of the acquisition of a competitor, is deterred because of the fear that unless the investment is made promptly, the penalty will be attracted. This is the so-called "immediacy" doctrine which stems from some Tax Court decisions in which it was held that there was an unreasonable accumulation where there were no definite plans for future expansion.[47] However, this is not the same as saying that there must be an immediate investment of the accumulation. It must be remembered that there is a long lag between the period of accumulation and the time when the issue comes to trial, never less than 4 or 5 years, and usually much longer; and if at the time of the trial the money has not in fact been invested, it is only natural for the Treasury and the courts to doubt the professed intentions of the owner-managers. In my opinion, where the administrators in the first instance and the courts in the second are persuaded that the owner-managers have bona fide intentions of expanding and have evidenced this intention by the formulation of specific plans, they will not impose the penalty even if up to the time of decision there has not actually been an investment. There may be perfectly valid reasons for the long-period accumulation. Thus during the war, when there could be no new construction—except for purposes related to the war effort—a long delay in going forward with a contemplated building program would not automatically bring down the penalty if in fact when construction was possible the company proceeded with such construction or otherwise explained why it had not.[48] In 1954, Congress apparently sought to allay the fears of owner-managers in this situation by providing that reasonable needs of the business include "reasonably anticipated" needs of the business. However, I still feel that in the final analysis, the question is going to turn on the credibility of the testimony of the owner-managers.

Still another criticism which is directed at the section is that it tends to prevent corporations from accumulating sufficient cash reserves against a period of depression. It is said that in good years, corporations under the threat of the tax pay out more than they should and then in lean years, they have nothing to pay out whether in dividends or in maintenance of payrolls, expansion programs, and so forth. Another facet of this charge is that the tax tends to accentuate inflationary and deflationary trends; that it forces the distribution of dividends in good times and leaves little or no cash against the day when it would be desirable from the viewpoint of the economic cycle to maintain dividends or employment. At first blush, this argument seems to have considerable force, but upon analysis, I find it unpersuasive (except possibly as to companies with sharply variable earnings).

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[47] See e. g., *Eastern Railway and Lumber Co.* (12 T. C. 869 (1949)); *Southland Industries, Inc.* (5 T. C. M. 950 (1946)).
[48] See, e. g., *J. L. Goodman Furniture Co.* (11 T. C. 530 (1948)).

In the first place, it is clear that the great bulk of the dividend distributions come from publicly owned corporations. For example, in 1952, 1953, and 1954, at least two-thirds of the total dividend distributions were paid by corporations listed on the New York Stock Exchange.[49] Such companies, as I have pointed out above, are rarely influenced by section 531 so that the discontinuance of dividends during a downward phase of the cycle by corporations which are allergic to this section would not be particularly significant. Similarly, the greater part of industrial payrolls is paid by corporations which are not influenced by the penalty section and it seems unlikely that a company which had distributed dividends under the threat of 102 would maintain employment during a depression period merely because it had withheld distribution in the earlier period.

Finally and perhaps most important, expansion and retrenchment whether of employment, capital investment, or dividends, depends to a far greater degree upon the psychological environment than it does upon the provisions of the tax law. Speaking generally, businessmen will expand or retrench, depending upon what they think the prospect is. If they feel that the promise for the future is bright, they will go forward, otherwise not. I do not say that the penalty section plays no part in the decision of individual companies. I have already indicated that it does play a significant part in the decisions of some companies, but overall, I doubt whether the penalty section produces any important effect on the business cycle. The section, in the case of those companies which are particularly allergic to it, does tend to prevent as large a reserve against contingencies—the hoard against the proverbial rainy day—as the owner-managers would like to have, but even here I find it difficult to believe that many companies have been forced into bankruptcy because they distributed dividends under the threat of section 102. I know of no such company.

(c) *Does the penalty tax stimulate the acquisition of small businesses by larger ones and thus tend toward the concentration of business enterprises, that is, do smaller companies tend to be absorbed by larger ones whether by exchange of stock*[50] *or by purchase for cash?*

(While such acquisitions would tend to the concentration of business, they would not necessarily stifle competition—they might in fact have the opposite effect.) Here my personal experience and observation lead to an affirmative answer, but with a qualified "yes." In many cases the penalty section was only one of several factors which induced the owners of the company to merge with or sell out to another company. In some cases, the owners were getting old or tired or their health was failing and they wanted to take it easy and let someone else assume the major burden of running the business. Either they had no children competent to run the business or if they

[49] In 1952, 1953, and 1954, total dividend distributions approximated 9.1, 9.4, and 9.9 billion dollars, respectively. Council of Economic Advisers, Report on Economic Indicators, 24 (June 1955). Dividend distributions by corporations listed on the New York Stock Exchange for this period were approximately 5.97, 6.2, and 6.8 billion dollars, respectively. Research and Statistics Department of New York Stock Exchange, Estimated Aggregate Amount of Cash Dividend Payment on Stocks Listed on the New York Stock Exchange.

[50] Where the acquisition is by an exchange of stock, the capital-gains tax may be avoided.

did, such children were disinclined to follow in the footsteps of their fathers. Still other sellers wanted what they thought would bring additional security as the result of merging with a stronger firm. Still others were concerned about the problem of paying death duties and wanted the marketable security of a publicly owned corporation in preference to the unmarketable stock of a closely owned corporation. There were still other personal reasons for selling out such as an irreconcilable split between two families who equally owned a business. I do not personally know of any case where the sole motivating factor behind the sellout to a larger company was the penalty tax. Similarly, I have known of liquidations—in the sense of the business being discontinued—which were influenced in part by the penalty section but none where the liquidation was dictated solely by it. In this connection, it may be noted that there has recently been a flood of mergers and other combinations of publicly owned corporations which are ordinarily not affected by the threat of section 531. Nevertheless, it is my belief that the charge that section 531 tends to cause mergers and sellouts, that might otherwise not have taken place, is to an appreciable extent justified.

(*d*) *Does the tax otherwise thwart the judgment of corporate management?*

As I have indicated above, I do not think that it does in the case of publicly owned corporations. In the case of corporations which are particularly susceptible to the penalty, that is, closely owned corporations, it does often affect the judgment of the owner-managers. Apart from impelling them to actions that already have been mentioned, such as undertaking expansion, it stimulates debt rather than equity financing (although this is also stimulated by the fact that interest on debt is deductible whereas dividends on stock are not). Profits may legitimately be used to reduce debt but a redemption of stock in preference to dividend distributions is suspect. The section also, in a number of instances, has caused artificial juggling to reduce apparent liquidity. Thus cash (or the equivalent) would be reduced in year-end balance sheets through heavy purchases of material or supplies or through relaxation of efforts to collect outstanding accounts receivable. I also feel that the tax in the case of a large number of closely owned corporations has spurred the companies into adoption of pension and profit-sharing plans and the granting of certain fringe benefits to employees. However, it is dobutful whether such artificial manipulation is widespread. Most successful businessmen are businessmen first and tax avoiders second. Still another and undesirable effect of the section is that in some instances it keeps surplus funds uninvested. If surplus funds are invested in securities of other corporations—not controlled by the taxpayer corporation—this tends to negate the argument that they are needed in the business. Accordingly, many companies keep their idle funds entirely in cash or Government bonds.

Among minor criticisms of the section are—

(1) That it acts as a deterrent to funding depreciation. (This criticism hardly seems valid in view of the fact that depreciation is allowed as a deduction and thus can be funded free from the accumulation penalty tax as well as from the income tax itself.)

(2) That the section is sometimes used as a threat by revenue agents to club a taxpayer corporation into agreement on other issues. (This happens often enough to justify the criticism.)

(3) That because of the section of some industrialists have shifted from domestic to foreign operation. (This has not happened to a degree of any consequence. Where there has been such a shift, the likelihood is that it has been impelled by a tax holiday in the foreign jurisdiction. Moreover, the present policy seems to be to encourage foreign investment so that criticism to the extent that it is warranted at all would not apply currently.)

(4) That companies threatened with the tax are loath to contest it because of possible harmful publicity. (Like the second minor charge mentioned above, there is something to this criticism, but it does not occur often enough to be significant.)

(5) That enforcement of the penalty varies with locale and, it may be added, with revenue agents. (Here, too, there is justification for the criticism, but, short of an examination of each vulnerable corporation by some central agency, this infirmity cannot be avoided.)

III. Effect of the Ordinary Income Tax on Certain Expenditure Policies

There can be no doubt that, when the corporate income-tax rate is as high as it now is, it will have a significant effect on deductible expenditures for expansion, business promotion, and goodwill development and on such items as employees' life insurance, sick benefits, pension and profit-sharing plans, executives' expense accounts, and charitable contributions. At a 52-percent rate, certain expenditures become prudent which might otherwise be imprudent. A deductible dollar costs only 48 cents and tax-oriented business judgment is an inevitable consequence of this disparity. If a dollar costs only 48 cents, that frequently makes it worthwhile to do things and take risks which perhaps might not be done if the full dollar cost were incurred. I used to think that this was bad,[51] and I still do to the extent that it costs smaller and weaker companies more to do these things and take the risks than it does the big companies.[52] However, I am coming around to the view that if the graduation of the corporate tax is eliminated, a high rate of corporate tax is not altogether bad since it tends to stimulate such activities as sales promotion, research, and new product development and these activities, in turn, generate jobs and income.

On the other hand, corporate income taxes, like all other taxes, tend to become a cost component. Management is interested in how much will be left for the stockholders after taxes, and they will, so far as they can, fix their prices at levels which will produce a desirable return for the shareholders. Thus, while the tax may spur employee benefits, and other deductible expenditures of the character mentioned above, thus increasing consumption and investment, it will also tend to increase prices and decrease dividend distributions, thus decreasing consumption and investment.

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[51] See Rudick, The Effect of the Excess Profits Tax on Business, Proc. National Tax Association, 405–409 (1951).

[52] A corporation which pays only a 30-percent rate (the first $25,000 of taxable income is subject to this lower rate) incurs a net cost of 70 cents for every deductible dollar spent while a corporation which is not making any money at all incurs the cost of the full dollar.

(I think it is clear that if we are to achieve expanding stability and stable growth in our economic system, we must adopt measures which at the same time encourage investment and increase consumption. Investment and consumption must grow together; they must mesh. When they do not, the probable result is either an unhealthy inflation or a debilitating deflation.)

While, as I have indicated above, a high rate of corporate income tax is not an unmixed evil, I believe that when the budgetary situation indicates that tax reduction is in order, the corporate rate should share in that reduction. I further believe that graduation in the corporate rate should be eliminated and that the resultant saving in revenue should be applied entirely to a further reduction in the rate of corporate tax.

In any event, it is apparent to at least one observer of corporate management that the high rates of corporate income tax have acted as a powerful spur to deductible expenditures such as those mentioned earlier, i. e., business promotion, pension-fund contributions, charitable contributions (which are often a form of business promotion), and so forth.

The remarkable growth in the number and size of employee pension and profit-sharing plans is to a very important extent attributable, in the judgment of many, to the fact that high tax rates made he cost of contributions relatively low.[53] Until the last 2 or 3 years, charitable contributions by publicly owned corporations or by corporations with potentially unsympathetic minority stockholders, were not materially increased by the high corporate income-tax rates for a number of reasons, the principal one of which was fear of successful stockholder attack. Lately, however, modernization of local corporation laws and enlightened judicial sanction has removed this impediment in most jurisdictions and many of our large corporations have established company foundations to which they annually contribute far greater amounts than they could have dreamed of doing a decade ago.[54] In fact, it begins to look as if a significant part of the cost of financing higher education will be assumed by big business.[55] It is fairly certain that charitable contributions by such corporations would have been smaller had the tax rates been lower.

It is also reasonably certain that research expenditures have been materially increased as a result of high tax rates. Prior to 1954, a large part, perhaps even the greater part, of such expeditures was,

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[53] The number of insured pension plans, i. e., plans administered by insurance companies, increased from 10,050 at the end of 1949 to 15,730 on December 31, 1953. The number of noninsured pension trusts administered by banks and trust companies increased from 1,930 at the close of 1949 to 4,890 at the end of 1953. Factors Affecting the Stock Market, S. Rept. No. 1280, 84th Cong., 1st sess. 93 (1955). In 1948, corporate contributions to employee benefit plans (all industrial groups) amounted to $1,153,499,000; in 1952, the latest year for which Treasury figures are available, the contributions aggregated $3,182,260,000. See Statistics of Income for 1948, pt. 2, p. 94, table 3; 1952 Preliminary Report, pt. 2, p. 6, table 1. At the end of 1954, pension funds not administered by insurance companies totaled $11.2 billion while pension funds administered by insurance companies totaled $9.8 billion. New York Times, October 12, 1955, p. 45.

[54] The Manual of Corporate Giving, National Planning Association, Washington (1952); Ruml and Geiger, The Five Percent, National Planning Association, Washington (1951); see Progress and Problems in Corporate Giving, 25 Investor's Reader, 1 (1955); corporate giving by industrial groups in 1939 amounted to $30,730,000; in 1948, to $239,337,000, and in 1952, the latest year for which Treasury figures are available, to $398,579,000 Statistics of Income for 1939, pt. 2, p. 72, table 3; Statistics of Income for 1948, pt. 2, p. 94, table 3; 1952 Preliminary Report, pt. 2, p. 6, table 1.

[55] See Summary Report of Conference on Corporate Contributions to Higher Education, Council for Financial Aid to Education (1955).

theoretically, not deductible currently, but it is probable that in practice only a small percentage of research expenditures was capitalized. The current tax law specifically permits such expenditures to be deducted currently.[56]

Liberality in the expense account allowances of corporate executives and the provision of certain other perquisites of employment such as free vacation facilities are other concomitants of high corporate tax rates. Here, however, the high individual rates of tax also play an important role: where the corporation can absorb expenses which the employee might otherwise have to defray personally, e. g., the use of a company car—there is nothing necessarily illegitimate in such practice—he has received a highly desirable prize.

Like the other items mentioned under this heading, advertising outlays and other sales-promotion expenditures have been increased by the impetus of the high corporation income-tax rate.[57] So too have capital-asset acquisitions—plants, machinery, patents, etc.—where the cost of the acquisition can be written off over a relatively short period. Thus, a tremendous amount of industrial construction has been fostered by the special 5-year amortization allowance with respect to plants and installations which can qualify as an "emergency facility."[58] Although there are no statistics as yet, it is probable that the accelerated depreciation provisions enacted in 1954 have provided an important impetus to the acquisition of depreciable property. The effect of the corporation tax on expenditures of this character will presumably be covered by another paper.

IV. Conclusion

The penalty tax on corporations improperly accumulating earnings must be kept in the statute. Its complete abolition, suggested by some, would provide a gateway to wholesale tax avoidance and is simply not thinkable. The provisions imposing the tax are admittedly not ideal: on the one hand, the touchstone (and now the measure) of liability is subjective and therefore difficult to ascertain, and on the other hand, the law is not effective enough in reaching its prime target. Nevertheless, the present provisions are better than nothing. The 1954 amendments are obviously designed to allay the fears of corporate owner-managers. But they are not an unmixed blessing. Heretofore the administrators of the law, because the tax was imposed on all the undistributed income, had to assert an extremely heavy penalty or none at all and hence they were generally inclined to give the taxpayer corporation the benefit of the doubt. Now, however, the tax is only imposed on that part of the accumulation which is found to be unreasonable and since the potential area of disagreement as to what is a reasonable amount is much larger than the single question of whether there was a reasonable accumulation, the amount of litigation under the section may be increased rather than decreased. In other words, a revenue agent, no longer required to impose a severe penalty, if any, may be less inclined to respect the sincerity and judgment of the

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[56] Sec. 174

[57] Advertising expenses by corporations (all industrial groups) in 1948 were $3,465,984,000. Statistics of Income for 1948, pt. 2, p. 94, table 3. For 1952, the latest year for which statistics are available, they amounted to $5,026,771,000. 1952 Preliminary Report, pt. 2 p. 6, table 1.

[58] Sec. 168. Certain grain-storage facilities are also eligible for the 5-year amortization subsidy. Sec. 169.

owner-managers and more inclined to substitute his own judgment of what is reasonable, knowing that the penalty can be much more modest.

While the new provisions with respect to the burden of proof should prove helpful to corporations whose protestations of good faith are well founded, they are not likely to materially reduce the vulnerability of corporations without any real defenses. Moreover, the shifting of the burden to the Government in certain situations may result in a much more careful scrutiny of the taxpayer's business records than the corporation would welcome.

Some years ago,[59] I concluded that the problem of unreasonable accumulation would be better solved by a return (with corrective modifications) to the provisions of the early laws which imposed no tax on the corporation but under which the shareholders of the corporation found guilty of the condemned purpose were taxed individually on the undistributed income of the corporation. Despite some administrative difficulties, I think it would be worthwhile to again try this approach to the problem.

As to the effect of the ordinary tax on corporate expenditures for items such as sales promotion, pension fund contributions, and the other items mentioned above, there is not much to be added. Obviously, tax-oriented judgments are more common under a 52 percent rate than they would be under a 35 percent rate and less common than under a 65 percent rate. That the high corporate tax rates have induced the establishment and growth of pension funds cannot be doubted, nor can it be doubted that they have been responsible to a significant extent for the willingness of large corporations to aid the financing of higher education. These phenomena have disturbing aspects as well as beneficial ones, but the discussion of the pros and cons of growing pension funds and the financing of higher education by big business is far outside the scope of this paper.

I conclude that a high corporate rate, providing it is not too high, is probably a neutral factor; i. e., it stimulates as much economic activity as it curtails. Naturally what is too high will vary with circumstances. In an economy influenced by high defense and other expenditures by the Federal Government, a rate may be tolerable which would not be tolerable were we able to afford, without prejudice to our security, a very materially reduced Federal budget. The present 52 percent rate (30 percent on the first $25,000 of taxable income) is plainly not unbearable, neither is it comfortable, and I would hope as I indicated earlier that when tax reduction is vouchsafed us, the corporate rate should not be completely left out in the cold.

THE OVERALL IMPACT OF THE CORPORATE INCOME TAX

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1. Has the Corporate Income Tax Limited Corporate Growth and Reduced Willingness To Undertake New Ventures?

The question may be taken in two parts: First, as referring to the expansion of established corporations; and second, as referring to new

[59] Rudick, op. cit., supra, note 2, p. 218. In the light of current conditions, I would modify some of the criteria then suggested.

businesses. The answer cannot be made categorically nor derived statistically for either group. No one knows to what extent decisions to start new businesses, to discontinue old businesses, or expand established businesses are influenced by taxation. Presumably rational men deduct the tax on net income when estimating the return to be expected from capital investment. Certainly they review the effect of the tax on past operations and attempt to forecast its effect upon the return to be derived from reinvested earnings or new financing. Presumably they weigh these past or expected returns against the risk involved and compare them with known or prospective returns in alternative fields of investment. And yet businesses are launched, abandoned, and expanded for other than purely financial reasons. A venture may be undertaken to create a job for one's self or friends or relatives or to satisfy an irresistible urge to create or compete. An existing firm may be liquidated because the operator dies and his heirs prefer leisure to labor. A going concern may be enlarged to gain prestige, to give battle to a hostile competitor, or—as with a public utility—to expand because it must, whether profitable or not. Sideline enterprises known in advance to be losers may be entered deliberately to establish deductible losses.

We have no data by which these imponderables can be tested. We have ample data to prove what everyone knows, namely, that the American economy and its corporate sector have expanded during the same decade that corporate income taxes have increased. Gross national product is twice that of 1945. There are 20 percent more business firms in the United States today than there were in 1946. Business expenditure for new plant and equipment will be over three times as great in 1955 as in 1945. Total corporate assets, exclusive of banks and insurance companies, are 50 percent greater than in 1946. Dollar totals of security registrations with the Securities and Exchange Commission were $3 billion in 1945, have averaged $7 billion per year since, were $9 billion in 1954. The record of corporate securities issued for new capital is even more impressive; $1 billion were offered in 1945, $6 billion in 1954.

Although several of the factors responsible for our corporate growth since 1940 have undoubtedly been modified by the impact of both individual and corporate income taxes, the effect of those taxes has probably been less significant than cursory analysis might indicate. Certain facts can be cited to confirm this view. The favorable treatment of capital gains, especially during this period of corporate growth, has encouraged individuals to invest. The ability of a corporation to expand from depreciation, depletion, and amortization accruals, all of which are tax-free, accounts for an important percentage of their growth. When these accruals are added to retained earnings the total is greater than the net increase in corporate assets during the period. Implicit here also, among other imponderables, are such factors as inflation, anticipated or real, large Government expenditures, and general business optimism. The shifting and incidence of the income tax, a problem that has recently been reexamined by economic theorists, is also pertinent, although beyond the province of this paper.

More important for our immediate purpose than the fact of corporate growth or our speculation as to its extent if corporate income had been taxed differently or less severely is the long-run effect upon the

financial health of the business population. Are corporate financial structures sound? A tax that places a premium upon debt financing and penalizes equity financing is a tax that encourages corporations to indulge in unwise practices with respect to the management of their asset and capital structures, the management of their income and reserves, and the determination of dividend policy. These policies and practices, if ill-advised, may court future disaster for themselves, their creditors, and the entire economy.

The basic distinction between equity and debt, between owners and creditors, is deeply imbedded in the capitalist system. All capital, in fact, is divided into two kinds: that which is owned and that which is borrowed. The law recognizes the distinction by sanctioning different types of contracts for savers and owners and provides for the different treatment of each during bankruptcy and corporate reorganization. The several States have enacted legislation providing for the control of the investments of banks, insurance companies, and certain trust funds; until recently modified these investments were restricted to debt contracts and equity issues were excluded. The distinction is evidenced in the free capital market where there are different rates of capitalization for the anticipated return on shares and the contractual return on bonds. Cyclical fluctuations in business are accompanied by the different behavior of stock and bond prices.

In the interest of sound financial policy, as well as the investor, securities whose provisions operate to evade the distinction between equity and debt should not be issued. The dividing line between stockholders should be redrawn sharply and kept clear in the future. Convertible and warrant-bearing bonds are examples of investment hybrids that blur this line. Convertibility and detachable warrants, in the vernacular of finance, are "sweetening" devices, designed to attract, if not to seduce, the conservative investor. They combine two elements that do not mix: investment and speculation. The speculative element becomes profitable for the purchaser, if at all, at just the time when it becomes unprofitable for the company to have him exercise his privilege. The holder of such an issue will assert his rights when the company's stock, which he is privileged to obtain by converting his bond or cashing his warrant, could be more advantageously offered by the corporation to the outside market. This problem receives further attention in the pages that follow.

2. How Significant Are the Provisions Relating to (a) Loss Carryovers and (b) Capital Recovery in This Respect?

(*a*) The carryover provisions permit a corporation to carry a net operating loss back 2 years and obtain a refund on taxes paid or to carry the loss forward and charge it to net operating income for as many as 5 years. Established corporations must apply the carryback first to the first year preceding the loss year, then to the second; they may then carry any remaining balance forward to the first year following the loss year, then to the second, and on to the fifth year or until the loss is absorbed. New corporations realizing losses during their first year carry the loss forward for 5 years.

(*b*) Under the 1954 act a corporation may elect to recover a greater percentage of the cost of a capital asset in the earlier years of its useful life. Two methods, both modifications of traditional straight-

line depreciation in favor of accelerated depreciation, are permitted: the declining balance method, and the sum-of-the-year-digits method.

Referring again to (*a*), loss carryover is designed to reduce the risk attendant upon investment. By it, Government shares in investment losses as well as gains; the device aims to answer the "heads I win, tails you lose" objection to the tax on business profits. But to obtain the full advantage of this provision there must, of course, be gains to which losses can be carried. Furthermore, nonoperating or other income, if the corporation enjoys such, must be reduced by losses realized in the same taxable year, thus reducing the amount of the carryover to operating gains in future years. If corporate management realizes, first, that losses are cushioned only by gains and, second, that gains must be cushioned, if at all, by losses, the provision can hardly be expected to stimulate the incentive to invest. Investors would hardly finance a new venture on the promise that its managers planned to operate at a loss during the third year in order to obtain the 2-year carryback.

Conclusive evidence on this point does not exist although the findings of an extensive investigation of taxation and business incentives are available.[1] Professor Butters reports that—

> by and large, the tax structure appears to have had only a relatively limited and specialized impact both on the basic incentives which motivate the private economy and on the structure of this economy. The effects of the tax structure on the aggregate levels of employment and real income realized over the last 10 to 15 years have been even more limited, as is obvious from the record levels achieved in both employment and income during this period.[2]

His further statement that "taxes are more likely to determine how a thing is done than they are to determine what or whether an action is taken" supports the thesis of this paper, viz, that taxation affects financial policy more than it affects decisions to launch business ventures.

Questions pertinent to the Butters-Lintner conclusion concerning the tax stimulus to business investment are raised by Professor Heller of the University of Minneosta.[3] He, with all who are interested in the problem, would like to know "how widely businesses and investors have availed themselves of the tax bonuses given for certain acts, such as building plant, buying equipment, conducting research and so on" and whether "(*a*) having achieved tax savings by taking advantage of the new provisions, did businesses use the funds to increase dividends, investment, working capital, or what?" (for one of the "whats" we suggest the retirement of long-term debt) and (*b*) "* * * did the incentive of liberalized or preferred tax treatment elicit a greater flow of investment than would otherwise have occurred?" The answer to the last question will be ventured in advance: "not a greater flow, but the same flow, into different channels, different types of securities, different industries."

Accelerated depreciation, if corporations adopt it, will reduce their profits and increase their accumulations. Although not immediately relevant to the question before us, it may also affect their cost ac-

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[1] See papers by J. Kieth Butters and John Lintner, titled respectively "Taxation Incentives and Financial Capacity" and "Effect of Corporate Taxation on Real Investment," Papers and Proceedings of the 66th Annual Meeting, American Economic Review, May 1954, pp. 504, 520.

[2] Ibid., p. 505.

[3] Appraisal of the Administration's Tax Policy, Walter W. Heller, National Tax Journal, March 1955, pp. 18–19.

counting and therefore, possibly, their prices. Companies changing from straight-line to declining-balance depreciation have already reported that their income taxes are lower and their cash positions are stronger. That this was to have been expected can be readily perceived by noting that the depreciation of an asset with no salvage value and a life of 20 years would, for the first year, be 5 percent of the cost of the asset under straight line, 10 percent under declining balance, and 9.52 percent under the sum of the year-digits method But unless the company is continually adding new depreciable assets the advantage of acceleration becomes less each year and the results could prove to be embarrassing in the future.

The new venture is rare that can begin business with its market full-blown. As sales and output increase unit costs decline and profits rise. Under the declining balance method the just-organized company would take 10 percent depreciation the first year but by the 10th year it would depreciate the same assets only 3.87 percent. Its taxes would therefore increase as the result of declining out-of-pocket expenses and lower charges for depreciation. Unless obsolescence justified replacement or sales required expansion of plant and equipment any benefit to the firm from fast capital recovery would be short-lived. Furthermore, since higher taxes are to be faced each year, the depreciation reserve becomes, in effect, a reserve for the payment of those taxes unless the firm is willing to charge taxes to each year's operations, thus reducing its net income and compelling it to pay lower dividends as the tax depreciation benefit is reduced. To keep this reserve, or any reserve, invested while it is not needed and have it available when it is needed is a neat financial trick, one that few firms are staffed to perform. To employ depreciation for expansion or working capital purposes is to run the risk of being unable to obtain other financing when the occasion arrives for spending the reserve for its intended purpose. Tax relief should not take the form of an inducement to change time-tried and value-proven financial practice. Depreciation should be related to the individual firm's experience with physical wear and tear, not to tax relief during its developmental period.

3. Has the Tax Affected Significantly the Financial Policies of Corporations as a Whole?

Competent observers are unanimous in agreeing that the corporation income tax, as levied, has been responsible for the increase in corporate debt. Bond interest is deductible from net income while dividends on common and preferred stocks are not. Therefore, by trading on its equity the corporation pays lower taxes and enhances the per share earnings on its stock. When the two results of such borrowing are expressed in terms of (*a*) the interest burden and (*b*) the percentage earned on net worth the dangers inherent in the upward trend of debt financing become apparent. Before considering these dangers specifically certain financial facts will be set forth.

(i) Internal sources of corporate capital are revealed by the following data:

[Billions of dollars]

Year [1]	Profits before taxes	Profits after taxes	Cash dividends	Undistributed profits
1945	19 0	8.3	4 7	3.6
1950	40 0	22 1	9.2	12 9
1955	42.5	21.2	10 7	10.5

[1] Quarterly at annual rate.

Depreciation, deducted as an expense from gross income, is another source of capital funds. This item increased from $5.3 billion in 1946 to $11.8 billion in 1953.

(ii) Outside financing, as obtained by new corporate issues, was as follows:

[Millions of dollars]

Year	Bonds and notes	Common stock	Preferred stock
1945	4,855	397	758
1950	4,920	811	631
1954	7,488	1,213	816

(iii) Earnings and dividends per share of common stock for three corporate groups were as follows:

[Dollars per share]

Year	Industrials, 125 stocks		Public utilities, 24 stocks		Railroads, 25 stocks	
	Earnings	Dividends	Earnings	Dividends	Earnings	Dividends
1945	$2 72	$1.75	$1.72	$1.30	$4 30	$2.19
1950	8 45	3 77	2.62	1 76	7 36	2.50
1955	10 90	5 00	3 10	2.23	8 95	3.42

(iv) Yields to investors in the above issues are indicated by the following:

[Percentages]

Year	Industrials		Public utilities		Railroads	
	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks
1945	2 68	3 99	2 89	4 99	3 06	5.51
1950	2 67	6 51	2 82	5 66	3 10	6.50
1955	3.18	3 63	3 22	4 32	3 32	4.77

(v) The combined capital structures of industrial, public utility, and railroad corporations, expressed in percentages, were as follows in 1950:

	Industrials	Utilities	Railroads
	Percent	*Percent*	*Percent*
Long-term debt	13	41	38
Preferred stock	6	9	8
Common stock	29	35	26
Surplus	52	15	28
Total	100	100	100

Source: Guthmann and Dougall, Corporate Financial Policy, 3d edition, 1954, p. 214, compiled by the authors from Statistics of Income for 1950 and Statistics of Railroads in the United States, 1950.

Reference to the above paragraphs in the ensuing arguments will be for illustrative purposes only. Data based upon such large totals, while rough, is useful in pointing up overall effects and relationships.

Corporate profits after taxes increased from $8.3 billion to $21.2 in the 1945–55 period (par. i.), an increase of 155 percent, cash dividends increased 128 percent, and undistributed profits 178 percent. Obviously, those responsible for the management of corporate income decided to grow from within and pay out a smaller percentage of the profits to stockholders. At the same time, when they did elect to seek outside financing they resorted to debt issues in large amounts, offering $7,488 billions of bonds and notes in 1954 and only $1,213 billions of common stock.

Retained earnings are not tax free to the corporation but they are to the stockholder if he keeps his stock. Presumably his book value per share increases in direct proportion to the retained earnings; to the extent (and no one knows to just what extent) that the market gives effect to the greater book value, the holder has a paper capital gain. If he cashes this gain it will be taxed at 25 percent. Therefore the corporation accommodates its high-bracket stockholders by issuing stock dividends or splitting the stock. It seems significant that the industrial group, with a much smaller ratio of debt to equity capital, has distributed a much smaller percentage of their net earnings than the public utilities (par. iii.).

A corporation that trades on the equity successfully can earn more on its net worth and could pay higher dividends than one that does not. A simplified example will illustrate the principle, as well as the risk, of employing "cheap capital." John Jones needs $100,000 to launch a venture and persuades Peter Smith to invest $40,000 in the enterprise and incorporate. Jones contributes $10,000 and his patented idea and borrows $50,000 at 4 percent interest to complete the capitalization.

The company grosses $20,000, has operating expenses of $8,000, pays the $2,000 interest, and nets a profit of $10,000 upon which it pays the corporate income tax of $3,000. John and Peter can share $7,000 on their $50,000 investment, a return of 14 percent. Peter, accustomed to capitalizing returns on investments of this sort at 8 percent, values his stock at $70,000 and is well pleased. But in a lean year sales drop $4,000 and operating expenses only $1,000. Taxes drop to $2,100 but interest remains at $2,000 and John and Peter realize only $4,900 on equity, a return of 9.8 percent. Peter thinks his stock is now worth $21,000 less than before, knows that it has yielded $1,680 less, and takes John to task at their next stockholders' meeting, suggests that he improve his management or resign.

Multiply the above example by 10 or 100 and the gains and the risks of employing cheap capital become apparent. The principle is the same when millions of dollars of bonds and thousands of stockholders are involved, except that the fixed percentage taken by the corporate income tax is 52 percent when income exceeds $25,000. Since 1950 total dividends paid have been greater for the heavier borrowers. Electric and gas utilities paid $52.3 million in 1950 and $85.6 in 1954, an increase of 63 percent; for railroads the increase was 29 percent, for manufacturing companies 6 percent, and for those engaged in trade 2 percent.

As could have been expected, many corporations have turned to convertible bonds during the present high-tax period. Anxious to trade on the equity, and obtain the advantage of deductible interest, but faced with rising bond yields as the bull market for stocks continued, appeal to the conservative investor has taken this form. But the market has also behaved as would have been expected, and has paid more attention to the conversion value than to the coupon rates or the investment value of these securities. Convertible bonds, as this is written, have declined with the stock market; by contrast, orthodox senior issues have strengthened as equities have sold off. Corporate financial management augments its own risks by injudiciously issuing convertible bonds. Conversion, when exercised, dilutes the common stock equity, perhaps at just the time when the company would prefer to continue trading on the equity or would, if it could, continue the tax advantages of debt financing. And certainly, if the company uses convertibles for refunding instead of new capital purposes, it is losing control over its own equity-to-debt ratio. The writer regrets that data is lacking showing the volume of convertible and warrant-bearing bonds that have been offered during the current high-tax, high-earnings period.

While data is not at hand to prove the point or measure its significance, tax-free interest can be said to be of little or no advantage to small companies, or even larger ones that are still in the developmental stage. Unable to borrow or float debt issues they must earn 10 percent on their capital in order to net 7 percent, more if their income exceeds $25,000. They must grow, if at all, by withholding earnings that have already been taxed. Even after they can show a record that would impress outside investors they are likely to be confined to equity financing and prevented from obtaining "cheap" capital for a considerable period.

Owner-control is a related consideration. There are two ways to control a corporation: (1) By the ownership of a majority of the votes and (2) by a deliberate dispersion of voting power among many shareholders. Small companies employ the former; large "public" corporations use the latter. Both incline toward retained earnings for expansion purposes and both are influenced to do so by the corporate income tax. Each does so, however, with a different effect upon corporate financial policy. The large company that retains its earnings, the "growth" company, will use stock dividends and stock splits to obtain more stockholders, each with fewer shares, to gain control for a smaller percentage of the holders. To be well dispersed the shares must be low priced, low enough for small taxpayers to afford. But when this has been accomplished, if proxy fights are

to be avoided, dividends must be regularized, made to appear generous. If management adopts a policy of establishing a rate that it thinks it can pay and tries to maintain that rate, rain or shine, the administration of its net income becomes a much different problem. The dividend equalization reserve may become as important as deferred liabilities or depreciation in the life of such a company.

4. Have the Dividends-Received Exclusion and Credit Provisions Had a Significant Impact on Corporate Financing?

The dividend-received tax credit and exclusion provisions, enacted as part of the Internal Revenue Code of 1954, have been applicable only since July 31, 1954.

These provisions are designed to alleviate the double taxation of corporate earnings. Dividend-paying stocks should become more attractive to investors because of the higher net yield after taxes although this will be conditioned by the direction of corporate dividend policies. It should also result in decisions to engage in more equity financing. In terms of investor incentives the credit provision should prove to be more significant than the exclusion provision.

The Treasury estimated that the dividend exclusion would reduce revenue by $46 million and the dividends-received credit by $158 million in the fiscal year 1955, a total of $204 million. Because of the recent high rate of dividend payments, however, a somewhat higher estimate might now be made. The loss to the Treasury is, of course, a gain elsewhere in the economy although the nature and amount of that gain may differ from the amount of revenue reduction.

The exclusion of the first $50 of dividend income yields a tax saving on that amount at the individual's tax-bracket rate. If the taxpayer already owns stocks that pay $50 or more per year he gains nothing from the exclusion provision by acquiring more dividend-paying stocks. Investors who received little or no dividend income now will probably remain indifferent to stock investment. While some investors at the margin may, of course, be attracted by the exclusion, the increased demand from this source for equity securities is unlikely to be large.

The credit provision is of greater significance. Four percent of the amount of corporate dividends received (beyond the $50 exclusion) can be subtracted from the individual's tax. This permits a moderately attractive tax saving for lower bracket incomes that include dividends beyond the amount of the exclusion, and a very marked savings in percentage terms for dividend recipients in the higher brackets. An individual in the 20-percent bracket who receives $100 in dividends subject to this provision will retain $84 instead of $80, an increase of 5 percent. An individual in the highest tax bracket (91 percent) who receives an additional $1,000 of dividend income would have paid, before the credit, taxes of $910 and retained $90. After the credit, however, his retained income is increased by $40 (4 percent of the $1,000) and becomes $130, an increase of almost 45 percent.

Whether this will result in increased equity purchases cannot be foreseen definitely. Certainly the provision is a positive rather than a negative one and definitely favorable to the market for corporate shares. A tax benefit of this kind tends to be capitalized and this in-

creases the prices of corporate stocks. Moreover, the psychological impact of this provision, if the market regards it as a step toward the eventual removal of "double taxation," may also be capitalized. If the market for equity securities is strengthened by these tax provisions, corporate management will be more likely to consider equity financing. It is safe to conclude, although impossible to prove, that the dividend-received tax credit and exclusion provisions of the present tax law favor dividend income and are thereby conducive to some shift by corporations from debt financing to equity financing. For the investor, these provisions would also further the shift toward equities.

ECONOMIC IMPACT OF THE CORPORATION INCOME TAX

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The corporation income tax is at the present time our second most important source of Federal revenue. First introduced as an excise on corporate profits, in 1909, this tax became a permanent part of the Federal income-tax structure in 1913. Up until the time of the Second World War, the corporation tax was imposed at relatively low rates. Levied at 1 percent in 1913, the rate was quickly moved up to 12 percent during the First World War; and it remained at approximately this level until it was boosted to 15 percent in 1936, and to 19 percent in 1939. By 1942, however, the rate applicable to ordinary corporate profits had been raised to 40 percent. The rate was reduced to 38 percent for a short period after the war, but was lifted to a new high of 52 percent during the Korean crisis. The corporation tax was scheduled to be reduced to 47 percent early in 1954, but this reduction has twice been postponed—first, to January 1, 1955, and then to January 1, 1956. Consequently, we still have in effect today a levy which takes over half of the profits earned by any corporation in excess of $25,000. At present income levels, the tax yields close to $20 billion annually, and accounts for about 30 percent of the Federal Government's total budget receipts.

It goes without saying that this tax has had a considerable impact on the practices and policies of American corporations. Many of these effects have already been discussed in other papers. Over the past 15 years the tax has also had considerable impact on corporate profits available for distribution or reinvestment. Although corporate profits before tax rose from $9.6 billion, in 1929, to $34 billion, in 1954, or by 240 percent, corporate profits after tax rose from $8.3 billion to $18.9 billion over the same period, or by only 103 percent. In 1929 the ratio of corporate profits before tax to national income was 11 percent; in 1954, it was 11.3 percent. But over the same period, the ratio of corporate profits after tax to national income fell from 9.4 to 6.6 percent. The higher spread between profits before and profits after taxes at the present time is, of course, a reflection of the rise in corporate tax collections. It is with the collection effects of the tax that we shall be primarily concerned in this paper.

But before we can attempt to appraise the effects which the collection of a 52 percent levy on corporate profits is having upon the growth and stability of the economy, we must consider the difficult question of

tax incidence. What do we know about the incidence of the corporate tax? Is is borne by the stockholders? Or is shifted in whole or in part onto the customers and employees of the corporation? Unfortunately, these are not questions which can be answered very precisely; nor can we be sure that the best answers we can give to them today will be equally good answers at some later time. But if we are careful to explain the sense in which we use the term "incidence," we can advance a number of propositions to which most economists would subscribe.

What Do We Know About the Incidence of the Corporation Income Tax?

The term "incidence of taxation" is one which has been used in a number of different senses. Some students of taxation, when they tackle the problem of incidence, are attempting to determine on whom the more immediate burden of the tax rests. Others, however, are concerned with the manner in which the burden of the tax is finally allocated as among various groups in the economy. The former may be said to be concerned with the initial incidence of the tax, and the latter with its ultimate incidence or effects. The concept of initial incidence includes only the short-run effects of the tax on profits, wages, and prices. The analysis focuses on the short-run price and output decisions of the individual firm. The purpose of the analysis is to determine where the tax will rest after all adjustments to it have been made except those which would require changes in the size of existing fixed plant and equipment, or in technology. On the other hand, the concept of ultimate incidence embraces the long-run as well as the short-run effects of the tax. The analysis of incidence, when the term is used in this sense, takes into account the adjustment of capital investment to the tax, and the broad economic effects of the tax on aggregate employment and the level of income. In this case the question being asked is where the tax comes to rest after the scale of fixed plant and equipment, the number of firms and their form of organization, and technological methods, have been fully adjusted to the new economic conditions which follow the imposition of the new or increased tax.[1]

The initial incidence of the corporation-income tax has been actively debated by economists and businessmen for a good many years. In the midtwenties, when the Colwyn committee was holding hearings in Great Britain in connection with its report on national debt and taxation, it was told by economists that the tax could not be shifted, and by businessmen that they could and did pass it on. Similar differences of opinion may be found today; but there is more general agreement concerning the circumstances under which shifting is and is not possible.

The view that a tax on net income cannot be shifted in the short run is substantially correct under assumptions of competitive conditions. In a competitive market, the firm that raises its prices above those of other firms will lose its customers. Consequently, even though a successful firm may want to pass on a tax imposed on its net profits, it

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[1] For a more complete discussion of these points, see Goode, Richard B., The Corporation Income Tax, New York, 1951, ch. 4.

cannot safely do so unless less successful firms are prepared to take the same action. But since the less successful firms will have smaller tax liabilities, and since the least successful ones may well have no income tax to pay, uniform action on the part of all firms is very unlikely to occur. Only if the tax falls on some element of short-run cost, is it likely to affect the supply of a product produced under competitive conditions. Virtually all short-run costs are, however, allowed as deductions in computing statutory net income under the Internal Revenue Code. Consequently, supply will not as a rule be affected by a tax on net income, and prices will not rise.

In an oligopolistic market, however, the situation is somewhat different. Here the individual firm can vary its prices without having to fear the loss of the bulk of its customers. Even in this case, however, it may be argued that it will not pay an oligopolist to raise his prices in an attempt to recoup the tax if he was previously charging a price which maximized his profits by equating marginal revenue with marginal cost. At this point the added cost of producing one more unit of output is assumed to be equal to the additional receipts to be derived from the sale of this additional unit. In other words, if it is assumed that businessmen always seek to maximize their profits, and that they generally succeed in doing so, even in an oligopolistic market there would be little incentive for tax shifting in the short run.

Some students of business contend, however, that many business firms, and especially the larger ones, do not operate on the principle of profit maximization in terms of marginal costs and revenues, but instead set standards or targets of reasonable profits.[2] Firms which have a substantial monopoly position for their products may aim, it is said, at limited rather than maximum profits in order to discourage potential competition, to restrain wage demands of organized labor, or to maintain customer good will. Or management, which typically has a small financial interest in the modern corporation, may want to limit profits in order to maximize its own benefits. So-called standard profits may be set with reference to (1) what it takes to attract outside capital, (2) what earnings are needed to finance planned expansion, or (3) what the company or comparable companies have normally earned. If the objective of a firm is to maintain standard profits in any of the above senses, an increase in the corporate rate might well induce shifting. Moreover, in any situation where profits could have been increased by raising prices before the higher taxes were imposed, it would be possible for prices to be nudged higher by an increase in the tax rate. Only in rare cases, however, would complete shifting be possible.[3]

To the extent that the initial incidence of the corporation income tax is on the stockholder or the corporation itself, the tax will of course reduce the rate of return on corporate investment. Moreover, to the extent that statutory net income on which the tax is levied includes certain fixed costs, the tax itself becomes a cost which business firms will ultimately have to recoup through higher prices. For example, although contractual interest charges are deductible in arriving at taxable income, no provision is made for the deduction of

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[2] See Dean, Joel, Management Economics, New York, 1951, p. 29.

[3] For a discussion of some of the obstacles to tax shifting in oligopolistic markets see Shoup, Carl S., Incidence of the Corporation Income Tax, the Journal of Finance, June 1951, p. 193.

the noncontractual interest return on invested capital. Consequently, it is generally agreed that, in the long run, a portion of the tax is shifted forward to consumers, and that a somewhat smaller portion is shifted backward to wage earners. As a result of the lower rate of return on corporate investments, and the effect that it is likely to have on the amount of real investment being made, it is believed that consumers pay more for products requiring large amounts of capital in their manufacture than would be the case under a lower tax. On the other hand, the smaller the amount of real investment over any period of time, the lower is likely to be the productivity and the wages of the individual worker.

The extent to which the corporation income tax can be shifted in the long run depends of course on the effect which a reduction in net profits after taxes has on the supply of equity capital. The general opinion seems to be that profit is rather compressible over the long period, and that a universal tax applicable to the dominant form of business enterprise does not greatly affect the general supply of capital, even though it may have some relative price effects as between different areas of enterprise. Furthermore, if the corporate rate is increased at a time when profit expectations for the future are rising, the higher taxes may have very little dampening effect either on the supply of equity capital or on the volume of investment. On the other hand, there are circumstances under which it will be relatively easy for corporations to pass on corporate tax increases, such as during the Korean boom of 1950–52, when most firms found themselves in a strong sellers' market.

Although it is generally agreed that a portion of the corporation income tax is shifted in the long run, we know very little about the way in which the ultimate incidence of the tax is actually distributed among stockholders, consumers, and wage earners. Some economists estimate that as much as 50 percent of the tax has been passed on; but others suggest that the percentage of the tax borne by stockholders is much higher.[4] Unfortunately, making informed guesses is about the best we can do at present, since very little empirical research has been done in this area.

Assuming that a considerable portion of the corporation tax has been shifted forward to consumers since the end of the Second World War, will it be likely to stay shifted in the event of a recession more serious than those which we experienced in 1948 and in 1953? Conditions since the war have been peculiarly favorable for forward shifting, but if the going should get harder, will competition force a squeezing down of profit margins? If it does, the impact of a 52 percent corporate rate on investment may turn out to be more severe than the record of the past decade would indicate that it has been thus far.

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[4] In a study of the distribution of total taxpayments by income groups which was made a few years ago, it was assumed that one-third of the corporation income tax was shifted forward, and that one-eighth was shifted backward. These particular ratios represented "the most likely set of assumptions" with which the authors of this study thought that they could work at the time. See Musgrave, Richard, et al., Distribution of Tax Payments by Income Groups: A Case Study for 1948, National Tax Journal, March 1951, p. 16.

What Is the Significance for Federal Tax Policy of Different Assumptions With Respect to This Incidence?

The conclusions we reach or the assumptions we make with respect to the incidence of the corporation income tax have an important bearing on Federal tax policy. If, for example, it is assumed that a substantial portion of the tax is shifted either forward or backward, the need for giving stockholders relief from their so-called double tax burden is much less serious than it would be if we were to conclude that the tax fell exclusively upon them as the owners of the enterprise. Similarly, a shifted corporation income tax would presumably be much less of an impediment to investment than one which could not be shifted, but it would have a more significant impact upon consumption. Consequently, if the objective of Federal tax policy is to stimulate investment, the choice of instrument would depend to a considerable extent on the assumptions made with respect to incidence. To the extent that the corporation tax does not fall directly on corporate stockholders, individual income tax rate reductions would seem likely to be more effective in encouraging investment than corporate rate reductions. On the other hand, if the policy objective is to bolster consumption, a corporate rate reduction that would be passed on to consumers in the form of lower prices might be regarded as highly appropriate.

Although most of the recent criticisms of the corporation tax appear to have been based on the assumption that it falls almost exclusively on the stockholders, it would seem that an equally good case against the tax could be made on the opposite assumption that it is largely passed on. A corporation income tax that is in effect a concealed sales tax would conflict with two basic and generally accepted principles of taxation—those of equity and overtness. If it is agreed that the persons who actually pay a tax should be aware of the fact that they are doing so, and that tax burdens should be distributed in accordance with some accepted criterion of taxpaying ability, a shifted corporation tax must be viewed as a very poor tax. This is further evidence that the conclusions reached concerning the incidence of this tax are significant for tax policy.

Finally, the assumptions which we make concerning the incidence of the corporation tax should influence our choice among alternative methods of reducing the relative importance of this tax, should we decide that we could afford to make a move in this direction. If, for example, it is assumed that a considerable portion of the tax has been shifted, it would not be particularly appropriate to lighten it by granting relief directly to stockholders. This would be giving them credit for taxes which were in fact being paid by other persons. The fact that there is still considerable uncertainty regarding the way in which the burden of the corporation tax is being distributed would seem to suggest that the method adopted for reducing its relative importance should be one which would give the corporation itself the maximum opportunity to allocate the tax savings as it saw fit. Such a policy would increase the likelihood that consumers and wage earners, as well as stockholders, would receive their appropriate shares of the relief afforded.

While our uncertainty concerning the ultimate incidence of the corporation tax makes it a difficult tax to defend, from a purely pragmatic standpoint this also makes it a difficult tax to give up. So long

as businessmen think that a large portion of the tax is being paid by consumers, and so long as consumers and wage earners think that it is being paid by the stockholders, all three groups are likely to press less strongly for corporate tax reductions than they are for reductions which they believe will more directly benefit them. At a time like the present, when our revenue needs are very great, a tax that is both productive and relatively painless cannot be easily discarded.

Would Reducing the Importance of the Corporation Income Tax Affect the Stabilizing Capacity of the Revenue System?

The Federal revenue system is at the present time quite responsive to changes in the level of employment and income. When income and employment decline, as they did between July 1953 and July 1954, the drop in tax receipts is proportionately greater than the fall in income. This means, of course, that the expenditures being made in the private sector of the economy do not have to be cut back as sharply as receipts from production are falling, and that total effective demand will not shrink as rapidly as it otherwise would. It is because of this that the revenue system may be said to serve as an important automatic stabilizer.

Because of the sensitivity of corporate profits to changes in the level of economic activity, and because of the high rate at which most corporate profits have been taxed, the corporation income tax has accounted for a large part of the stabilizing capacity of the Federal revenue system in recent years. Between July 1953 and March 1954, employment in nonagricultural establishments fell by 2.9 percent, and industrial production dropped by over 10 percent, but corporate profits before taxes fell by 17.7 percent. Over the full 12-month period from July 1953 to July 1954, when personal income derived from production was falling at an annual rate of $4.4 billion, corporate income was decreasing at an annual rate of $7.4 billion. The decline in personal taxpayments which was attributable to the decline in personal income derived from production was about $1 billion, but the decline in the tax liability of corporations which was attributable to the drop in corporate profits before taxes was $4.5 billion.[5]

As the President pointed out in his January 1955 Economic Report:

> Had it not been for this reduction of taxes, it is unlikely that corporations would have increased their dividend payments at an annual rate of $300 million during this period, thus bolstering the flow of personal income. Nor is it likely that they would have maintained their capital expenditures at so high a rate, thereby supporting the Nation's income base.[6]

Therefore, there can be little doubt that reducing the importance of the corporation income tax would reduce the stabilizing capacity of the Federal revenue system. But this does not necessarily mean that we are precluded from making adjustments in the corporate sector of this system. The present high rates were imposed in order to raise the revenue needed to finance heavy defense costs. The stabilizing effects of these high rates has been a welcome byproduct which we shall presumably want to give up as soon as our revenue needs become less pressing. On the other hand, in considering the desirability of tax policies which would reduce the importance of the corporation

[5] See January 1955 Economic Report of the President, pp. 14–18.
[6] Ibid., p. 21.

income tax and increase that of other components of our revenue system, we should not overlook the fact that none of the other principal sources of Federal revenue would be able to contribute as much to the cushioning or dampening of any deflationary or inflationary forces which may develop in the economy.

Although any reduction in the importance of the corporation income tax would seem likely to reduce the stabilizing capacity of the Federal revenue system, it should be observed that a lower corporate rate might contribute to the overall stability of the economy in other ways. For example, to the extent that a high corporate rate encourages corporations to increase the proportion of debt in their capital structures, this tends to accentuate cyclical instability. It has also been argued that a high corporate rate, especially if it is in excess of 50 percent, makes corporations less inclined to maintain strict controls over their expenditures in good times, and less determined to resist demands for wage increases which exceed current increases in labor productivity. To the extent that these arguments have validity, a reduction in the importance of the corporation income tax would, of course, make some contribution to overall economic stability.

Would Compensatory Increases in the Yields From Other Taxes Result in a Tax System More or Less Repressive on Overall Economic Growth?

One of the most serious charges which have been made against the corporation income tax as a major source of Federal revenue is that it represses the growth of the economy. At first glance this might not appear to be a very significant point since all taxes are by nature repressive. Their function is to curb spending in the private sector of the economy so as to release resources for public use without a rise in prices. But the complaint against our high-rate corporate tax goes further than this. It is based on the conviction that different taxes tend to curb different kinds of private spending, and that the corporation tax excessively curbs a type of spending that is essential for continued economic growth. This, of course, suggests that compensatory increases in the yields from other Federal taxes would be less repressive. The complaint also rests on the assumption that the corporation tax is borne in large part by the corporation itself, or by its stockholders.

What are the necessary ingredients of economic growth, and to what extent is it true that the corporation tax is more repressive than alternative sources of Federal revenue? In his 1955 Economic Report, the President pointed out some of the things which we must do if we are to realize the growth potentials of our economy. Businessmen must be actively engaged in starting new enterprises and in expanding old ones. The tools of industry must be multiplying and improving. Research and technology must be opening up new investment opportunities. Encouragement must be given to enterprise and innovation. But the President recognized that balanced economic growth depends on more than expanding investment opportunities and the incentive to exploit them. Growth also depends on rising educational levels, improved work skills, widely distributed income levels, and an eagerness on the part of consumers to improve their living standards.[7]

[7] Ibid., p. 3.

A heavy corporation tax that is borne by the corporation or by its stockholders undoubtedly does discourage the starting of some new enterprises, or the expansion of old ones. It also makes the financing of growing firms out of retained earnings more difficult. Ventures which may be expected to yield attractive rates of return before taxes look much less promising when it is realized that this return may be more than cut in half by the tax collector. Thus the tax chokes off before they are born enterprises which might make significant contributions to the Nation's growth. Similarly, the owners and management of existing concerns may be held back from a decision to expand by a tax rate which promises too little in the way of an added return for the sacrifices and risks that are involved. Finally, a tax which takes over 50 percent of the net profits of a successful enterprise necessarily cuts down very sharply the ability of such firms to finance expansion from internal sources. In a number of ways the corporation tax could, therefore, be curbing a type of expenditure which is closely associated with economic growth.

This charge against the corporate tax is, however, hard to reconcile with the level of plant and equipment expenditure which has been maintained since 1950. New construction of commercial and industrial structures jumped from $5.7 to $7.2 billion between 1950 and 1951, and has continued to rise steadily since then. The seasonally adjusted annual rate for the second quarter of 1955 was $9.8 billion. Investment in producers' durable equipment rose from $21.1 billion in 1950 to $24.4 billion in 1953. During the 1953-54 recession, investment in this form dropped to $22.3 billion; but by the second quarter of this year, the seasonally adjusted annual rate was again up to $23.7 billion. A recent survey of business investment programs for the last 2 quarters of 1955 indicates that if present plans are fullfilled, new records in capital spending will be established.[8] Thus there is little or no evidence that aggregate business investment has been significantly curbed by the high taxes on corporate profits.

There are, of course, a number of possible explanations for this. For one thing, as we have suggested above, this has been a particularly favorable period for tax shifting, and those corporations which have been able to take advantage of this fact have simply not felt the full weight of the tax. Second, it may well be that a high corporate rate is less of a deterrent to investment than one might suppose it to be. Given a high and steadily rising level of consumer demand such as we have been enjoying in recent years, with the impact this has had upon sales and earnings, the pressure on businessmen to expand their plants and to improve their equipment may have been strong enough to overcome the tax pressures which would have held investment down under less buoyant conditions. The fact that many facilities built or acquired during this period could be amortized for tax purposes over a 5-year period also served to lighten the impact of the high corporate rate on private investment. But conditions so favorable to tax shifting and business expansion cannot be expected to last indefinitely without a break, and steps are already being taken to limit the types of facilities which will be eligible for rapid amortization in the future. Consequently, the fact that the 52 percent corporate rate does not appear to have repressed business investment

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[8] Survey of Current Business, U. S. Department of Commerce, September 1955, p. 2.

over the past 5 years is no guaranty that it will not do so under somewhat less favorable circumstances in the future.

If we were to reduce the relative importance of the corporation income tax in the Federal revenue system without any sacrifice of total revenue, any one or more of several types of compensatory action would be required. Individual income tax rates could be raised or personal exemptions could be lowered. Alternatively, we could increase the rates or broaden the coverage of the existing system of excises.

An increase in individual income tax rates, to the extent that it reduced the disposable income of persons to whom business now looks for equity capital, would probably reduce the supply and availability of such funds. Individual income tax rates in the upper-middle and top-income brackets are already higher than they should be from the standpoint of promoting an optimum rate of growth. On the other hand, it is unlikely that rates could be raised in the lower brackets without some increases in the middle and upper brackets, especially if these rate increases were made necessary by a lightening of corporate tax burdens. While the great majority of individual income taxpayers who are found in the lower income brackets might be willing to accept in principal the wisdom of some deemphasis of the corporation tax, they are not likely to support such a move if it is going to mean an absolute increase in their own tax burdens without commensurate increases all the way up the scale.

Lower exemptions, or increased reliance on consumption taxes would not be as likely to have a repressive effect on investment unless their impact upon disposable income and consumer spending was sharp enough to affect adversely the sales and profit expectations of businessmen. There can be no doubt that one of the major factors behind the present boom is the high and rising level of consumer demand for goods and services. If at the time that corporation taxes were reduced, compensatory increases in individual income taxes and in the excises caused consumer demand to drop off, it may be questioned whether the net effect on investment would be favorable or unfavorable. The outcome would depend upon the size of the compensatory increases that would be needed, and the chance of a favorable outcome would be greatest if the shift was made gradually under conditions of rising income and output. Under such circumstances a considerable part of the revenue loss resulting from lower corporate taxes would be offset by the effects of economic growth.

To the extent that the corporation tax has been shifted, and to the extent that any reduction in the corporate rate would be passed on to consumers in the form of lower prices, the effect of giving the corporation tax a less important role in the Federal revenue system would be less significant from the standpoint of the growth of the economy. If the compensatory increases fell mainly on consumption, the effect of these increases would tend to offset the effects of the corporate rate reduction; but if they fell on savings the net effect might be adverse to the maintenance of an expanding scale of investment.

If the Corporation Income Tax Were To Be Reduced in Importance Relative to Other Components of the Federal Tax System, How Might This Be Done, and What Would Be the Advantages and Disadvantages of Each?

There are a number of ways in which the importance of the corporation income tax could be reduced in the Federal tax system. The first, and perhaps the most obvious way would be to reduce the corporate rate. As we have seen earlier, the present 52-percent rate came into effect during the Korean crisis as an emergency measure, and at the time it was enacted Congress also made provision for a subsequent reduction. There is a good deal to be said for reducing the rate to a percentage somewhat under 50 percent. While businessmen may not be spending their 48-cent dollars any more freely or carelessly than they would spend 52-cent ones, and while giving them a somewhat higher equity in their profits might not have an appreciable effect on their investment and employment decisions, getting the rate down below the split-even point would appear to be sound policy. The principal disadvantage of a modest rate cut at this time would seem to be its cost; and to the extent that we can absorb that without raising other taxes elsewhere, this would not seem to be a major objection.

On the other hand, a sharper rate reduction at a time when individual income-tax rates were being held at roughly their present levels would be open to the objection that retained profits would be taxed too lightly in relation to distributed profits, thereby giving closely held corporations a greater incentive to retain earnings than they now have. Moreover, a flat-rate reduction would be considerably more expensive in terms of revenue than a form of relief that was limited to distributed earnings.

A second method of reducing the importance of the corporation income tax, and of lightening its impact upon stockholders, would be to give at least a partial deduction for dividends paid out. This would, of course, be a move in the direction of placing stockholders in somewhat the same position as bondholders taxwise, since interest on corporate debt is now fully deductible for tax purposes. One advantage of this approach would be that it would cost less than a flat-rate reduction. Even if the effect of a dividend credit was to induce firms to pay out a larger portion of their earnings, the effect that this would have on corporate tax receipts would be offset to a considerable extent by increases in individual income-tax receipts. A second advantage would be the fact that a dividend credit would reduce the incentives for debt financing, and would thereby contribute to a better balance between debt and equity in corporate capital structures. Its principal disadvantage would be that it would make the corporation tax completely or partially a tax on undistributed profits. This might make it more difficult for small growing firms to finance their expansion out of retained earnings. Not only would they be under greater pressure to distribute their earnings in order to minimize tax liabilities, but of the funds retained a very high percentage would continue to have to be paid to the Government.

A third approach to corporate tax problem would be the so-called withholding approach under which the stockholder would have imputed to him both the dividend which he had received and the corporation tax paid on the corporate income from which the dividend was de-

ceived. Actually, this approach is not so very different from the dividend credit approach, although it would be less likely to be regarded as the equivalent of a tax on undistributed profits. Consequently, the withholding approach would presumably be more acceptable to those persons who believe that tax pressures for profit distribution would retard economic growth. A major objection to the withholding concept in the minds of some students of taxation is that "it really goes too far and in effect ignores corporations as separate taxable entities." [9] It has been pointed out that under this approach income distributed to tax exempt institutions or individuals would escape tax altogether, regardless of the profitability of the corporation, since the Treasury would be required to make cash refunds in those cases where the "withheld tax" was in excess of the tax liability of the individual or institutional dividend recipient.

A fourth approach to the corporate tax problem, and the one which was adopted by Congress in the 1954 Revenue Act, is to give the individual dividend recipient a tax credit with respect to dividends received. For example, under the present law, the individual taxpayer may deduct from his tax liability an amount equal to 4 percent of the dividends he has received. The principal advantage of this approach would appear to be its simplicity. Its principal disadvantage, on the other hand, is that it does not come as close as do the other approaches to distributing tax relief in proportion to the present overburden of the corporation tax on individuals at different income levels if it is assumed (1) that the tax is borne by stockholders, and (2) that there would be no overburdens if individual stockholders could be treated in the same way as the partners are in unincorporated enterprises.

The choice between these alternative methods of reducing the relative importance of the corporation income tax in the Federal revenue system is clearly not an easy one to make. Each of the approaches to which serious consideration has been given has its disadvantages as well as its advantages. From the standpoint of providing the maximum investment incentive, and at the same time of making as sure as we can that the persons being relieved are those who are bearing the tax, the dividend credit method would seem to rank somewhat ahead of the other methods; but this is, of course, still a debatable issue. We have still a good deal to learn concerning the incidence and effects of the corporate tax before we can be sure of the impact it is having on the economy or of the best ways of making certain that this tax will not become a barrier to sustained economic growth.

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[9] Dan Throop Smith, Two Years of Republican Tax Policy: An Economic Appraisal, National Tax Journal, March 1955, p. 9.

XIII. TAXATION OF SMALL BUSINESS

TRENDS IN INDUSTRIAL CONCENTRATION

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The Joint Committee on the Economic Report has posed the general question whether the present tax structure may be affecting the degree of concentration, i. e., the extent to which the business of the Nation is carried on by a relatively small number of enterprises; otherwise stated, the question whether relatively smaller enterprises are tending to account for more and more, or for less and less, of the national product. So wide and basic a question must, of course, be analyzed into a great many component questions, one of which is to examine what has happened to the pattern of concentration in recent years. Of course, whatever trend exists may not be due to the tax structure; it may indeed exist despite it, and would be stronger if the tax system were different. But, as a first preliminary step, an examination of concentration for its own sake seems necessary.

CONCENTRATION DISTINGUISHED FROM SIZE

Concentration is not the same thing as size. It is a relatively simple matter to ascertain the number of employees, or amount of assets, etc., of any given business concern. (The amount of sales, the most popular measure, is by all odds the poorest.) But we usually cannot do much with this kind of information. An establishment or a firm with, say, 200 employees is very tiny in the chemical manufacturing industry but very large in the retail food distribution industry. Furthermore, what is large at one time may be considered small at another. This is especially true when we are considering dollar figures, which increase both because of general price-level increases and because of increases in productivity all along the line.

This is not to say that information on size is useless. On the contrary, it may be important. For example, it is generally true that the smaller the firm selling securities in the capital market, the higher the costs of securing a dollar of proceeds. But this is interesting chiefly as an explanation for whatever tendencies we observe in relative size distribution, i. e., in the degree of concentration. What we propose to do is to look at trends in concentration before World War II as a background for what has happened since. At this stage, the best we can do is to ask what change in trend, if any, seems apparent—whether any deflection is visible as we pass from one period to the other. That is how we would expect to see any impact from the present tax structure.

Concentration in the Whole Economy, or in "All Manufacturing"

Much attention has been paid in the past to such figures as the percent of all corporate assets, or of all national wealth, held by the largest 200 (or some other small number) corporations in all lines of industry. So far as we can tell, this share increased in the late 1920's, and was very possibly increasing earlier. Since the early 1930's, it has declined substantially. This fact is not as significant as it sounds, since about half of this group consisted of the holdings of public utilities—railroads, electric power, telephone, etc. Because of the Public Utility Holding Company Act of 1935, there was a really massive deconcentration in this sphere, amounting to about $16 billion—at current prices, it would be more. But since this deconcentration resulted from the action of Congress, it can hardly serve as evidence of any strictly economic trend. Hence we are thrown back on the nonutility sphere, and in practice, this means the manufacturing industries, where the great bulk of large businesses and concentrated industries are to be found. So far as all manufacturing is concerned, it would appear that since 1931 (the first year for which reliable figures are available) there has been a small downward trend. Thus, in 1931, the largest 139 manufacturing corporations held not quite 50 percent of all assets; in 1947, they held 45 percent; in 1951, about the same.

Measurements of such very broad areas as all manufacturing are certainly of some interest, but it is limited. For example, increasing concentration might have come about even though in every industry there was decreasing concentration (and vice versa). The reason is that the more concentrated industries might have been growing faster. Or it might be that the larger industries which had the larger business concerns were growing faster, even though they might be no more concentrated than average. From a statement that concentration in manufacturing as a whole was increasing or decreasing, it would be impossible to draw even the most limited and tentative conclusions as to what was happening in any particular line of industry. For this reason, measurement of concentration in the economy as a whole, or in manufacturing as a whole, should in my opinion be regarded as of secondary interest. Back in the early 1930's, there were some visions of the largest 200 companies taking over 70 or 85 percent or even more of the economy by the early 1950's; that, at least, can be safely dismissed, but there is little else to say on the subject.

Concentration Over the Half Century

The kind of concentration measure to which we pay most attention today is one which takes one industry at a time. "Industry" may of course refer to a relatively wide or narrow group. Using the coding system of the standard industrial classification, we have, for example, the two-digit industry, No. 20, "Food products." Within this broad grouping, we have the three-digit industry, No. 201, "Meat products." Within this, we have the four-digit industry, No. 2011, "Meatpacking, wholesale," the five-digit industry, No. 20111, "Fresh beef," and so on. This breaking down by industries serves two purposes. One is obvious—the closer we get to separate industries, the closer we get to

actual markets and market behavior. This does not mean, however, that each "industry" is a market, in the sense that it sells a fairly well-defined group of products which have little substitution from other industries. But obviously we have come a great deal closer, at least, to actual markets when we have the industries divided that finely.

The other advantage to industry-by-industry treatment is the technical statistical reason that the greater the number of subdivisions, the less the chance of the total figure being dominated by irrelevant regroupings from one industry to another. This was explained previously, when referring to the limited usefulness of very broad groupings like "all manufacturing."

It has been possible to set up industry divisions for the period around 1900—from 1895 through 1904—and measure concentration there by the so-called concentration ratio. This ratio is the percent of industry sales accounted for by the largest four concerns in the industry. Comparison is then possible with later years, as follows: Around 1900, 33 percent of all value added by manufacturing was produced in industries where the concentration ratio was 50 percent or higher. In 1947, only 24 percent of all value added by manufacture was in industries where the concentration ratio was 50 percent or higher. This would appear to indicate a substantial reduction in concentration of manufacturing over a 50-year period. One must, however, treat these figures with reserve because the data for the early period was gathered from a motley group of sources—good, bad, and indifferent. There is no reason to suppose that, on the average, they tended to be too high or too low; but there is always the possibility that it happened that way.

This agrees with general impressions. There were quite a few industries around 1900 where the largest company was much bigger, relative to the industry, than it is today—steel, oil, farm machinery, distilled liquors, sugar refining, meatpacking, etc.

A comparison has also been made between the years 1935 and 1947, in somewhat different terms. Only 130 industries (out of a total of 450 four-digit industries) were comparable as between these 2 years; the average concentration ratio declined slightly over 12 years. This decrease was caused, so far as we can make out, by the faster growth of less concentrated industries. It was not due to all or most industries tending to become a little less concentrated.

Finally, we may mention some studies of profits and growth in assets during wartime, which show smaller companies more profitable, and increasing faster, than large.

What this all adds up to is nothing spectacular. It might be characterized as creeping deconcentration. It certainly did not promise to remake the size structure of American business. It is important mainly as a taking-off place for more recent developments.

Postwar Tendencies in Concentration

In two important respects, the world in which business enterprise must live is different from what it was before the last war. The first is the very high level of corporate and individual income taxation. The second is the Government guaranty of high employment. In part, these two facts are interrelated. That is, the sheer size of the Government expenditure is an element of stability because it means

that a large fraction of the total national expenditure—which is another way of saying the gross national production—is decided by Congress, and is not subject to the vagaries of the business cycle. Perhaps more important is that no government in the free world, including our own, will tolerate anything remotely resembling the unemployment of the 1930's. Real controversy exists over implementing the policy—how much unemployed labor and capital is tolerable, at what point the Government ought to take action, etc. But no more depressions like the 1930's is an important fact, and the knowledge of this stability is also an important fact.

Now, the high level of taxation works in one direction, high employment in the contrary direction. As to high employment: The swings of the business cycle bear harder on the small firm because it is inherently less diversified; it depends on fewer products, fewer distribution channels, fewer key personnel. Small firms are the ones which show the greatest scatter of profits, from highest to lowest. Hence a change in the economic weather affects them more strongly. Furthermore, their small size puts them in the position of the gambler with a small bankroll. He may have a good system for winning on the average, but he cannot win all the time, and unless he has something to fall back on, he is more easily wiped out by a run of bad luck. It is the insurance principle, and a large diversified company is a self-insurer.

We have some very thorough studies of the relation between size of corporation and rate of profit during the depression years 1931–36; and in every industry group in every year, the larger the enterprise, the better the profit showing—even though "better" often meant only smaller losses. But for the years 1937, 1939—both far from real prosperity—and 1942, there is little if any such relationship. In some industries, the tendency appeared to be for larger firms to earn more; in others, the other way. Unfortunately, we have nothing for later years, and this is indeed a glaring statistical deficiency, one of many. But at least it can be said that removal of the threat of depression is more favorable to the smaller firm, and therefore is a tendency toward deconcentration.

High levels of individual and corporate income taxation, however, work in the other direction, for reasons set forth in detail by Mr. Lintner. An established concern, which has taxable income, can take a chance of losing money it puts into expansion of its present activities or a venture into new lines; if it succeeds, the Government will take half the earnings; if it fails, the Government will in effect make up half the loss. In contrast, a new firm keeps half the gains, but stands all the losses. Year in, year out, this cannot but be an influence—although we cannot say with assurance how strong—toward greater concentration. Reinforcing it is the high taxation of individual incomes. Stockholders in the high income-tax brackets are not anxious to receive dividends which will mostly go to the Government, and they would rather see the earnings plowed back and reinvested than to take them out and look around for a different enterprise, possibly a small one, to put their money into. Finally, it is the small firm which depends most heavily on retained earnings for its growth, and has least access to the capital market, and must pay higher costs of money.

Postwar Statistics

It had been hoped that this statement could present the results of some recent research into concentration trends. Unfortunately, they were not available in time to meet the committee's deadline. It is not beside the point, however, to warn of the dangers of simply projecting past tendencies out into time, and supposing that a creeping deconcentration up to the early postwar was continued afterward. The above thumbnail sketch of forces working for and against greater concentration should indicate that a deflection of the trend in either an upward or a downward direction is entirely plausible. My own findings will cover concentration among corporations by the large two-digit industry groups; this has the advantage that the corporation is the taxpaying unit. A much larger body of data will be made available by the Census Bureau late next year or in early 1957, on concentration trends in the four-digit industries, with a given corporation of course showing up in as many industries as it participates. I hope that the Census Bureau will be able to make full use of the large amount of basic information which it will have gathered; this depends on the funds available, which of course is for the Congress to decide.

I do not know what this forthcoming data will show. If the prewar trend seems to be continuing, perhaps the Congress will not wish to look any further, on the ground that even if the tax structure is contributing to greater concentration—as it probably is—something else is operating to offset this. But if the trend is horizontal, or shows actually increasing concentration, then the committee may well wish to look further into the matter, and that is where we will run into real trouble. For example, there is practically no information on the relative profitably of large and small concerns—as indicated earlier, the last large-scale study is 13 years old. I have referred throughout to the position of big business in the economy; the financing of small business remains one of the chief dark spots in the research picture. There is no use laboring the point; we may establish the existence of a trend in concentration, but we have not even begun on the job of tracing the why of any such tendency, still less the specific influence of the tax structure. The general considerations mentioned earlier are no substitute for careful studies of the asset structure of enterprises large and small, growing and stable, incorporated and nonincorporated; studies by size class in absolute and in relative terms; studies by identical groups to trace their varying fortunes through the recent past. The impact of taxation must be put into this more general picture, but so far we are not even started on drawing it.

RAISING VENTURE CAPITAL FOR SMALL AND NEW BUSINESS

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The impact of the Federal income tax upon the birth and development of small and new business has for many years been a matter of concern to the Congress. For the most part attention has been devoted to the rate of tax upon the business itself, with the result

generally that some measure of relief from the high corporate-tax rates has been extended. For example, in the recent excess-profits-tax law a ceiling was imposed on the rate of tax applicable to new businesses. And at the present time the corporate-tax rate applicable to the first $25,000 of corporate income is limited to 30 percent whereas all additional income bears a 52-percent tax, a reduction amounting to $5,500 a year if the company has at least $25,000 of income.

Perhaps the most serious problem of most small and new businesses is the raising of capital to satisfy their financial needs. If the Federal tax law is to be molded so that to the extent practicable it tends to foster the development of these businesses, a serious look must be taken at the provisions of the tax law that bear upon the raising of venture capital for closely held corporations. This requires a study not merely of the tax status of the corporation but—more significantly—that of the persons supplying the capital. What is their tax position under the present law? Does the Federal tax law deal with such persons in a manner calculated to facilitate or encourage the flow of venture capital to these companies, or does it interpose difficulties and obstacles which should be removed or modified?

When a business seeks venture capital one is likely to find that it is already incorporated or the parties are in agreement that a corporation is to be organized. Further, one is likely to find that in order to attract capital in a new or untried business the suppliers of the capital must be offered a portion of the common stock because only through the growth in value of that stock interest are they likely to be adequately compensated for the substantial risk assumed. Thus the problem to be dealt with is the determination of the Federal income-tax rules applicable to persons holding common stock in small or new corporations.

Usually there is no ready market for the sale of shares or obligations of such companies. They are not listed on securities exchanges, nor are they generally traded in "over the counter," nor is there reasonable likelihood that this will occur in the foreseeable future. Frequently a sale cannot be made unless substantially all the stockholders are willing to sell simultaneously in order to give the purchaser the entire interest or adequate working control of the enterprise. Accordingly, the investor is faced with the fact that if he is to recoup any substantial part of his investment before a sale or liquidation of the entire business in the distant future it must be accomplished by having the corporation repay to him all or a part of the funds advanced.

Under these circumstances, in considering whether to supply the needed funds, the investor is likely to ask: "Can the financial structure of the corporation be so arranged that I may own part of the common stock and yet, if the venture proves successful, have a substantial part of my investment repaid to me without prohibitive surtaxes?"

Then, looking on the pessimistic side, his second question is likely to be: "If the venture fails and my investment becomes totally or partially worthless, to what extent can I take a deduction on my Federal income-tax return?" The answers to these questions will frequently have a significant bearing upon his decision whether or not to make the investment.

Repayment by Corporations of Funds Advanced by Common-Stock Holders

Let us consider a typical case of a prospective small new enterprise. Mr. Jones has originated a new process which he feels can be developed successfully if adequate capital can be secured. He has put $5,000 into a new corporation and now approaches Mr. Smith with the request that Mr. Smith supply the needed funds. After investigation Mr. Smith is inclined to put up $100,000 on the basis of furnishing (*a*) $5,000 for new common stock, which would give him 50 percent of the total outstanding common stock; and (*b*) $95,000 for senior securities, i. e., bonds, notes, or preferred stock, which would rank ahead of the common-stock interest. Mr. Smith inquires of counsel whether if the business is successful and develops substantial earnings his $95,000 of senior securities can be paid off and treated by him as a return of capital without tax at that point, or whether such a payment would represent income to him taxable at surtax rates. Let us consider the problem first if his senior interest is represented by preferred stock and then if it is represented by bonds or notes.

Redemption of preferred stock

Under the Internal Revenue Code if a stockholder receives a dividend it is subjected to full surtaxes, offset to some extent by the dividend credits and exclusions enacted in 1954 (secs. 34 and 116). The law states that a "dividend" is any distribution made by a corporation to its shareholders "out of its earnings and profits"; and it further states that every distribution to stockholders is to be treated as made out of earnings and profits to the full extent that earnings and profits exist in the corporation. Thus it is not possible for a corporation simply to designate a payment made on its stock as a return of capital to the stockholders and have it treated in that fashion in the tax returns of the stockholders. The payment will nevertheless be treated as a dividend if the corporate earnings exceed the amount distributed—at least if no stock is surrendered by the shareholders in exchange for the amount distributed.

What if the shareholders do surrender stock in exchange for the amount paid out to them by the corporation? Let us first take the simple case in which there is only 1 class of stock outstanding, consisting of 100 shares and that each of the 2 shareholders owns 50 shares. Let us assume that each shareholder sells 20 of his shares to the corporation for $20,000 at a time when the corporate earnings exceed $40,000. The code provides that where the shareholders have the same percentage interest in the outstanding stock of the corporation after the surrender of the stock as they had before, a payment by the corporation in exchange for its stock will nonetheless be treated as a dividend to the stockholders if the transaction is "essentially equivalent to a dividend" (sec. 302). Under Treasury regulations long outstanding and numerous court decisions, such a transaction would undoubtedly be treated as essentially equivalent to a dividend in the absence of most exceptional circumstances, since the shareholders will each own 50 percent of the outstanding stock after the transaction, just as they did before.

Now let us suppose that the 2 individuals had each invested $5,000 in the common stock of the corporation upon its organization and

$45,000 each in its preferred stock. Thus each owns one-half of the common and one-half of the outstanding preferred stock. Can the corporation after it has earned $90,000 redeem all or part of its preferred stock pro rata so as to return that part of the stockholders' investment without the amount being taxed as a dividend? Again the answer seems to be "No," for the redemption of stock pro rata among the shareholders would doubtless be treated as essentially equivalent to a dividend.

Now let us return to the case of Messrs. Smith and Jones, where each invested $5,000 in the common stock of the corporation but in addition Smith invested $95,000 in preferred stock. Can the corporation redeem Smith's preferred stock without the redemption being treated as a dividend? Section 302 of the code provides specific protection against dividend treatment if simultaneously with the redemption of the preferred stock the corporation also redeems a substantial part of the common stock owned by that shareholder so that as a result there is a substantial reduction in his proportionate interest in the common stock. It would be reasonably clear, of course, that if the preferred-stock holder owned no common stock, the preferred stock could be redeemed from him without dividend treatment. The statute, however, does not specifically deal with the case in which a holder of both preferred and common stock has his preferred stock redeemed without simultaneous redemption of any of his common stock. The Treasury regulations have never dealt with the situation despite the many instances in which it exists and the court decisions are not sufficient to set the matter at rest. Thus under present law there appears to be considerable doubt whether those willing to risk venture capital can, after the corporation has been profitably operated, secure a return of part of their investment from the corporation by a redemption of their preferred stock without being subjected to dividend tax if they retain their proportionate interest in the common stock of the corporation.

Mr. Smith then is likely to be advised that there is a possibility that a redemption of his $95,000 of preferred stock after the corporation has accumulated earnings and profits would be treated as a dividend. Although the fact that Mr. Jones would receive no corresponding payment would provide a strong argument that the redemption would not be essentially equivalent to a dividend, there could be no assurance of this result in the present state of the law.

Repayment of loans

What, then, if the $95,000 of senior funds are advanced by Mr. Smith as loans to the corporation, represented by bonds, notes, or open account indebtedness? May the corporation repay the loans without risk of dividend tax to him?

Let us assume for this purpose that the terms of the loans would be such as to bear all the normal indicia of indebtedness—a fixed maturity date in the reasonable future, a fixed interest rate, not subordinated to other indebtedness, etc. In such a case as far as the form of the indebtedness is concerned the answer would be that such loans may be repaid to stockholders without tax to them. But in recent years a problem has been raised by a series of court decisions as to whether such loans will be recognized as true indebtedness if the amount of such loans from stockholders is large in relation to the

amount invested in stock of the corporation. Frequently referred to as the problem of "thin incorporation," this question has plagued the small incorporated business seeking to raise capital. There is no provision in the code dealing with the matter, nor have the Treasury regulations contained any enlightenment. The problem has been considered in a substantial number of court decisions with varying results. Speaking generally it might be said that the decisions to date indicate that a financial structure in which loans from shareholders are no greater than four times the amount invested in stock is likely to be upheld, though a higher ratio might be sustained in particular instances and a lower ratio would certainly enjoy a greater measure of safety. Perhaps the chief difficulty is that no reasonably clear guide is available. Furthermore, if the financial structure is finally held to be too "thin," the entire indebtedness must apparently be regarded as a stock investment, requiring disallowance to the corporation of the entire deduction for interest on the advances and leading to dividend tax to the holder if redemption of preferred stock in the same amount would have been taxed as a dividend.

The American Law Institute draft of a proposed Federal income-tax law provides a definition of the term "indebtedness" which would make the ratio of indebtedness to stock investment immaterial if the loans met certain prescribed minimum standards. For example, there would have to be an unconditional obligation to pay a sum certain in money; there would have to be a fixed maturity date; the debt could not be subordinate to trade creditors generally; interest could not be contingent in amount upon earnings and would have to be payable unconditionally not later than the maturity date of the principal amount.[1] If the loan met those minimum standards, interest on it would be deductible by the corporation and the repayment could not be taxed as a dividend to shareholders, regardless of the amount of the loans in relation to the stock investment. Failure to meet those standards would not prevent the loan from being found to represent indebtedness rather than stock investment, but in making the ultimate determination in such case all the surrounding factors, including the debt-to-stock ratio, could be taken into account.

The proposed draft of the American Law Institute represents a carefully considered effort to solve a difficult problem which besets those endeavoring to design a financial structure for a small corporation which is in need of venture capital. In reaching the conclusion that the amount of indebtedness should be immaterial if all the other earmarks of debt are present, an important factor was that under existing court decisions it appears probable that 80 percent of the capital may be furnished in the form of indebtedness in any event. There seems to be no reason to sow so much confusion in the vital area of venture-capital financing for the sake of the small revenue which could be involved as to the remaining 20 percent.

The solution suggested in the American Law Institute draft could, of course, be modified in a number of respects. But it is highly important that some reasonably clear rule be adopted in the statute so that business and investors may know what standards must be met in order to insure recognition of indebtedness as such.

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[1] A. L. I. Federal Income Tax Statute, February 1954 Draft, sec. X500 (g).

In the hypothetical case we have been considering, Messrs. Smith and Jones would probably be advised that Smith's $95,000 of senior money out of a total financing of $105,000 should not be put in entirely for bonds or notes, for the debt-to-stock ratio would then be more than 9 to 1. In the present state of the tax law some part of the senior financing should, as a matter of caution, be provided by way of preferred stock, but there is no clear guide as to how much should be handled by preferred stock and how much by indebtedness.

Deductibility of Losses

The second important question Mr. Smith will ask in determining whether or not to proceed involves his position taxwise if the business fails and his investment is lost. Will his loss be a capital loss, deductible for practical purposes only against any capital gains he may have and resulting in a tax saving at the most of only 25 percent of the loss (the maximum tax rate on capital gains); or will it be an ordinary deduction and available as an offset against salary, dividends, interest, and the like, and resulting in a tax saving at his topmost surtax bracket? The answer to this question may have a significant bearing upon his decision to furnish the capital funds required, for it will have a material effect upon the net amount of risk assumed.

The general pattern with respect to the treatment of worthless investments by individuals presently found in the Internal Revenue Code is as follows:

(1) Losses on worthlessness of stocks, whether common or preferred stocks, are deductible only as capital losses.

(2) Losses on worthlessness of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by a corporation, with interest coupons or in registered form, are also deductible only as capital losses.

(3) Losses on worthlessness of open account indebtedness of corporations or on corporate notes which do not bear interest coupons and are not in registered form—

(*a*) are deductible as ordinary deductions if the debt is created or acquired in connection with the individual's trade or business or the loss from worthlessness is incurred in his trade or business; but

(*b*) are deductible only as capital losses if not so related to his trade or business (secs. 165 and 166).

The net result of these statutory rules is that the only instance in which the worthlessness of the investment can result in an ordinary deduction against surtax income of an individual is one in which the debt is represented by open account or plain notes and the debt is acquired or the loss is incurred in his trade or business. Whether or not the debt has been acquired or the loss incurred in the individual's trade or business is a question which has caused much litigation and again has produced considerable uncertainty. Despite some conflict in the decided cases it appears probable that an ordinary deduction will be denied to an individual who does not make loans to a number of different businesses, even though he may be actively participating in the management of the borrowing corporation. Thus an individual who may have made advances to a dozen different corporations in which he is interested may be able to treat the worthlessness of one

of the loans as an ordinary deduction, whereas another individual lending money to the same corporation may have to be content with a capital loss if he cannot show the same frequency of loans to various corporations. How many loans to how many different borrowers one must make in order to constitute a trade or business is, of course, not a matter to be answered with assurance. Nor are the prospects likely to be encouraging for the average investor who engages in such transactions infrequently.

A number of alternative solutions may possibly be available in specific transactions. For example, in the case of some new businesses it may be possible to operate in the initial stages as a partnership, the supplier of the venture capital being either a general or a limited partner, until the business has passed through its initial stages of development. If the business fails in the partnership form the investor can deduct his loss as an ordinary one. But while this form of doing business may solve the tax problem, operation as a partnership form may not be suitable to the particular business and has the disadvantage that it forfeits for the general partners the safety of limited liability.

Another method, suggested by several recent court decisions, is to have the corporation borrow funds from a bank or other lender on notes which are endorsed by the individual stockholder. For example, in our hypothetical case Mr. Smith, instead of advancing personally $95,000 of financing, might arrange all or part of that financing by having the new corporation borrow the funds from a bank on the basis of his personal endorsement of the note to the bank. Several recent court decisions indicate that in that event he can take an ordinary deduction if the venture fails and he is called upon by the bank to pay off the loan.[2] But the final word on the tax effect of this method of financing has not yet been spoken by the Treasury or the courts.

A corporation furnishing venture capital for new business may use a loss on a bad debt to greater advantage. Corporations may take as deductions against ordinary income losses on the worthlessness of loans to other corporations on plain notes or on open account. The statute does not make it necessary for the corporation to show that the loan is related to its business. Corporations may also take as an ordinary deduction losses on worthlessness of bonds, preferred stock, or common stock in certain cases if they own 95 percent or more of each class of stock of the corporation, although if they own less than 95 percent the loss is a capital loss. Because of these and other differences in the treatment of debt and stock investments made by corporations, the "thin incorporation" problem mentioned above can plague the corporate investor as well as the individual.

Returning to our Mr. Smith, we find as a result that unless he is a frequent lender to businesses he is not likely under present law to obtain an ordinary deduction in the event of worthlessness of his loan to this corporation. How frequent and extensive his loans would have to be is quite uncertain. The average Mr. Smith, who may have lent money from time to time to several corporations but who is not really in the banking business, would probably be told that his status would be in considerable doubt. He would have to be cautioned about the

[2] Sec. 167 (f), inserted in the law in the 1954 code revision, provides specifically for an ordinary bad-debt deduction in certain cases involving the guaranty of a noncorporate obligation even though not related to the trade or business of the guarantor. No specific provision is made in the code as to the effect of the guaranty of an obligation of a corporation.

"thin incorporation" problem so that he would not run undue risk that his loan would be treated as an equity investment rather than debt. The procedure of guaranteeing a corporate bank loan would be suggested to him but without complete assurance that he would have an ordinary deduction if the business failed and he were called upon to make good the loan. By and large he would be faced with considerable confusion as to his tax status.

POSSIBLE STATUTORY CHANGES

The upshot of these many and varied rules is that the present Federal income tax law does little to encourage the furnishing of venture capital by private interests to small and new business. True, it does offer the possibility of selling out at a long-term capital gain with a maximum tax rate of 25 percent. But there is no ready market, such as is available for the securities of publicly held corporations, nor is there likely to be unless and until the business in the distant future has grown out of the "small and new" category and entered the ranks of the well-established successful companies.

Most of the present rules governing these matters have been designed so far as feasible to protect the Treasury revenue in the case of closely held corporations where the possibility of tax manipulation may be ever present. Certainly the avenues of tax avoidance must be adequately blocked and revenue needs borne constantly in mind. But certainly, too, some of the present unfortunate confusion can be eliminated and some modifications made to increase the chances for the small and new business to secure venture capital.

For example, at least two statutory changes might be suggested for the consideration of the committee:

1. Elimination of the "thin incorporation" problem along the lines suggested in the American Law Institute draft proposal, thereby making immaterial the ratio of debt to stock where all the other normal indicia of indebtedness are present. Funds loaned by shareholders could then be repaid to them without risk that such repayments would be taxed as dividends. While it is believed desirable to eliminate the thin incorporation problem entirely, if the Congress should determine that some limit upon the capital structure should be imposed a minimum standard which investors could follow should be specifically prescribed in the statute.

2. Adoption of a statutory rule permitting preferred stock issued for full value to be redeemed by a corporation without treatment as a dividend if the ownership of the preferred stock is substantially disproportionate to the ownership of the common stock. For example, in our hypothetical case in which Jones invested $5,000 in the common stock and Smith owned a like amount of common and, in addition, acquired all the $95,000 of preferred stock, the proposed amendment would make clear that the corporation after successful operation could redeem Smith's preferred stock without tax to him. Such a rule would probably have the collateral advantage of relieving some of the "thin incorporation" difficulties, since it would permit this result to be accomplished through use of preferred stock instead of indebtedness.

A real stimulus for venture capital investment in small business by private interests might be provided if losses on the investments could be deducted against ordinary income of the investor. For example, individuals might be allowed to deduct loss from total or partial worthlessness of loans, or perhaps even preferred and common stock investments, in certain types of small or new businesses, whether or not the investor can be shown to be in the trade or business of making such loans. This, of course, would remove the present doubt as to the extent and frequency of the lending required in order to constitute a trade or business. But it would do much more. It would establish a situation in which the investor, outside of his regular business, could furnish risk capital in exchange for corporate notes and common stock and place himself in a position to derive long-term capital gain at a maximum tax of 25 percent ultimately if the venture proved successful, and yet take at least the amount advanced for notes as deduction against surtaxable ordinary income if it proved a failure. This possibility is now available, albeit with some confusion and uncertainty, in the case of corporate investors and in the case of individual investors who can establish that they are acting in a trade or business of lending money. Whether or not this treatment should also be made available to individuals who may not be acting in trade or business may in large measure depend upon a policy decision as to the extent to which the tax laws should be molded so as to stimulate the flow of capital into small and new business. In the field of natural resources, the Congress has allowed investors in oil and gas fields to deduct as expenses most of the cost of drilling wells (the so-called intangible drilling costs, dry holes, etc.) and yet has allowed percentage depletion on wells retained and capital-gain treatment on wells sold. This treatment has clearly influenced the flow of capital funds into oil and gas drilling; it is quite likely that the corresponding treatment would quicken the flow of funds into small or new businesses.

If such a step is to be taken, perhaps some limitation should be drawn as to the size or kind of business to which it would apply. It might possibly be confined to "small" and "new" businesses. No wholly satisfactory definition of "small" or "new" business has ever been developed, nor is it likely to be. The Federal income tax law gives a lower corporate income tax rate to the first $25,000 of annual net income. Translated into terms of capital, this might suggest the possibility of making the rule applicable to those corporations having no more than a $250,000 or $500,000 capitalization, including funded debt.[3] The rule might also be limited in its application to those corporations engaged in the active conduct of trade or business, excluding those which are mere investment companies. Consideration might also be given to extending the treatment to somewhat larger capital structures where the corporations are engaged in the development of new products or processes, a fact which might be certified by some other governmental agency outside the Treasury Department as has been done in the case of amortization of emergency facilities.

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[3] Perhaps some protective device would have to be incorporated against the possible use of multiple corporations. Cf. I. R. C. sec. 1551.

Summary

The income-tax position of the individual supplying venture capital to new and small business deserves special attention in the present review of Federal tax policy. The present system has grown up over a period of many years as a series of special rules, applicable generally to corporations both large and small, old and new, venturesome or conservative. If the Nation is to preserve its tradition of economic opportunity for small business a healthy tax climate for the supply of capital must be fostered. Most of the attention given to the tax problems of small business has been focused heretofore upon prescribing a lower rate of tax for the first $25,000 of corporate income—a reduction which now amounts at the most to $5,500 annually. Equal attention must be given to the tax status of the investor himself. If as a matter of tax policy the Congress wishes to facilitate the flow of venture capital to these businesses, the current uncertainties in the tax position of the investor must be eliminated and some of the current rules modified. Recoupment of a substantial part of the investment without dividend tax must be permitted and some more favorable treatment accorded to losses. Some direct loss of revenue would doubtless result, but there would be countless offsetting advantages from the suport thus given to free and independent enterprise.

SMALL BUSINESS AND THE NONINTEGRATED INCOME-TAX STRUCTURE

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Private Versus Public Corporations

Corporations, although having common legal characteristics, are most heterogeneous as to financial size, numbers of stockholders, the nature of their business activities and the extent to which identity exists between corporate ownership and control. The so-called private or close corporations are those in which the shareholders are in effective control of the business. Thus for private corporations the corporation becomes an expression of the personality of the stockholders—their alter ego. As a personal type of business enterprise it strongly resembles in many respects the proprietorship or the partnership. It serves as an instrument to fulfill the personal, as well as the business, interests of the controlling shareholder or shareholders. Insofar as the personal interests of shareholders, as found in income-tax considerations, shape the business conduct of the corporation, important tax problems arise. These problems, on the other hand, are not present in the case of those public corporations in which there is effective separation of ownership and control. Shareholders may not influence corporate policy to serve personal interests in minimizing individual tax. Retention of corporate earnings is presumptively for legitimate corporate purposes uninfluenced by possible tax advantage to individual stockholders.

IMPORTANCE OF THE PRIVATE CORPORATION

The relative numerical importance of private or close corporations in the corporate universe is indicated, in some measure, when it is noted that, of 597,385 corporate income-tax returns (with balance sheets, and with and without net income) for 1951, 93 percent had total assets under $1 million; 88 percent had total assets under $500,000; and 79 percent had total assets under $250,000. These corporations are of an asset size which, with relatively few exceptions probably, would qualify for close identity between corporate ownership and control. On the basis of net income, corporations (returns with balance sheets) with total assets under $1 million accounted for 6 billion of a total of $45 billion, or 14 percent, of reported net income before corporate income and profits taxes. Corporations (with balance sheets, and with and without net income) with assets under $1 million represented assets of $71 billion of total corporate assets of $468 billion, or 11 percent. It is perhaps unrealistic to attempt to segregate private from public corporations on the basis of total assets, especially with a breaking point of $1 million; possibly this represents a substantial understatement of the total number, total assets and total pretax income of private corporations. It is realized that there are many corporations with assets greatly in excess of $1 million which would fall within the category of private corporations.

Public corporations customarily find it of advantage to have their securities listed and registered on national securities exchanges. As reported by the Securities and Exchange Commission, as of June 30, 1954, the unduplicated number of corporate issuers having securities traded on exchanges totaled 2,588. These corporations had an aggregate listing of 3,057 unduplicated issues of stocks and 1,081 unduplicated issues of bonds, or a total listing of unduplicated corporate security issues of 4,138. If the total of unduplicated issues of stock should be taken as representative of the majority of public corporations, the proportion of public corporations to total corporations would appear to be of the general order of 1 percent, with some 99 percent of our corporations private in character. It is interesting to note in this connection that the total of corporations with $10 million or more of assets numbered 5,854 in 1951 (corporate returns with balance sheets, and with and without net income). These corporations accounted for 69 percent of total pretax corporate net income, or some $31 billion of the $45 billion total, and 73 percent of total corporate assets, or some $471 billion of the $648 billion of total assets. Corporations with less than $10 million of total assets thus received 31 percent of total pretax net income, or $14 billion, and had 27 percent of total corporate assets or assets of the value of $177 billion.

UNDISTRIBUTED EARNINGS AND TAX AVOIDANCE

On the basis of the data above it appears clear that the overwhelming majority of our individual corporate entities are of a private character, and that they receive a substantial segment of total corporate income and represent many billions of dollars of corporate assets. These closely held private corporations may be, and will be, utilized to serve the tax advantage of the owner or owners by retention rather than distribution of corporate earnings under our nonintegrated in-

come-tax structure given a sufficient incentive. Congress has provided an adequate inducement in this respect by imposing a double tax on corporate earnings—if distributed, first, as earnings to the corporation and, second, as dividends to the shareholders, except for the modest dividend tax relief as provided in the Internal Revenue Code of 1954. The adequacy of the tax inducement to engage in tax avoidance through the corporate device is indicated by the marginal rates of the individual tax which range from 20 to 91 percent. A taxpayer would indeed be possessed of a sterling character who, having his corporation at hand, could resist the inducement to minimize his personal tax by reducing the amount of the distributed corporate income, particularly if his personal requirements did not necessitate additional income from this source. Moreover, Congress has provided a further inducement, in the form of an alternative tax, for corporate retention rather than distribution of current earnings by imposing a maximum rate on long-term capital gains of 25 percent. With the high progression of rates of the personal tax, with, for example, taxable net income in excess of $6,000 to the individual subject to a 30-percent rate, the tax advantage of the alternative, namely, converting current dividend income to a long-term capital gain (by retaining earnings within the corporation), is established in the lower brackets of tax rates. For those who wish to avoid all personal tax on income, whose circumstances permit, earnings need only to be retained within the corporation. Capital gains are taxable only when realized; consequently, if the securities are held until death, no tax liability arises. These provisions of our tax laws are of common knowledge, with individual sensitiveness thereto accentuated by the sharply progressive rates of tax. The use of the corporation as a tax avoidance device is not in any sense confined to individuals of great wealth. Instead, individuals of modest incomes whose interests dictate the use of a corporation in their business activities can and do realize tax advantages through nondistribution of earnings. Perhaps the public dissatisfaction with the high progressive rates of the personal tax would be in greatly increased volume were these congressionally provided avenues of tax avoidance less wide and less readily available to many members of the community.

Undistributed Earnings and Tax Equity

Earnings retained free of personal tax within the corporation may be directed either to real investment currently or in the immediate future, or to inactive employment as found in the buildup of corporate liquidity. Perhaps a partial offset to the tax inequity exists when the retained earnings add to the self-financed real investment of the enterprise. The increase in capital formation thus occasioned is a growth factor in the community contributing to general well-being. Further, if the investment is well-conceived, the corporation's aggregate earnings will be increased in the future which, in turn, will increase the personal tax liability of the owner or owners upon distribution. Apart from losses of invested earnings which may arise from unwise investment decisions, the inequity is one which appears to relate itself primarily to the factors of time and amount in the increase in the owner's liability to personal tax. Measurement of these factors quantitatively is not possible—the ripening time of real

investments displays wide variations, and the discount process of determining the present value of a future tax payment is compounded with imperfections.

For those who believe strongly in the encouragement of small business as found in its contribution to the virility and growth of the economy, the inequity of not subjecting undistributed earnings to personal tax at the time of accrual is perhaps a small price to pay with small business so heavily dependent on its own earnings for expansion and development. Further, the corporate tax may be regarded as a partial contribution to the tax liability which would arise if the enterprise were conducted as a partnership or proprietorship with current earnings covered by personal tax.

On the other hand, corporate retained earnings which do not add to, nor are intended for, real investment, but serve as an avoidance device for personal tax, serve only to create an inequity for which no justification appears to exist. These funds add neither to investment nor to consumption. They are sterile in their conception and in their dedication. They constitute the basis of a maldistribution of personal tax. The progressive schedule of personal tax rates is vitiated in its higher brackets to the extent this avoidance occurs. Recipients of salary and wage income and of business income from partnerships and proprietorships suffer an unequal tax treatment which appears to be without adequate defense.

The Accumulated Earnings Tax

The accumulated earnings tax, which made its appearance in the Internal Revenue Code of 1954 as code sections 531 to 537, inclusive, represents a modification of former section 102 of the code. This modification, it is believed, is sufficiently far-reaching and comprehensive as largely to remove any substantive barrier to personal tax avoidance as found in corporate retention of earnings. If this conclusion is correct, the Congress has opened more widely a tax avoidance loophole and thus increased the inequity of the personal tax as it bears on the various members of the community.

The principal changes in the former section 102 may be briefly summarized as follows:

First, the statutory burden of proof (sec. 534) heretofore on the corporation to show "by the clear preponderance of the evidence" that the accumulated earnings or profits are not beyond the reasonable needs of the business, when subject to a deficiency assessment by the Internal Revenue Service, has now been shifted to the Government if the taxpayer corporation, upon notification of a proposed deficiency assessment, submits within 30 days a statement of the grounds (together with facts sufficient to show the basis thereof) on which reliance is had to establish that all or any part of the retained earnings have not been accumulated beyond the reasonable needs of the business.

As has been stated elsewhere, the legislative history of efforts to limit tax avoidance through corporate earnings retention provides rather conclusive evidence that even partially effective enforcement of the statutory prohibition against unreasonable accumulation of corporate earnings waited upon the shift in the burden of proof to the taxpayer corporation in the Revenue Act of 1938.

Second, the 1954 code apparently repeals the so-called immediacy doctrine employed by the Internal Revenue Service in the administrative enforcement of the predecessor act.

As applied by the Service the immediacy doctrine simply tested earnings accrual by corporations to a dedication to real investment or a bona fide business use in the immediate or reasonably foreseeable future. This doctrine removed from corporate use a generalized defense to outsize liquid surplus accruals that such funds were to be invested at some remote point of time. It is questionable whether the accumulated earnings tax can have real meaning or content without some realistic time and program limitation with reference to the implementation of the proposed real investment or business use from accumulated liquid earnings.

Third, the 1954 code provides, in addition, an accumulated earnings credit (sec. 535) with a specified credit minimum, namely, that the credit allowable "shall in no case be less than the amount by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year." The accumulated-earnings credit (other than the specified minimum) is such part of the earnings or profits "as are retained for the reasonable needs of the business."

The provision that the tax applies only to the earnings unreasonably retained creates an enforcement problem which appears to be so serious as largely to impair any residual statutory effectiveness. The Internal Revenue Service must now establish a dividing line between earnings reasonably accumulated and those which are not. Because of the degree of judgment involved, this may be regarded as a fruitful area of litigation should attempts of enforcement occur. Further, the courts have tended to resolve questions of doubt in such matters in favor of the corporate owners. The base of the tax has now been reduced to whatever amount of corporate earnings as are unreasonably accumulated. Although the formal rates of tax remain unchanged, such contraction of the tax base as may result from this section reduces the effective rate of tax which, under the predecessor section, appeared to be inadequate to prevent tax avoidance.

The provision of an accumulated earnings credit of $60,000 would appear to accomplish little other than the extension of a statutory invitation to corporate owners to engage in the prohibited purpose, at least to the absorption of this amount of credit.

It should be noted that the accumulated-earnings tax as it now stands is the only prop to the high marginal rates of the personal tax as found in the prevention of tax avoidance through retention of corporate earnings.

Dividend Tax Relief and Corporate Earnings Retention

The provisions for the $50 exclusion from gross income of dividend income and the 4 percent tax credit against dividend income in sections 116 and 34 of the Internal Revenue Code of 1954 would appear to accomplish little in reducing the incentive for personal tax avoidance and the use of the corporation for this purpose. Taxpayers subject to comparatively high marginal rates of tax, and with substantial amounts of dividend income, will not find their marginal and average tax rates sufficiently reduced to have any appreciable effect

upon the desirability of availing themselves of the long-term capital-gains alternative. The continued use of the corporation as a vehicle for personal tax avoidance thus appears to remain unimpaired. The need for integration of the corporate and personal income taxes thus continues, with the dividend relief provisions barren of accomplishment in this respect. Consequently, an accumulated-earnings tax with substance and effectiveness is a necessity as a barrier to a broad avenue of tax avoidance.

Integration of Income Taxes

Full and complete integration of the corporate and personal income taxes simply means that corporate shareholders would be taxed on an equal basis with the recipients of noncorporate income, whether or not distribution of corporate income occurs. Various alternatives have been suggested which would provide for partial equalization of the taxation of corporate and noncorporate business income as found in the credit for dividends paid, the withholding tax credit and the credit for dividends received. Partial integration of the corporate and personal taxes would be a step forward in serving the interests of tax equity and in reducing somewhat the incentive to retain corporate earnings. The existing high personal and corporate taxes, however, would seem to require that the integration of income taxes should be carried forward to as complete a point as possible. In this respect it may be suggested that the partnership approach appears worthy of more serious exploration as a method of achieving income-tax integration than has occurred to date. Under the partnership method, corporate shareholders would include in their individual income-tax returns their proportionate shares of the corporate income or loss, regardless of whether the income had been distributed. The corporate income tax would no longer apply, and common tax treatment would be accorded corporate and noncorporate business income. Corporate hoarding as a tax-avoidance problem would disappear.

It has been urged that the administrative difficulties in the application of the partnership method to all corporations are so great as to render it impractical. However, these administrative difficulties appear to be limited very largely to those comparatively few corporations of giant size which are public in character, representing, at the outside, perhaps no more than 2 percent of our total corporate entities. Private corporations, which essentially are incorporated proprietorships or partnerships, have simple capital structures, few shareholders and infrequent transfer of shares. It appears difficult, if not impossible, to make a case for the private corporation as an entity apart from its owners except in a purely legal sense. Far more important than any concept of "corporations as separate taxable entities," which may be employed to rationalize the status quo of corporate taxation, is the overriding consideration of tax equity between and among individuals. Further, it may be contended that the private corporation in its economic behavior and policies resembles far more closely the proprietorship or the partnership than it does the bona fide public corporation. Perhaps it is time to emphasize, for tax purposes, the essential differences between the private and the public corporation rather than their legal similarities.

Optional application of the partnership method probably would have a limited effect in equalizing taxes on corporate and noncorporate business income, because only those corporations securing a tax advantage presumably would elect this method. Consequently, an adequate coverage of private corporations by the partnership method would appear to require mandatory application. Legal and administrative ingenuity would seem equal to the task of properly classifying private corporations and formulating equitable rules for corporate reporting and shareholder inclusion of corporate income or loss in tax returns. It is to be anticipated that the application of the partnership method to private corporations would be opposed by those corporations whose owners find an advantage in the existing system of taxation. However, the closure of an important avenue of tax avoidance and the more equitable distribution of the personal income tax among members of the public would seem to offer advantages far outweighing any objections.

Internal Revenue Code of 1954 and the Unincorporated Business Option

Section 1361 of the Internal Revenue Code of 1954 provides an option to unincorporated business enterprises to be taxed as domestic corporations. In the words of the Senate Finance Committee:

> This section is intended to permit certain proprietorships and partnerships the opportunity to elect to be taxed as a domestic corporation while still conducting the business of the enterprise as a proprietorship or partnership.[1]

Election of this option by unincorporated business enterprises commits them irrevocably to corporate tax status for the future so long as the original proprietor, or partners, owns in excess of 80 percent of the enterprise. However, in any year in which the person, or persons, originaly electing the option no longer owns more than 80 percent of the enterprise, revocation of the corporate tax status occurs and a new election of the option is necessary.

To the extent this option is elected by proprietorships and partnerships, now and in the future, the area of personal tax avoidance is enlarged and a more inequitable distribution of personal tax takes place. It is possible that the proponents of this section of the code hoped that the provision of this option would result in more uniform tax treatment of business income. However, the result is simply to increase the volume of business-generated personal income subject to differential tax treatment in comparison with income in the form of wages and salaries.

It is interesting to note that Congress has provided a one-way option, that, while unincorporated business may elect to be taxed as a corporation, corporations are not given the option of being taxed as a partnership.

Economic Growth and Stability

The Internal Revenue Code of 1954 has altered the tax status of private corporations and those unincorporated business enterprises which elect to be taxed on a corporate basis. Private corporations now appear to be in a good position to hoard corporate earnings with

[1] Senate Finance Committee, 83d Cong., 2d sess., S. Rept. 1622, p. 455.

impunity—instead of directing such earnings currently to real investment or to dividends. This is the result of the substitution of the accumulated-earnings tax for former code section 102. The provisions for dividend tax relief appear to offer little inducement for private corporate earnings distributions as an offset to hoarding. Section 1361 of the code offers to unincorporated business the tax avoidance opportunities now enjoyed by private corporations. On balance, the conclusion seems inescapable that comparatively more corporate hoarding will occur in the future than in the past. Apart from considerations of tax equity, this has implications relating to the growth of the economy.

It is impossible to say what proportion of the retained earnings of private corporations, at any one time, constitutes a measure of hoarded funds. That the aggregate of such funds may not be inconsiderable finds support in the higher bracket rates of personal tax and the wide awareness of this method of tax avoidance. We should disabuse our minds of any belief that corporate hoarding to avoid tax is a rare and an exceptional occurrence. It is true, of course, that corporate hoarding which increases corporate liquidity serves advantages other than minimizing personal tax. Thus there are mixed motivations for such corporate action, as well as a variety of rational explanations for the result. From the point of view of the corporation, increased corporate liquidity has a beneficial result on corporate solvency and in the corporation's ability to withstand competitive and economic shocks, whether or not needed for these purposes. It gives to the corporation a greater potential for growth even though unutilized. On the other hand, corporate hoarding is a practice limited to the profitable corporations, not the unprofitable. It is found in those corporations which have demonstrated their competitive strength and their ability to meet economic hazards. In the corporate universe these are the corporations in which high liquidity is perhaps the least needed and where it serves the least purpose.

To the extent that there is a greater relative volume of corporate hoarding caused by the recent changes in the code, corporate real investment will be synchronized less closely to profits realization both in amount and time. Real investment of retained profits by corporations will be lessened relatively during the prosperity phase of the cycle, thus affecting adversely the growth of real capital. This is unlikely to be counterbalanced by an increase in investment, generated from such liquid funds, during the recession and depression phases of the cycle as business expectations become pessimistic and a policy of caution tends to prevail. This cushion of liquid surplus may lead to less corporate activity during these phases of the cycle because retrenchment of output and employment carries a minimum hazard. The success of this policy may induce the corporation to rephrase in higher terms its liquidity requirements for the future. Investment postponed may be, in fact, investment lost. Further, owners of private corporations who find that the essential or perhaps sole inducement to corporate hoarding is avoidance of personal tax presumably have little or no intention of directing these liquid savings to real investment. They represent savings which may be held free of the individual tax indefinitely into the future. The rate of growth of real investment in the economy over the short, as well as the long,

period thus tends to suffer, with these savings implementing neither investment nor consumption.

Short-run stability, as well as long-term growth, of the economy would appear to be served by a tax program which seeks to minimize corporate hoarding of funds. When business expectations cause a decline in the rate of self-financed corporate investment, a counterbalancing increase in dividends, rather than an increase in corporate liquidity, would contribute to short-run stability through support of consumption.

CONCLUSION

The nonintegrated taxation of income, combined with the present statutorily relaxed approach to the problem of corporate hoarding, introduces an element of instability and attenuation of consumption in the short term. Further, some reduction in the short run in the rate of real investment financed from retained corporate earnings likewise occurs. In the long period aggregate investment tends to suffer without any apparent compensating advantage.

Equity in taxation requires substantially equivalent tax treatment of individual incomes, whether in the form of salaries and wages or business income, to the fullest extent practicable. This is not the case at present. Rather, the Internal Revenue Code of 1954 appears to increase the disparity in the taxation of business and nonbusiness income. Major correction of this disparate taxation seems to lie in a more fully integrated income tax structure. The application of a mandatory partnership method of taxation to the private corporation appears to be the most promising solution to this problem. The public corporation, in which tax-induced corporate hoarding is not an important concern and for which a strong case can be made for a taxable entity apart from its shareholders, would receive the full focus of the corporate income tax. With a nonintegrated corporate and personal income tax system limited to the public corporation and its dividend distributions, disparate taxation would be reduced and the problem of tax avoidance through tax-induced corporate hoarding largely resolved. To the extent that there is validity in the view that the public corporation is properly a taxable entity apart from its shareholders, some differential taxation may be justified.

TAX CONSIDERATIONS INVOLVED IN CORPORATE MERGERS

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The effects of taxes on the extent and character of merger activity deserve careful consideration because mergers can seriously affect the competitive structure and performance of the economy and because tax considerations are widely believed to be a major cause of mergers.[1] The size structure of most of our more concentrated industries today was originally established by mergers culminating at the turn of the century, and the then prevailing levels of concentration were increased

[1] Throughout this paper, the term "merger" is used in a very broad sense to refer to all combinations of formerly independent companies and not in a restricted legal or technical sense. In other words, the word "merger" is used interchangeably with the phrase, "sale or purchase of business enterprises."

still further in the major merger movement of the 1920's. While assets acquired in these mergers account for only a moderate fraction of the size of major firms in major industries today, a large part of their present size represents the subsequent growth of assets and business units originally acquired in mergers.[2] It is a fair statement to say that if the larger mergers of the period 1880 to 1930 had not occurred, prevailing levels of concentration in most of our major industries—and the degree of concentration in the manufacturing and mining sector of the economy as a whole—would be very substantially lower than they are today.

This early history is important in pointing up the potentially great significance of mergers, and establishes the importance of carefully examining the effects of taxes on merger activity. But there is no reason to think taxes were an important factor for either the acquiring firms or for the sellers in these early mergers. They are uniformly explained by authorities on other grounds, and we have the further evidence that personal, corporate, and estate tax rates were relatively low, except for the brief interval of the First World War.

To study the effects of taxes on mergers we must turn to more recent periods when effective and marginal tax rates have been high, and tax considerations have consequently been more important in all types of business decisions. Since 1929, there have been two significant waves of merger activity, one beginning in 1940 and 1941 and reaching its peak in 1946 and 1947, the other picking up in 1950 from the low levels of 1948 and 1949 and continuing to build up through 1954 (the most recent years for which data are available).[3] This paper will summarize for the committee the results of the extensive study my colleagues and I made of the effects of taxes on mergers in the first and larger of these two recent merger movements.[4] Although we have undertaken no further serious research in this area since 1950, I will describe in broad outline the more important changes in tax law since that time.

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[2] See J. Fred Weston, The Role of Mergers in the Growth of Large Firms (Berkeley, University of California Press, 1953), ch. III, and Lintner, Butters, and Cary, as cited, ch. X.

[3] Since the effects of mergers before 1930 have been emphasized in the preceding text, a few brief observations should perhaps be added to keep these recent merger movements in historical perspective: There were four times as many mergers in 1946 and 1947 as during the last prewar years, but merger activity had been at a very low ebb throughout the depressed decade of the 1930's. There were fewer reported mergers in 1954 than in either 1946 or 1947 at the crest of the previous movement, and the rate then was little over one-third that of the late 1920's. Similarly, the number of reported mergers in the 4 years 1951–54 was less than in the 4 peak years 1944–47, and both recent periods showed about one-third the number reported in the 4 years 1927–30. In view of the large increase in the number of business firms in existence, comparison of the proportions of business units disappearing through merger and sale would be even more marked. Moreover, acquisitions of large companies by the already largest concerns in manufacturing and mining were both absolutely and relatively very much less frequent—and both the absolute and relative growth of the already largest companies in the economy was very much less—in the mergers occurring between 1940 and 1947 than in the mergers during the 1920's. The merger movement of 1940–47 produced increases in concentration, however measured, in almost all broadly defined industry groups, but the increases were relatively small in all groups, except food and textiles. (See Butters, Lintner, and Cary, Effects of Taxation on Corporate Mergers (Boston, Harvard Graduate School of Business Administration, 1951), chs. IX and X.)

The FTC has taken samples of mergers in 1951–54 in which the size of acquired firms was noted. (See Federal Trade Commission, Report on Corporate Mergers and Acquisitions (Washington, Government Printing Office), May 1955.) The fact that acquisitions involving more than $10 million and more than $50 million accounted for a considerably larger fraction of all acquisitions in these samples, than the corresponding fraction we found in our exhaustive studies of mergers in 1940–47, indicates that the effects of recent mergers on concentration have probably been greater, possibly substantially greater, than the effects produced by mergers during 1940–47; but much more detailed analysis is required before firm conclusions regarding the effects of the recent movement on concentration, and how these effects compare with those in 1940–47, are possible.

[4] Butters, Lintner, and Cary, as cited in the preceding footnote. Much of this paper is based upon, and parts are paraphrased or quoted directly from, ch. I of this reference.

Our studies leave no doubt that tax considerations have had a very substantial influence on the extent and character of merger activity since 1940—although for reasons which will be developed subsequently their impact is considerably more specialized and generally less controlling than often believed. Various features of the tax structure exert strong pressure on owners of closely net businesses to sell out or merge with other companies, while others provide inducements to going concerns to acquire other business units. Since one of our principal conclusions is that tax considerations are generally very much more important in decisions to sell going business units to other firms than in the decisions of companies to acquire other business units, the bulk of the discussion will be devoted to these more important effects. The following section will develop the tax considerations which are important to potential sellers. Subsequent sections will then briefly review other considerations which frequently lead to the sale of business firms and the relative importance of tax and nontax motivations of sellers. Another section will consider the tax considerations that may lead companies to acquire other businesses and relate these tax factors to other motivations involved in business acquisitions. Our general conclusions are summarized at the end of the paper.

Tax Incentives To Sell

The tax structure definitely has exerted strong pressures on the owners of many closely held businesses to sell out or to merge with other large companies. Moreover for both tax and nontax reasons the merger route is often chosen in preference to other ways of relieving these pressures, such as, for example, a public distribution of part other large companies. Moreover for both tax and nontax reasons the number of businesses actually sold because of tax considerations appears to be considerably smaller than is frequently asserted.

The tax incentives to selling are essentially twofold. The first of these tax incentives is to sell out a closely held business to lessen the impact of the estate tax. This incentive for sale was of substantial importance in the mergers investigated in our fieldwork covering the period 1940–47, but special relief provisions in the Revenue Act of 1950 and later acts considerably lessen its significance in more recent mergers. The second major tax incentive is for owners to sell out a successful closely held business in order to take their profits out of the firm by the capital-gains route as an alternative to having the profits distributed as dividends subject to high individual income-tax rates or left in the company and possibly taxes at section 102. This incentive for sale also proved to be important in our fieldwork, and has been strengthened by the higher tax rates enacted after the Korean attack.

ESTATE TAX MOTIVATIONS

Sales motivated by estate-tax considerations may be caused by the liquidity problems that would be encountered in meeting estate-tax liabilities if the business were still in the estate at death or by uncertainties regarding the valuation of the business for estate-tax purposes. It will be convenient to consider liquidity problems and valuation uncertainties separately.

The liquidity problem is how to raise the cash with which to pay the estate tax. Unless the owner has sufficient funds outside his closely held business to cover his estate tax and to meet his other liquidity needs, he is likely to feel compelled to dispose of part or all of his closely held stock during his lifetime. If he dies without so doing, his executors may be forced to make the sale after his death.

While most owners of closely held businesses of any size have to give this matter serious thought, the circumstances under which liquidity needs create strong pressures to sell are much more specialized than is often realized. Ordinarily the following conditions must all occur simultaneously:

1. *The stock of the company held by any one individual must be valuable enough to place him in a fairly high estate-tax bracket.*—The greater the value of the stock held by one individual, the more likely is a sale to be made for tax reasons. As a very rough rule of thumb, liquidity considerations are likely to constitute an important incentive for sale only when an individual holds stock worth at least, say, $250,000-$500,000. If less than this amount is held, and frequently when more is held, estate taxes will be sufficiently small so that by prudent planning reasonable provision usually can be made for them without recourse to sale.

2. *The stockholdings in question must constitute a major fraction of the total investment portfolio of such an individual.*—His cash, insurance, and other liquid assets must be insufficient to finance the estate taxes which will be due on his death as well as the other immediate cash requirements of his estate and heirs. Because of the progressive rate structure of the estate tax, holders of larger amounts of closely held stock will need to have a larger portion of their holdings in cash and marketable assets than will holders of lesser amounts of closely held stock. With allowance for this fact, the larger the percentage of the owner's total holdings which are invested in the stock of a closely held company, or in other nonmarketable assets, the stronger will be the tax incentives to liquidate part or all of these holdings.

3. *There must be no market, or only a thin and inactive market, for the securities of the company in question.*—To the degree that the securities are marketable, the liquidity problem can be solved simply by selling part of them at any time without prior preparation.

The above conditions, since they must hold simultaneously, tend to define fairly narrowly the size of company in which liquidity considerations in connection with the estate tax are most likely to constitute an important reason for sale. The great bulk of small companies—most of those with assets of less than $1 million and many which are considerably larger—are eliminated because no single stockholder owns enough stock to need to worry about the impact of the estate tax. At the other extreme, most very large companies have sold stock to the public at some stage of their growth and thereby created a market for their securities. It is in between these ranges—say in the $1 million to $25 million asset class and especially in the $5 million to $25 million asset class—that one would expect on analytical grounds to find the greatest density of sales for liquidity reasons, and our empirical findings confirmed this expectation.

Since the Revenue Act of 1950 special relief provisions have considerably reduced these pressures to sell for liquidity reasons. In this

act and subsequent legislation the previous requirements that distributions of cash by closely held companies be treated as dividends subject in full to personal income-tax rates has been substantially relaxed so long as the distributions are made under prescribed conditions for the payment of death taxes.[5] The practical effect of these provisions has been to make money distributed in redemptions of stock closely held in estates essentially free of tax. The specific terms not only exempt distributions falling within their scope from the probability of being taxed as ordinary dividends, but in addition limit any capital gain on the distribution to the excess of the amount paid for the redeemed stock over its fair market value at the date of the owner's death so that the gain, if any, ordinarily will be small.

These provisions greatly facilitate the maintenance of independent existence of family corporations on the death of a major owner. The terms are sufficiently broad to cover a large percentage though not all of the cases in which the need for funds to pay estate taxes would otherwise have exerted strong pressures on the owners to sell out. We may note, however, that in addition to meeting the technical requirements for eligibility under the tax law a further necessary condition for this favorable result is that the executors of the deceased owner's estate be in a position to arrange for the redemption of the necessary part of his stock. This means that the executors of the estate must be in a position to control the policy of the administration in question and that the corporation must have on hand, or be able to obtain on acceptable terms, the cash with which to redeem the necessary portion of the stock. Moreover it should be noted that, even where these conditions are well satisfied, these provisions take care of the problem only in situations in which the owners are willing to defer the final provision of liquidity for their estates until after their death. Owners who desire to provide the necessary funds for their State taxes and other liquidities prior to their death will not generally benefit from these provisions.

In addition to liquidity considerations, and often reinforcing them, uncertainty as to the valuation which the Treasury would place on the stock of closely held companies in determining estate-tax liabilities was frequently mentioned in our field interviews as a factor tending to stimulate the sale of such businesses. In general, however, valuation problems do not appear to have been a major reason for the sale of closely held enterprises. They seem more frequently than not to be of secondary importance in relation to other tax motivations for sale, especially liquidity considerations, and to nontax motivations. The main reason for the uncertainty on the part of taxpayers about the valuation which would be placed on the stock of their closely held companies is simply that there is no objective test which can be applied to determine the value of such holdings in the absence of trading in the securities of the company in question. Impartial experts often differ by very wide margins in their estimate of the fair market value of such securities.

The evidence which we have seen does not justify the conclusion that the Treasury is deliberately or consistently unfair in the valua-

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[5] In general these conditions limit the period within which the distributions may be made and limit the benefits to owners whose estate consists largely of stock in a family enterprise. These provisions also apply only to that part of the proceeds of such stock redemptions which do not exceed the tax imposed because of the owner's death.

tion which it places on the securities of the closely held companies. Numerous businessmen, nevertheless, believe that an unreasonably high valuation is ordinarily placed on the securities of closely held companies by Treasury agents, and isolated instances of such valuations undoubtedly do occur. Regardless of the dubious factual foundation for this belief as to general Treasury policy, the fact that it is widely held and the risk of encountering a high valuation in any individual instance adversely influence the willingness of businessmen and investors to hold the securities of closely held companies—especially as the owners grow older and become more conscious of impending estate-tax problems. As already indicated, however, this concern is only infrequently of critical importance in influencing the owner's action.

The greatest concern over Treasury valuation policies was expressed by owners of so-called one-man companies, i. e., companies which would lose much of their value when their owners ceased to direct their affairs. In view of the extraordinarily difficult problem of measuring the contribution of the owner's personal services to the value of such enterprises, unreasonably high valuations are not improbable when these contributions are large. Occasionally, the fear of unreasonably high valuations under these circumstances appears to have constituted a major reason for sale; even in these instances, however, it is not altogether clear how much of the owner's worry really had to do with death taxes as such and how much with the effects of death itself.

INCOME TAX, CAPITAL-GAINS TAX, SECTION 102

The impact of the estate tax on the owners of closely held companies is reinforced by the combined effects of high income taxes and of low capital-gains tax rates. As already noted, if owners of closely held companies are to pass their holdings on to their heirs, they must accumulate large amounts of liquid assets in order to provide for the payment of their estate taxes and for their other liquidity needs. The personal income tax along with the double taxation of dividends often makes the accumulation of such funds in adequate amounts prohibitively costly, if not impossible, though as noted above this difficulty has been substantially mitigated for many owners of closely held companies by various relief provisions since 1950.

In addition to making it unattractive for the owners of closely held companies to retain their holdings, the tax structure further abets the decision to sell by providing very favorable tax treatment in the event that the owners decide to sell out. The gains from such sales are, of course, capital gains and hence are taxed at a maximum rate of 25 percent or 26 percent. If the sale takes the form of a tax-free exchange of securities, the owner may be able to transfer his holdings into readily marketable securities of high investment quality without incurring any taxes at all on the transaction. Thus, while funds taken out of the business as dividends may be taxed at rates as high as 82 percent under the 1948 act and 92 percent under the 1951 act, owners may convert the stock of their companies into cash or marketable securities at a tax cost ranging from zero to a maximum of 25 percent or 26 percent of the gain on the sale.

Even when no attention is paid to the estate tax, perhaps because the owners are still young, the income-tax structure itself may be a major factor in inducing the owners of closely held companies to sell out. This inducement will be especially strong for owners of rapidly growing companies which have developed a substantial capital value but which still represent highly risky investments, because of the still uncertain competitive prospects of the company and its liability to sharp declines in earnings and in the market value of its stock in the event of weakening general business conditions, or because of the unbalanced investment portfolios of the owners. The temptation for the owners of such companies to cash in their gains and invest them in less risky form while the opportunity is still available would be great, entirely apart from tax considerations. The market for business firms even in prosperous periods is notably thin; buyers are relatively much more difficult to find in depressed times than in prosperous periods, and frequently cannot be found at all; and experience has shown that bid prices are likely to fall off much more in proportion to realistic present values of future earnings reasonably to be anticipated, even assuming that buyers can be found in the event of depressed business conditions.

To the degree that the opportunity for further gains through retained holdings is curtailed by heavy taxation—including the corporate income tax (and possibly sec. 102 if earnings are retained) and the personal income tax on amounts distributed as dividends—the incentive for the owners of rapidly growing companies to play safe and cash in the gains already attained at capital gains rates will be correspondingly strengthened. Such taxes greatly increase the cost of either ploughing back earnings or of paying them out as dividends, and thereby lengthen the time span which would be required for the stockholders to diversify their investment position either by building up liquid assets within the company or by taking them out of the company. In this way they increased the gamble which the stockholders have to take by not selling out. The rate increases of the Revenue Act of 1950 and 1951 substantially augmented this incentive to sell out as did the excess-profits tax imposed in 1950; the more recent elimination of the excess-profits tax, reduction in personal income tax rates, introduction of the dividend credit, and perhaps also the change in the old section 102 have considerably weakened these tax incentives.[6] On balance, these tax incentives are probably weaker at the present time, in any given business situation, than they were prior to 1950.

Another factor which makes a sale to a large company more likely, especially if section 102 taxes are involved, is that the tax penalties and risks confronting the purchasing company often are much less severe than those confronting the potential seller. Such a purchaser ordinarily need not be concerned about section 102 taxes. The greater financial resources of large companies tend to reduce many of the risks encountered by a smaller, less well-established company; and, if losses should be incurred, a large purchaser would be more likely to be able to offset them against other sources of taxable income than would the existing owners. For all these reasons a closely held company

[6] For conflicting views regarding changes in sec. 102, see James K. Hall, Review of the Internal Revenue Code and Section 102, National Tax Journal, September 1955, pp. 275–286, and R. S. Holzman, The Accumulated Earnings Tax, Taxes—the Tax Magazine, October 1954, pp. 823 ff.

often has a substantially greater value to a potential purchaser than to its existing owners. A large purchaser, therefore, is likely to be able to offer a price so favorable that the existing owners will feel that it would be foolhardy to decline the opportunity to consolidate their position by cashing in their gains.

Relative Importance of Tax Motives for Sale of Business Units

These two combined tax effects—the estate tax and the income tax, sometimes complicated by section 102—have undoubtedly been a major factor motivating the merger or sale of many independent enterprises. But it would be incorrect to stress the importance of this fact too strongly. The conditions under which these tax effects exert their full force are highly specialized and apply to only a small proportion of all small- and medium-sized companies. Moreover, even when tax incentives are important, they are not necessarily controlling. The problem of whether or not to sell out a closely owned business is very complex and embraces the whole range of human motivations and interests.

Our field research on these problems indicated that nontax motivations are much more prevalent and are frequently far stronger than is often realized. We found, for instance, that management considerations—such as the desire of an owner-manager to retire, his ill health or death, and the lack of adequate management succession—were frequently recurring and impelling reasons for sales for all sizes of companies, but especially among smaller companies. Investment considerations likewise were important for all sizes of companies, but they tended to be especially crucial for the owners of the larger selling companies. They ranged from a desire on the part of the owner for greater diversification, improved quality, and more ready marketability of his investment holdings to a belief that his closely held company would decline in value either suddenly in the near future or gradually over the years and that it would therefore be wise for him to sell. We found that all these—and a host of other similar reasons, including a personal desire to become associated as an officer or director with a nationally known company—often far overshadowed tax considerations even when the conditions needed to make tax considerations important were strongly satisfied. Moreover, in some cases where the tax pressures are strong, they can be substantially relieved or bypassed by various courses of action other than sale of the business to another company.[7]

In our research on these problems we were able to divide 89 of the mergers covered in our field interviews into 2 categories: (1) Those in which taxes were of major importance, and (2) those in which they were of lesser or negligible importance, if any attention at all was given to them. In general, mergers were included in the former category only when the owner with good reason was consciously and seriously

[7] These alternatives are discussed in Butters, Lintner and Cary, op. cit., chs. V–VII.

concerned about his tax problems and when other motivations for sale did not dwarf the tax worries of the owner.[8]

The classification just described indicated that for the period from 1940 to about 1949 taxes were a major reason for sale for about two-fifths, or a little more, of the transactions in which the selling company had assets of between $15 million and $50 million as of the date of sale, for between one-fourth and one-third of the companies sold in the $5 million to $15 million asset-size class, for a little over one-fifth of the companies in the $1 million to $5 million class, and only rarely for the sale of companies with assets of under $1 million. These fractions obviously represent no more than reasonably good approximations of the percentage of tax-motivated sales as we have defined this concept, but within reasonable limits they provide a basis for appraising the relative role of taxes as a motivating force for merger activity in this period.

By combining these conclusions with our aggregate data on reported mergers for 1940–47, we were also able to make estimates of the overall role of taxes in the overall merger activity involving manufacturing and mining companies. Our estimate was that taxes were of major importance for something less than one-tenth of the total number of mergers of manufacturing and mining companies reported in the financial manuals for the years 1940 through 1947. About one-fourth of the mergers involving selling companies with total assets of over $1 million fall in this category. In terms of total assets rather than of numbers of companies, taxes appear to have been a major reason for sale in the mergers involving a little over one-fourth of the total assets of *all* companies sold in such transactions and about one-third of the assets of all companies sold with assets of over $1 million. The larger fraction for total assets transferred reflects the greater relative importance of taxes as a motive for the sale of large companies than of small companies.

Considerably wide margins of uncertainty are inevitably involved regarding their importance in mergers since 1950. We can infer from changes in the law that liquidity considerations under the estate tax have been less onerous in this more recent period. Similarly we would expect income tax considerations to have been more impelling under the higher rates (and excess-profits tax) than in the immediately preceding years, but on balance there seems to be little reason to expect any major difference in the effects of income tax factors when the comparison is made with the years 1940–47 involved in our earlier research and estimates. Income and estate taxes together have probably been somewhat less important in sales and companies of each size—at least up to companies having assets of less than, say, $20 million or $25 million—in more recent experiences than in 1940–47.

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[8] To say that taxes were a major reason for sale, however, is not to say that the sale was caused by the tax motivation in the sense that the merger would not have occurred in its absence. Often there were several reasons for sale of approximately equal importance in the minds of the owners, and it was impossible to say that any one of them was in itself decisive. Thus the figures obtained represent maximum estimates of the role of taxes as a cause of merger activity. They overstate to an unknown but probably large degree the sales in which tax motivations were clearly the decisive factor.

In some cases in which taxes were decisive in the immediate decision to sell, other nontax causes, such as the lack of adequate management succession, might have forced the owners to sell out at a later date. From the long-run viewpoint the effect of taxes in such cases might more properly be described as accelerating the sale rather than as causing a sale that would not otherwise have been made. For this reason, also, our figures on tax-motivated sales undoubtedly overstate the long-run effect of taxes as a cause for the sale of independently owned companies.

If the proportion of companies of each size involved in mergers had been the same since 1950 as in the earlier experience, we should conclude that tax considerations have been less important in mergers since the Korean attack than during World War II and the early postwar years. The FTC's recent studies, however, indicate that there were relatively more acquisitions of companies having assets over $10 million, and relatively fewer acquisitions of smaller companies in the years 1951 through mid-1954 than in the earlier period. Since tax motives are relatively more important among larger sellers than among smaller companies, this shift in the distribution of acquired concerns provides a substantial offset to the reduced importance of tax motivations in the separate size classes. The available evidence justifies no definite or firm conclusion that taxes have been either more or less important in all reported merger activity since 1950 than in the 1940–47 experience.[9] If attention is confined, however, to the proportion of all mergers involving acquisitions of more than $1 million, it would appear that tax considerations have been somewhat less important recently than in the 1947 period.[10]

TAX MOTIVATIONS OF BUYERS

Various features of the tax law also stimulate going business concerns to acquire other business units. Some successful companies, closely held by vigorous owners, and with substantial accumulations of cash which led their managements to fear that section 102 taxes would be imposed, have decided that the purchase of another company would be the most favorable means of investing funds in a manner that seemed likely to avert the assessment of section 102 taxes. Others have sought to reduce the regular income or excess-profits-tax liabilities they would otherwise have to pay by acquiring other com-

[9] The FTC sample (op. cit., p. 48 in related text) gives an estimate of 119 for the number of acquired firms having assets of $10 million or more in 1951–54; this is 5.7 percent of an estimated total number of 2,091 mergers of all sizes. In 1940–47 there were 58 cases having assets over $10 million which represented over 2.9 percent out of a total of 1,990 reported mergers. Similarly in the earlier movement acquired companies with assets between $1 and $10 million accounted for 477 mergers or 23 percent of the total. In the recent movement, the FTC finds a probable 608 companies with assets between three-quarters of a million and 10 million dollars, or 29 percent of the total. The reduction in this number involved in raising the FTC lower size limit from three-quarters of a million to 1 million dollars would probably be more than offset by the addition of that part of the 629 companies of unknown size which also had assets in the indicated size range.

The qualitative judgments given in the text regarding the probable net effect of changes in the tax law since 1950, and our earlier estimates of the importance of tax considerations in earlier mergers, would suggest that taxes are important (as we have defined the concept) in roughly 40 percent of the more recent mergers involving companies above $10 million, and between 20 percent and 25 percent of the smaller companies having assets between $1 and $10 million. On this basis, we would obtain an estimate that taxes have been important in approximately 10 percent of all reported recent mergers, which is very nearly the same as our estimate for earlier mergers.

The tenuous character of such estimates for the recent period is shown by the fact that, on the basis of its sample, the FTC could only be 95 percent sure that the "true" figure for companies over $10 million would lie between 72 and 185 even though 119 was the most likely single figure. If the lower figure should be correct, we would have to conclude tax motivations were less significant than in the earlier period, but if something approaching the higher figure is correct, the conclusions would be reversed. It must also be emphasized that our estimates of the relative importance of taxes in mergers of each size even in the 1940–47 experience were themselves based on data obtained regarding a sample of firms, so that similar statements can be made regarding this other important factor in the calculations. Careful readers will see still other qualifications that would be required if any definite conclusions were to be drawn. (The data used in this footnote will be found in FTC, op cit., and Butters, Lintner, and Cary, op. cit., pp. 206 and 246.)

[10] This conclusion is indicated, in spite of the tenuous character of the data, unless (*a*) as many as two-thirds or more of the estimated 629 cases of unknown size shown by the FTC had had assets of more than $1 million but less than $10 million, and/or (*b*) there were more than 119 actual acquisitions involving firms with more than $10 million assets, and/or (*c*) we have underestimated the relative importance of mergers in either or both of these size classes.

panies with unused excess-profits-tax credits, large accumulated losses which can be offset against the acquirer's income, or assets whose book value for tax purposes is substantially greater than their current market value.

In each of these latter situations, the acquiring company is gaining an advantage taxwise from provisions mostly introduced into the tax code during the later 1930's and early 1940's for the purpose of preserving equity and fairness among taxpayers, primarily with business firms as continuing separate entities in mind. The carry-forward and carry-back of operating losses, for instance, is a device to insure that effective tax rates on the total net income of a company with sharp fluctuations in its income will be approximately the same as that on another company with stable earnings adding up to the same total income over the period. The basic difficulty arises from the fact that such legitimate privileges or allowances granted in the law to independent continuing business units, put in a context of other provisions designed to preserve equity among taxpayers in cases where for legitimate reasons business units are bought and sold, create opportunities for purchases whose primary purpose or principal result may be tax advantages never intended.[11]

In our fieldwork we were able to interview buyers in more than three-fourths of the sample of 104 cases of mergers in the years 1940–49 which had been drawn for study,[12] and in addition we investigated the objectives and purposes of 12 of the 17 companies which had made the most frequent acquisitions during this period. We found, as might be expected, that the effects of the acquisitions on the tax liabilities of the acquiring company were very carefully considered in a very large majority of cases. We also found that the tax effects of the choice of each of the several alternative forms which the transaction might take—e. g. purchase of stock or assets either for cash or securities—were carefully evaluated, and that these tax considerations for both buyers and sellers in a large majority of cases determined the way the transaction was handled, once the decision to make the acquisition (or sale) was made.

But on the much more significant question from most broader points of view—the question of the relative importance of taxes in buyers' decisions whether to expand by merger or by other independent means—the results were quite different: The evidence we obtained indicated that tax motivations were seldom important in the sense that they constituted a major reason, not overshadowed by other considerations, for the acquiring company to decide to buy the other company. In fact, we found only three instances in our sample in

[11] Congress recognized the problem and in 1944 enacted a new section 129 disallowing and deductions or credits which acquiring companies gained through acquisitions in which the principal purpose was evasion or avoidance of tax. But the whole body of statute law, regulations, and case decisions has been increasingly fraught with technicalities. Such fine distinctions as those between form and substance, and such uncertain judgments as those between primary purposes and incidental effect, have frequently determined the final results in particular cases. The Internal Revenue Code of 1954 attempts to bring order by substituting a number of new provisions and more specific rules, but it is too early for even the specialists on these technical matters to say whether the objectives of eliminating abuse, reducing unintended hardship, and relieving previous uncertainties will prove to have been achieved. For a good discussion of these questions by a former legislative counsel of the Treasury, see Adrian W. DeWind, A Technical Appraisal of the Internal Revenue Code of 1954, National Tax Journal, March 1955, especially pp. 42–57.

[12] This sample incidentally included three-fourths of all mergers involving selling companies with assets of more than $15 million known to have occurred in the years 1940–49.

which these tax benefits proved to be important, in the sense indicated, in decisions to acquire another company. Two of these three involved acquisitions to avoid the possibly immanent assessment of section 102 taxes, and the other involved acquisition of another company through a set of transactions which substantially reduced tax liabilities. The significance of our failure to find more instances in which taxes were motivations of major importance in acquisitions is difficult to assess, in part because a large percentage of the mergers covered by our fieldwork occurred after the excess-profits tax had been repealed. But we did investigate a sufficient number of wartime mergers so that the near absence of important tax motivations in our sample would seem to indicate that they were of relatively limited importance for manufacturing enterprises. Although we have done no fieldwork on these problems since Korea, our earlier study would seem to establish some presumption to the same effect with respect to more recent mergers.

The basic reason why tax considerations were not of major importance to the buyers in a far larger proportion of all acquisitions lies in the importance of the nontax considerations involved in the decision to buy another company rather than to expand in other ways. During most of the period since 1940, for instance, the securities of many companies have been selling at prices which were quite low in relation to their asset values so that much the cheapest way to acquire needed facilities has often been to buy the stock of a going concern which owned them rather than to build them—quite apart from any tax benefits that might further "sweeten" the situation. In many cases, in addition to acquiring needed productive capacity at bargain prices by this means, the acquirers have obtained the additional benefits of a going organization and occasionally of highly competent management and technical personnel included in the package purchased at little or no extra cost. Similarly the fact that it takes time to build a new plant and even more time to develop and merchandise a new product, while a merger can be negotiated very quickly, was frequently a consideration that far outweighed any tax considerations in the decision to acquire another company. As a final illustration, the advantages of entering a new market in the preferred position of an established competitor by buying out an existing firm, and avoiding the many obstacles and necessarily intensified competition that would be involved in any attempt to break into a new line or area in competition with all existing firms, were frequently of considerable importance in the decision and made tax benefits of secondary importance.

General Conclusions

1. Taxes have been a highly significant motivation in the sale of a substantial number of closely held companies, but the role of taxes in this respect has been much more limited than often claimed.

2. In only about one-tenth of all reported mergers—and perhaps one-fourth of those involving more than $1 million—have taxes been a major reason for the sale. Tax considerations are more frequently important among larger companies, at least up to $25 million or $30 million of assets.

3. Our research would indicate that taxes are much less frequently of major importance in buyers' decisions to make an acquisition than in sellers' decisions.

4. While of limited importance in decisions whether to merge, tax considerations are very frequently of paramount importance for both buyers and sellers in determining the form of the transaction.

XIV. THE RELATIONSHIP OF THE TAXATION OF INCOME DERIVED ABROAD TO FOREIGN ECONOMIC POLICY, ROY BLOUGH, COLUMBIA UNIVERSITY; IRA T. WENDER, LORD, DAY AND LORD, NEW YORK CITY; EMILIO G. COLLADO, STANDARD OIL CO. (N. J.); JOHN F. COSTELLOE, RADIO CORPORATION OF AMERICA

INTRODUCTION

This joint paper is a result of the belief of its authors that the presentation of a single background paper analyzing the legal and economic aspects of the taxation of foreign income would assist the subcommittee in its consideration of this important area of foreign economic policy. The first section deals with the economic impact of United States business operations abroad and the relation of those effects to the interests of the people of the United States. The second covers the method and operation of the present system of taxing foreign-source income. The effect of United States taxation on the amount of private investment abroad is discussed in the next section, and the fourth section describes the various proposals which have been put forward for changes in United States tax treatment of foreign income and operations. Each panelist took primary responsibility for one of these sections.[1]

The original plan was to limit the joint paper to these four sections, to be followed by extensive separate policy papers by the members of the panel. In the process of developing the background papers it became apparent, however, that there is a considerable area of agreement among the four panel members on the elements of an appropriate policy. It seems likely that the concentration of recent public discussion on a few controversial details of proposed tax changes has obscured the much larger area of general agreement.

It was decided, therefore, to add a fifth section to summarize the agreement of the authors on desirable technical changes and on the most difficult aspect of proposed legislation on taxation of foreign income, that is, the definition of foreign income which is entitled to special tax treatment. In their separate recommendatory papers, the opinion of the panelists as to the type of tax treatment that should be accorded this foreign income is discussed.

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1. THE ECONOMIC IMPACT OF UNITED STATES BUSINESS OPERATIONS ABROAD

INTRODUCTION

Two major objectives of tax policy are (1) equitable distribution of the tax load and (2) a sound impact on the economy. With respect

[1] Sec. 1 by Roy Blough; sec. 2 by Ira T. Wender; sec. 3 by Emilio G. Collado; and sec. 4 by John F. Costelloe.

to the second objective, the choice among alternative methods of taxing income earned abroad cannot fail to have some effect on the magnitude and the kinds of United States business operations abroad as well as on the legal forms by which they are carried on. As a basis for judgment on the relative desirability of different tax methods it is necessary to consider whether various kinds of United States business operations abroad promote the well-being of the United States, and if so, how important their contribution is. Accordingly, the purpose of this section is to examine briefly economic effects of United States business operations abroad, and the relation of those effects to the interests of the people of the United States.

The interest of the people of this country in United States business operations abroad depends partly on the effects of those operations on the economy of the United States and partly on the effects on the economies of other countries. The two groups of effects are interrelated, since effects on other economies cannot avoid having secondary effects on our own. Quite aside from this aspect, however, the people and Government of the United States have shown a deep interest in the economic well-being and development of other countries. In part, the interest has been a humanitarian one. The awareness of the growing divergence in levels of living between different countries, and of the poverty, hunger, and disease so often present in the poorer countries, have appealed powerfully to our humanitarian sentiments and have led us to take constructive steps to aid these countries and promote their economic development without regard to its possible effects on us. In part the interest has been a political one. It is felt that political stability and the security of the free world are dependent on raising per-capita production and consumption in the poorer countries, where the growing awareness on the part of the masses of people that a better life is possible makes them not only unwilling to accept a continuation of conditions of hunger and misery but at the same time highly subject to Communist agitation and promises.

The secondary effects on our own economy of the economic development of the less developed countries are mixed in character and depend in part on the industries in which the development takes place. It is easy to point out cases where the development of a specific industry, e. g., a textile mill, in an underdeveloped country has reduced or is likely to reduce the importation of textiles into that country. It is even possible to conceive of cases where an industry that was built in an underdeveloped country would wind up selling goods to the United States in competition with domestic producers. Such a development could be clearly in the interests of the United States; the development, for example, of mineral and other raw material industries abroad may be very important to our future industrial operations, although domestic producers of the materials in question undoubtedly are adversely affected. On the whole, the effects on United States manufacturing industries of industrial development abroad are also likely to be beneficial. Industrialization in underdeveloped countries is usually accompanied by a substantial increase in national income and the record is rather clear that as national income rises the pressure within the underdeveloped countries for imported goods also rises and, if foreign exchange is available, imports increase. The kinds of commodities imported are likely to change as economic de-

velopment proceeds, but their total quantity rises if they can be financed. Accordingly, while certain United States industries may find their markets contracted by the economic development of underdeveloped countries, the markets of other industries will expand. Whether this expansion will be greater than the contraction, depends on whether the dollars available to foreign countries to buy our goods are increased, through increases in our imports, our private foreign investment, or our Government loans and grants, or a combination. Throughout the following discussion the dependence of United States exports on the availability of dollars will be stressed repeatedly; it can scarcely be overemphasized. Numerous cases where a foreign market "dries up" are the simple result of a lack of dollar exchange in that market.

Varieties of Business Operations Abroad

As will appear, different kinds of United States business operations abroad do not have the same impact either on the United States economy or on the economies of other countries. The following classification of these operations is used in the present discussion of their impact.

1. Foreign trade of the United States:
   - (*a*) Imports into the United States.
   - (*b*) Exports from the United States.
2. Investment abroad by United States investors:
   - (*a*) Portfolio investment.
   - (*b*) Direct investment.
3. Technical assistance by business.

Each of these categories is discussed briefly in the paragraphs that follow. Inevitably there is some overlapping; even more inevitably, limitations of space make it necessary to reduce the discussion to summary form.

Foreign Trade

Some United States business operations abroad are limited to foreign trade in its narrow sense of importing goods bought abroad at wholesale and exporting goods sold abroad at wholesale. Many business operations, however, combine importing or exporting with other activities, for example, manufacturing or retail trade. For purposes of analysis, the importing or exporting involved in these combined operations are discussed at this point. The operations that may be carried on in connection with importing or exporting—or may even give rise to them—will be considered below.

IMPORTS INTO THE UNITED STATES

In view of the great size and diversity of our land and natural resources, of our industries, and of our markets, we are prone to forget the tremendous importance to many other countries of being able to sell their products abroad and particularly to the United States. Our imports provide other countries with the dollars with which they can buy products which they either cannot produce at all or cannot produce efficiently. These countries can then employ their workers in industries in which they can produce with relative efficiency. Exports

to industrial countries are a major source of the funds available to the less developed countries to buy capital equipment needed for their further economic development.

Imports are likewise of value to the United States. The purchasing power of the American consumer's dollar is increased since he is able to buy in the least expensive market. Imports are the main source of the demand for our goods in foreign markets. The objection raised to imports, of course, is that imported commodities are often in competition with domestic products. Although this country has thrived on competition, and its policies seek to assure competition in the belief that thereby the efficiency of our production is increased, a major exception has been our policy toward imports. By concentrating attention on the firms and industries with which imports compete we have tended to overlook both the benefits of imports to the consumers in lower prices and to our export industries in expanded markets, employment, and profits.

Through protective tariffs, quantitative restrictions, and customs formalities the total volume of imports into the United States is held far below what it would be in the absence of these measures. Uncertainty regarding our future policy toward imports also is a factor operating to keep many foreign producers from attempting to sell in the United States market.

EXPORTS FROM THE UNITED STATES

Exports from the United States benefit other countries by supplying their needs cheaper or better than they could be supplied elsewhere. Our exports are in competition with goods produced by other supplying countries and possibly also with goods produced within the importing country. The same temptation for that country to restrict the importation of our goods exists as has been noted previously with respect to the United States.

Exports from the United States benefit our country by supplying markets for our products, thus enlarging employment in the production of such products. Our exports also supply us with the funds for buying needed imports.

While private and public investment can be and often are important it is clear that the ability of a country to import depends largely on its exports and that its ability to export depends largely on its imports. In any given case one of these is likely to be the factor limiting or determining the other. In the case of the United States it has been the exports that have been limited by our imports. We have had plenty of foreign exchange to buy more, but exports to our foreign customers have been held down by a shortage of dollar exchange. For many years the volume of our exports would have been much larger if people in other countries had had the dollars with which to buy our goods. One reason our exports have been as large as they have is that through private investment and governmental loans and grants this country has made dollars available to other countries in addition to those they have earned through selling us goods and services. Despite our grants, loans, and investments, however, there remains a dollar shortage to this day, as is indicated by the quantitative and other restrictions that many countries have placed on imports from the United States to prevent or cope with serious foreign exchange difficulties.

The accumulation over the past few years of substantial amounts of dollar exchange by a number of countries abroad might seem to controvert the conclusion that our exports have been limited by the dollars received by foreign countries. In general, however, the accumulations of dollar balances that have taken place have been for the purpose of restoring dollar reserves to the levels necessary to finance stable trading operations and not because of any lack of desire for United States goods. One exception may be noted to this general conclusion. A few countries making large sales to the United States or other dollar areas have accumulated substantial dollar balances in excess of their normal reserve requirements. The funds have not been used to buy additional goods either in the United States or in other countries that would have spent the dollars promptly in the United States. These insulated pools of dollars could finance increases in exports from the United States without impairing needed reserves. With this exception, it is clear that this country has no difficulty in selling all the goods other countries have the dollars to buy. To be sure, some United States producers cannot meet competition abroad and so cannot sell. Tax relief might help these specific producers to sell more. Since, however, the more they sell the less other American producers can sell, what one gained another would lose.

Investment Abroad by United States Investors

Foreign investment may be for various periods of time. Credit may be allowed for a short time, perhaps up to 6 months, to finance the transaction while delivery is being made and until the goods are sold by the foreign importer. The credit may be for a longer period to permit raw materials to be manufactured and sold, or to finance a machine that is expected to pay for itself over perhaps a 3-year period. Or it may be for a still longer period to finance the purchase or construction of a plant. It may be in the form of loans or of purchase of equity securities.

The shorter-term investments or credits are not likely to be accompanied by the participation of the United States investor in the operation of the business in which the investment has been made. Longer-term investments may or may not be so accompanied; those that are not are ordinarily referred to as portfolio investments and those that are as direct investments.

The investment picture is complicated by the fact that several kinds of transactions may be going on at the same time. In the case of portfolio investment, if new securities are issued to finance an expansion of operations in the host country the volume of funds for capital formation is directly increased. If, on the other hand securities are purchased by United States investors from their holders in other countries, the investment in the underdeveloped country is not enlarged, although the pool of funds from which such investment could be made is increased. The sale of securities by United States holders to foreign holders does not withdraw capital from the underdeveloped country.

In the case of direct investment, funds may be flowing out of the United States for new investment while at the same time funds may be flowing into the United States on account of the withdrawal of old investments. Earnings on previous investments may be reinvested

in the enterprise or invested in other overseas operations. When old investment is withdrawn this may either involve a liquidation of the project or, more likely, will reflect the selling of ownership in the property to local investors in the host country. Net investment by United States investors is the sum of the new investment moving abroad plus reinvested earnings minus investment being withdrawn. The net capital outflow is the gross investment moving abroad minus the investment being withdrawn; reinvested earnings do not enter into this calculation.

PORTFOLIO INVESTMENT

Under the heading of portfolio investment may be considered the impact of investment as such without the complications of the participation of the United States investor in the operation of the business. The importance that representatives of underdeveloped countries attribute to capital is extremely great, indeed, the impression is often given that more capital is all that is needed to assure rapid economic development. Internal savings in underdeveloped countries available for investment are often grossly inadequate, in part because of the very low level of income, in part because of the absence of institutions for gathering and investing local savings, and in part because of lack of confidence of wealthy people in the safety of local investment. Internal saving moreover does not solve the problem of securing the necessary foreign exchange for financing the purchase and importation of the capital goods that are available only in industrial countries. In the requests for foreign capital stress is often placed on public, i. e., governmental, loans and grants, preferably through international institutions, in preference to private investment. Nevertheless, there are only a few countries that frankly state that private investment is not welcome and most countries profess great desire for it, while a number of countries have taken important steps to create the kind of climate likely to attract it.

The benefits of investment, be it public or private, in the less developed countries may be quickly summarized. The funds received finance the formation of needed plant and equipment. If part of the expenditures are local currency costs, as is usually the case, the investment from abroad helps also to finance the foreign exchange component of domestic investment from local savings. The new capital builds up the industries in which it is invested, enlarges employment opportunities, and increases product and national income. These are the long-run benefits which make the whole operation attractive to the underdeveloped countries. The investment project, if successful, increases income by enough to finance a return on the investment and to permit the gradual repatriation of the capital, if desired. It is in this connection, however, that foreign investment may cause difficulties for the country in which it is invested. If the investment itself finances, or is accompanied by other investment in, the production of goods that reduce or balance the need for imports, or of goods for export for which foreign markets are successfully located, the foreign exchange may be readily available to permit the transfer of annual income or the repatriation of capital. But unless such is the result, the investment, however successful, may involve the country in which it was made in a foreign exchange crisis making it impossible to permit the transfer of income or principal.

It is this foreign-exchange problem, so distant from our thou .ts in the United States, but so continually threatening to many countries, that is one of the factors leading countries to be somewhat choosy in the investment they permit to be made. Another factor is the fear of economic and political domination by foreign business. This fear may be completely erroneous and is likely to be greatly exaggerated. It is not possible to say, however, that it is without basis in past experience. Still another factor is the belief that some industries producing, for example, consumer luxury goods, would be harmful to the carrying out of the economic development plans of the country, in that the availability of such goods would make the achievement of saving within the country more difficult. The point to be stressed here is that the limitations that some countries place on investment, particularly foreign private investment, whether or not the limitations may be wise, do not indicate a lack of need or desire for capital and do not serve as an excuse to the industrial countries for doing nothing to encourage the flow of capital—assuming the desirability, as previously discussed, of the more rapid economic development of the less developed countries.

Turning now to the effects of investment abroad on the United States economy, a distinction must be made between the effects at the time the investment is made and the effects when income is being withdrawn and capital repatriated. At the time the investment is made it adds to the supply of dollars and increases the demand for United States exports. The chances are, and especially in the case of direct investment, that much of the demand will be for specific capital goods, but whether or not such is the case, the dollars will be spent directly or indirectly for United States goods and services. An increase of private investment abroad can thus take the place of Government loans and grants or of imports in supplying dollars for buying our exports.

Under some circumstances the investment abroad merely replaces an investment that would otherwise have been made in the United States. In such case the increased foreign demand for United States goods and services is offset by a decreased domestic demand, with little effect on aggregate demand, although undoubtedly with some shift in the product purchased. There is then a syphoning off of capital that would have gone to increase domestic productive capacity or productivity. Under other circumstances, which seem likely to prevail most of the time, the investment abroad would constitute in whole or in part an increase in total investment and accordingly in total demand for United States goods and services. At a time when there was a shortage of attractive domestic investment opportunities, increased investment abroad would supply a highly welcome support to the domestic economy. If, on the other hand, the added investment abroad occurred during a period of domestic inflationary pressures, the resulting increase in demand could be expected to contribute to inflationary price increases. From the viewpoint of the future of the United States economy the impact of increased foreign investment depends largely on whether there is likely to be a growing shortage of domestic investment opportunities. This is a matter on which opinions differ widely.

It is sometimes suggested that United States private investment abroad, by increasing when domestic demand faltered and decreasing when domestic demand strengthened, might become a significant

factor in offsetting short-run fluctuations in the United States economy. It would not be wise, for a number of reasons, to count on this as a factor of significance. For one thing, the volume of overseas investment has not been large enough for variations to make much of an impact on the domestic economy, although a much larger volume is not impossible for the future. More central to the argument, while a decline in domestic investment opportunities may stimulate interest in overseas opportunities, some lapse of time is likely to take place before the stimulation is felt, so that the timing might be perverse. Moreover, if a depression were to spread to other countries, as often happens, the result might be to discourage overseas investment even more than domestic investment. Finally, it must be borne in mind that overseas investment that fluctuated in the intended manner could have unfortunate effects on the stability of the economies of the recipient countries.

United States investment abroad, particularly direct investment, has other advantages to the United States than the financing of exports, which may be illustrated with respect to capital equipment. The selling of equipment assures a continuing market for replacement parts. The industries buying the equipment are likely to turn to the United States for technical aid in using the capital and for management and other consulting services. In short, enduring economic ties with the United States are likely to be built up. Such ties are of great importance in the development of friendly and mutually dependent relationships with other countries.

When the investment abroad begins yielding a return and that return is brought home, the effect is to increase the income of the domestic economy. This kind of income was a substantial fraction of the national income of Great Britain for many years. If this kind of income is to be received in the United States, the paying country must find ways to increase its supply of dollars. In the absence of Government loans, grants, and new private investment, an equivalent increase must take place in the dollars spent by United States consumers and industries on imports of goods and services, otherwise exports will fall or the investor will not receive the income from his investment. Such imports do not operate to reduce the demand for domestic production since additional spending power has been added to enlarge the domestic demand. Yet in specific industries there undoubtedly will be competition. In short, it will be necessary for the United States to buy more noncompeting goods and services or to permit the entrance of more competing goods, since only in these ways can other countries earn the foreign exchange required in the transfer of dividends and the repatriation of capital investment.

It has sometimes been suggested that incentives might be given for investment in raw material industries abroad, on the ground that we need such materials, but not for investment in manufacturing industries, on the ground that they might reduce the foreign markets of our manufacturers. However, there is already a strong tendency for direct investment to go into industries that can earn dollars and thus assure the transfer of earnings to the United States. Such industries are notably the raw material industries, especially oil and minerals. Moreover, underdeveloped countries might be expected to react unfavorably toward attempts by the United States Government to give special incentives for investments abroad to go into such indus-

tries. As undiversified producers of raw materials the underdeveloped countries have suffered very severely over the years from fluctuations in the demand for and prices of their products. Moreover, with respect to mineral resources, they have some reluctance at seeing these removed and exported, since they may be needed for domestic industry later. This reluctance probably reflects a mistaken view, since raw materials and particularly mineral resources provide a quick way of getting capital needed for economic development. Nevertheless, the tendency more and more is toward insistence by the less developed countries on a diversified and balanced development. If industrial countries are to get the expanded volume of raw materials they desire, they must be prepared to contribute also to the development of processing and manufacturing industries.

Instead of bringing home as dividends or interest the income earned on foreign investment, such income may be either reinvested in the country where it was earned or invested in another country. From the viewpoint of the United States economy the effect is the same: the necessity for the United States to expand imports or otherwise to increase the supply of dollar foreign exchange is avoided, by being further postponed, and domestically available income is not increased. The investment of earnings constitutes a contribution to capital formation and economic development in the country where the investment is made. If the earnings are reinvested in the country where earned, no foreign exchange is supplied, in contrast to the case of original foreign investment, but neither is there the drain on foreign exchange that would be involved in the transfer of earnings. If the earnings are reinvested in some other country, foreign exchange, although not necessarily dollars, is supplied to that country while the country from which the transfer is made suffers a drain on its foreign exchange, although again not necessarily its dollar exchange. The effects of such transfers of foreign exchange would depend on the circumstances of each transfer.

To summarize this discussion, an increase in private foreign investment would permit the United States to maintain a high level of exports while reducing its public grants and loans abroad and not increasing its imports. But this is a postponement, not a solution, of the international trade problem growing out of our position as a creditor nation. The postponement might be an extended one if the volume of annual foreign investment were to rise rapidly over a long period of years. Sooner or later, however, if the private foreign investments are to be serviced it will be necessary for this country either to supply the necessary dollars for servicing the private investment or to see its exports decreased. The dollars might be supplied by increasing imports or, alternatively, by making sufficient public foreign grants and loans. An expansion of private foreign investment would thus give the country more time to adjust to a new relationship between imports and exports, but that adjustment would have to be made sooner or later if our investors were to receive the income on their investments to which they would be entitled.

The preceding discussion points to the conclusion that increasing private foreign investment would make a large contribution to the economically less developed countries, but that its benefits to the United States are in part dependent on events that cannot be foreseen with assurance.

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DIRECT INVESTMENT

In the case of direct investment, the United States investor—usually an operating incorporated business—not only invests funds in an enterprise in another country but also manages or participates in the management of the enterprise. This is to be distinguished from foreign trade where there is a wholesale transaction completed, as it were, at the water's edge. While not all businesses that have made direct investment are entitled to commendation for their operations or policies, in a great many cases direct investment is having very important effects in bringing to underdeveloped countries successful methods of engineering and business management. Indeed, some competent observers have suggested, perhaps extravagantly, that the major benefit of direct United States investment in such countries is that business management goes into the country, which it is not likely to do except as an accompaniment of investment. It should not be concluded that governments or people in the underdeveloped countries necessarily have such a high regard for the benefits to be derived from United States business in their countries. Moreover, to have beneficial results, methods must be adapted to special local conditions and attitudes; it is usually a serious mistake to attempt the transplantation abroad of United States methods without considerable adaptation. United States businesses abroad have, to an increasing extent, found it desirable to train local personnel and gradually withdraw United States personnel from any given plant or operation. The underdeveloped countries understandably insist that business operations within their borders shall be carried on by native personnel as they achieve the necessary competence. This does not necessarily mean that opportunities for United States personnel abroad will decline at least for some years to come, since the number of projects could be greatly expanded without exhausting the need.

To the extent that United States personnel must be paid in currency convertible into dollars, the foreign exchange problems raised by direct investment may be even greater than those raised by portfolio investment. Some companies have these problems in mind and endeavor to assist in enlarging the foreign exchange earnings of the country, although this may be possible only in a minority of cases.

The impact of direct investment on the United States economy has been pretty much covered in the earlier discussions of economic development in general and of portfolio investment. In brief, investment accompanied by United States management is likely to earn more than portfolio investment; it also constitutes a greater drain on the dollar exchange of the country in which the operation is carried on.

Under present circumstances most investment from the United States is direct investment; the experiences in earlier periods with portfolio investment have discouraged the development of a substantial market for securities of foreign businesses. Some observers believe that with access to the same institutional markets as domestic investment companies, and given equal tax treatment, investment trusts holding foreign securities could substantially increase their holding of such securities with the passage of time and the accumulation of favorable experience.

TECHNICAL ASSISTANCE BY BUSINESS

Undoubtedly direct investment provides the most favorable situation for the transmission of advanced engineering and managerial techniques from the United States to economically underdeveloped countries, since the necessary capital goes along with the techniques to put them into successful operation, and the United States company has a strong incentive to build up a successful going concern in the underdeveloped country. However, investment is often not feasible. The capital may not be available; the United States firm may not wish to invest capital in the underdeveloped country because of the risks involved or for other reasons; or the underdeveloped country may be unwilling to receive the investment because of its foreign exchange implications, or for other reasons. Moreover, capital may not be needed in some situations, only better methods.

Certain operations of United States business abroad are devoted to providing techniques without the investment of capital. Engineering consulting firms make engineering studies and advise on engineering aspects of going or prospective businesses. Engineering construction firms take contracts for design and construction of industrial plants under a variety of arrangements. Management consulting firms make management studies and give advice on the many aspects of business management. A few United States business concerns have taken on contractual responsibilities for the management of overseas, native-owned businesses, and for the training of local management. A considerable number of United States businesses are licensing the use of their patents and processes to companies in other countries, providing the necessary know-how and receiving royalties in compensation. All these operations are done for compensation and impose foreign exchange drains which are sometimes obstacles to entering into such arrangements. The impact of services of these and similar kinds in furthering the economic development of underdeveloped countries seems to be considerable and the volume of operations is growing.

2. TAXATION OF FOREIGN TRADE AND INVESTMENT

The purpose of this section is to outline the present method of taxing foreign source income and to describe briefly its operation.

THE PRESENT TAX PATTERN

In principle, the United States taxation of foreign source income follows a simple and consistent pattern. Domestic corporations, citizens and resident aliens are subject to tax on their entire income no matter what its geographical source. Since income from foreign sources will ordinarily have been subject to foreign income tax, foreign income would, in the absence of special provision, bear substantially heavier taxes than domestic income. To alleviate this taxation, domestic taxpayers are given an option to either credit or deduct foreign income taxes. Like State and local income taxes, foreign income taxes may be deducted from gross income to determine taxable income for United States tax purposes. Alternatively, foreign income taxes may be credited by reducing the United States tax due on foreign income by the amount of foreign income tax paid. The effect of the tax credit system is, therefore, to tax foreign source income at the

higher of the United States or foreign income tax rate. If the foreign tax is lower than the United States tax, the difference is paid to the United States. On the other hand, in a case in which the foreign rate equals or exceeds the United States rate, no additional tax is paid.

The credit is allowed only for foreign income taxes. Moreover, the claimant of the credit must, generally, be the person upon whom the foreign income tax is imposed. In the case of a United States corporation receiving dividends from a foreign corporation, however, the credit is also allowed for taxes paid by the foreign corporation if 10 percent or more of the voting stock of the foreign corporation is owned by the United States corporation. To prevent the foreign credit from operating to reduce United States tax on domestic income, a country-by-country limitation on the amount of the credit is imposed. Under this limitation, the amount of credit for foreign income taxes is calculated separately for each country from which a taxpayer derives income and the credit for each country's taxes cannot exceed the United States tax which would otherwise be imposed on the income from that country.

SPECIAL PROVISIONS

This simple pattern is complicated by the status of foreign corporations and by a number of geographical exceptions to the general treatment of foreign source income.

Foreign corporations.—Corporations organized under the laws of foreign countries are defined by the Internal Revenue Code as foreign corporations. Only a foreign corporation's income from sources within the United States is subject to United States tax. The separate tax status of a foreign corporation, whether or not controlled by United States interests, is recognized. However, when a foreign corporation distributes a dividend, the dividend is taxed to a United States recipient in the same manner as other income. The recipient of the dividend is permitted a credit for any tax imposed by the foreign country on it, but not for the foreign taxes paid by the foreign corporation unless the recipient is a domestic corporation which owns 10 percent or more of the voting stock of the foreign corporation paying the dividend. In such cases the United States parent may credit against United States income taxes on the dividend paid by the foreign subsidiary, a proportionate part of the foreign income taxes paid by the foreign subsidiary on its earnings. This treatment is also extended to the foreign taxes paid by a 50 percent or more owned foreign subsidiary of a 10 percent owned foreign subsidiary of a United States corporation, but no credit is allowed for taxes paid by a foreign subsidiary of the 50 percent owned foreign subsidiary.

Geographical deviations.—In addition to the special tax treatment accorded foreign corporations, the Internal Revenue Code creates several special categories of domestic corporations and provides exemptions for income earned abroad.

The best known of the special classes of domestic corporations are Western Hemisphere trade corporations. To qualify for the lower tax rate of 38 percent imposed on such corporations, a domestic corporation must: (1) Conduct all of its business in the countries of the Western Hemisphere; (2) derive at least 95 percent of its gross income from foreign sources; and (3) derive at least 90 percent of its gross income from the active conduct of a trade or business.

Domestic corporations which derive substantial portions of their income from possessions of the United States, like foreign corpora-

tions, are subject to United States tax only on income derived from sources within the United States. The requisites for this tax status are that a domestic corporation (1) derive 80 percent or more of its income from sources within a possession of the United States and (2) derive 50 percent or more of its income from the active conduct of a trade or business within a United States possession. This provision also applies to individual citizens of the United States except those conducting a business in Puerto Rico.[2]

Income earned by United States citizens from the rendering of services abroad is in certain cases exempt from United States tax. Complete exemption is extended to citizens who establish a bona fide foreign residence. Moreover, the first $20,000 per year of foreign-earned income is not taxed to citizens actually present in foreign countries for 17 months out of a consecutive period of 18 months.

SOURCE OF INCOME

Since the foreign tax credit, the geographical exceptions and the taxation of foreign corporations and citizens depend upon a determination of the source of income, the pattern requires the characterization of income by source. The code establishes rules according to the type of income. The source of interest and dividends is foreign if paid by foreign citizens or corporations, but special rules are provided if the foreign payor is a resident of the United States. Rents and royalties are foreign if paid for the use of property outside the United States. The income from the rendering of personal services is derived from the place in which the services are performed. The source of income from the sale of goods depends on several factors. If goods are manufactured in the United States and sold abroad by the manufacturer, the income from the manufacture and sale is apportioned under regulations. In the case of purchase of goods in the United States and sale of these goods abroad, the source of the income is the place of sale. The place of sale is usually considered to be the place in which title to the goods passed from the seller to the purchaser.

THE OPERATION OF THE TAX PATTERN

In this section the tax factors affecting investment will be discussed. To describe the operation of the United States system of taxing foreign business it is necessary to separate investment by individuals and by corporations, as well as direct investment from portfolio investment.

DIRECT FOREIGN INVESTMENT BY CORPORATIONS

On the level of direct corporate foreign investment, the most notable characteristic of the United States tax pattern is that tax consequences depend more on differences of form than substance. To illustrate the operation of the system and its dependence on form let us examine the tax effects of the different forms of organization of foreign investment by domestic corporations. In addition, special factors which may affect the form used for investment, the use of foreign holding companies and the effects of tax incentives offered by foreign countries will be described.

[2] A partial exemption from tax is provided China Trade Act corporations. This provision is now of little more than historical interest and will not, therefore, be discussed.

Forms of organization.—Foreign business may be conducted by a domestic corporation opening a branch in a foreign country. Alternatively, either a Western Hemisphere trade corporation subsidiary can be used if the foreign country is in the Western Hemisphere or a foreign corporation may be utilized.[3] The ultimate rate of combined United States and foreign tax which will result from the use of these forms varies substantially.

Branch.—Direct operation abroad as a branch results in foreign income being currently subject to United States tax. If taxes in the foreign country equal or exceed those in the United States, no additional tax burden flows from this form of organization; but if the foreign rate is lower, the foreign earnings are, thereby, currently subject to full United States taxes. On the other hand, since a branch is not treated as a separate tax entity, operation as a branch permits foreign losses to be deducted currently from domestic profits so that a substantial share of the losses are borne by the United States revenue. The net return after United States and foreign tax to a United States corporation operating abroad is 48 percent unless the foreign tax rate exceeds the United States rate of 52 percent.

Western Hemisphere trade corporations.—If the technical requirements of operation as a Western Hemisphere trade corporation can be met, organization in this form offers a 14 percent point reduction in the general rate of United States corporate tax. Moreover, since a Western Hemisphere trade corporation is a domestic corporation, the dividends received deduction is allowed so that only 15 percent of dividends paid by a Western Hemisphere trade corporation to another corporation are subject to tax. The effective combined rate of foreign and United States tax on the company's earnings plus the intercorporate dividends tax is thus about 43 percent if the foreign tax does not exceed the United States tax of 38 percent on the Western Hemisphere trade corporation's earnings. Further, the intercorporate dividends tax is not always imposed. If the parent corporation elects to file a consolidated return with its Western Hemisphere trade corporation and other domestic subsidiaries, no intercorporate dividends tax is imposed, but an additional tax of 2 percent is imposed on the income of the entire group less that from the Western Hemisphere trade corporation. In such cases, the entire tax burden is only 38 percent provided the foreign rate does not exceed 38 percent.

Foreign corporation.—The calculation of the combined United States tax on dividends of a 10-percent or more owned foreign subsidiary and of the foreign tax imposed on the foreign corporation's earnings is complicated by the manner in which the subsidiary foreign tax credit is computed. The actual rate of combined tax is generally lower than the 52 percent United States corporate rate. In brief, the difference in the rate arises from the fact that the foreign tax is allowed first as a deduction since the United States tax is computed on the dividends which cannot exceed the foreign profits less the foreign income tax and, secondly, it is also allowed as a credit. The result is that the total tax, both United States and foreign, on foreign earnings before tax will be less than 52 percent unless the foreign tax rate is zero or exceeds 52 percent. If the foreign rate is exactly half the United States, the combined rate of United States and foreign tax on

[3] The other special corporate forms discussed above are of too limited application to be analyzed in detail in this paper.

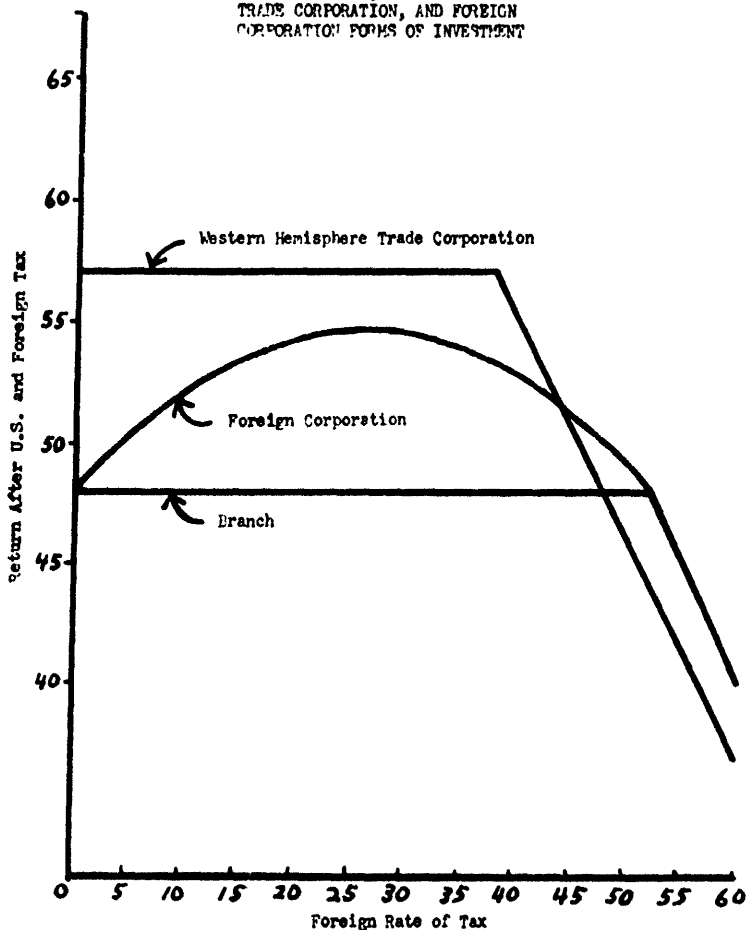
the foreign profits is approximately 45 percent of earnings before tax. As the foreign rate approaches 52 percent or zero from 26 percent, the combined United States and foreign tax burden approaches 52 percent.

Comparison of the forms of organization.—In graph I the net return under the three forms of organization is compared.

GRAPH I

RETURN AFTER U.S. AND FOREIGN TAX

COMPARISON OF BRANCH, WESTERN HEMISPHERE TRADE CORPORATION, AND FOREIGN CORPORATION FORMS OF INVESTMENT



The validity of the comparison is, however, subject to doubt. According to the Commerce Department's recent census of foreign investment actually only about 50 percent of foreign earnings are actually remitted to United States parent corporations. Therefore, in graph II a comparison of the net return from the use of Western Hemisphere trade corporations and from foreign corporations is made on the assumption that only 50 percent of earnings after foreign tax are actually paid out to the domestic corporate parent.

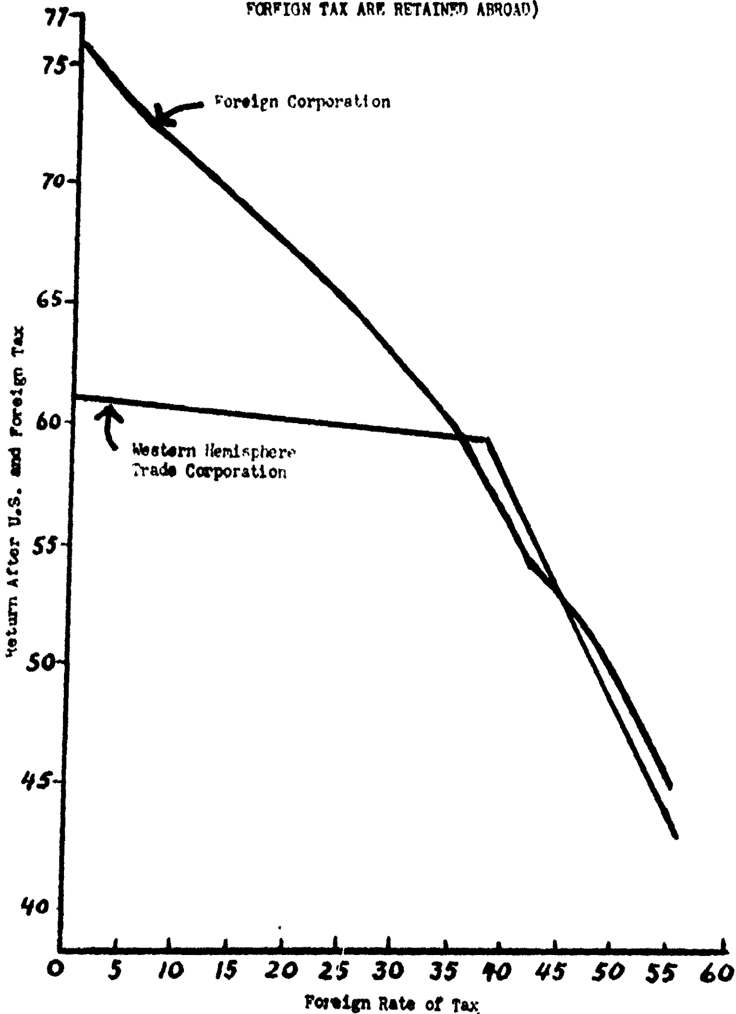
With the usual pattern of distribution of earnings, it is apparent from graph II that ordinarily a foreign subsidiary will be preferable

as the form of organization for a foreign investment. A foreign subsidiary permits the deferral of United States tax on foreign earnings until paid out in the form of dividends. As a consequence, the level of earnings after tax available for reinvestment in the business is set by the foreign rate, rather than the higher of the United States or foreign rate, as is the case with a branch or Western Hemisphere trade corporation. On the other hand, a corporate investor that wished to currently withdraw all foreign earnings would, if motivated only by tax considerations, usually choose to operate as a Western Hemisphere trade corporation. The decision as respects a corporate foreign investor is, therefore, largely determined by whether it wishes to accumulate foreign profits for expansion or whether it wishes to distribute currently its foreign profits.

GRAPH II

RETURN AFTER U.S. AND FOREIGN TAX

(ASSUMING HALF OF EARNINGS AFTER FOREIGN TAX ARE RETAINED ABROAD)



It should not be assumed from the foregoing discussion that the choice of form is made solely on the basis of tax considerations. Foreign subsidiaries are frequently chosen because of the other advantages they offer. They give the business a local flavor, which is frequently an asset, and they tend to serve to insulate the parent company from the jurisdiction of the foreign country.

Special considerations affecting the form of organization.—The general tax considerations discussed above in the choice of the form in which an investment will be made are often affected by special factors. In the extractive field, the limited deduction for exploration expenses, the deduction of intangible drilling costs, and the allowance of percentage depletion can make the branch form more advantageous than foreign incorporation. If the exploration and development of a foreign mine or deposit is conducted by a United States corporation directly, these expenses can be deducted in computing the United States tax of the enterprise. On the other hand, no part of these expenses is allowed as a deduction in computing income from dividends of a foreign subsidiary. This is true whether or not these expenses are recognized as deductions by the tax system of the foreign country. Consequently, it is frequently advantageous for extractive industries abroad to use branches as the medium of investment. Many foreign countries, however, will not permit the development of their resources except by corporations organized under their laws.

In countries like Canada and those of Western Europe, which traditionally impose relatively heavy income taxes, use of the branch form may be advantageous. Little, if any, additional United States tax is imposed on current earnings because the level of foreign taxes approximates that in the United States. Losses of the branch are deductible from domestic income. Moreover, in the event of devaluation a portion of the loss is then borne by the United States. Although companies do not usually expect initial losses, a branch permits deduction of such losses if incurred.

Other considerations may also dictate the choice of the branch form. In some countries valuable trademarks or trade names may be lost if a corporation other than the parent United States corporation uses these rights. As a result branches are often used to protect trademarks and trade names. Another factor which may lead to the use of the branch form is foreign laws which do not permit complete ownership of a local corporation by foreigners. In Japan, for example, this has resulted in branch operations by many United States corporations.

Foreign holding companies.—There has been a growing tendency for new foreign investors and for companies rapidly expanding abroad to organize their foreign operations through a holding company. In such countries as Canada, Liberia, and Panama, a corporation can be organized which is not subject to income tax so long as all of its business is done outside that country. The holding company utilizes earnings from export and from other foreign activities to finance investments in new countries. The effect of holding companies is, therefore, to defer United States tax on foreign earnings until those earnings are actually brought back to the United States as dividends.

A foreign holding company makes possible the accumulation of export profits, dividends, royalties, interest, and other income free of

United States tax. Thus, profits earned in one country can be used free of United States tax for investment in another country. As a result, an investor utilizing a foreign holding company can have up to twice as much capital available for foreign expansion as it would if its foreign income were subject to United States tax before being reinvested abroad. This is particularly true when much of the holding companies' income is derived from export, royalties, and interest, since these items of income are subject to little or no tax abroad. Since management frequently wants a corporation's foreign expansion to be self-financed, corporations investing through foreign holding companies do actually tend to expand more rapidly abroad.

Companies which have invested abroad for many years cannot usually transfer existing investments to foreign holding companies without becoming subject to prohibitive capital-gains taxes. The reason for this is that the tax-free reorganization of foreign corporations is only permitted if the approval of Commissioner of Internal Revenue is first obtained. In practice, this consent is rarely given.

The possibility of using such foreign holding companies can put responsible United States corporations in a dilemma. On the one hand, the directors of such corporations will wish to have their corporations pay their fair share of the burden of supporting their Government and they will wish to avoid all charges of tax avoidance. On the other hand, the use of such intermediate foreign holding companies is a perfectly legitimate way of increasing the ultimate return to stockholders whose interests the directors are pledged to uphold. At the same time, the investments made through the holding companies can serve to build up the foreign economies receiving the funds.

Tax incentives by foreign countries.—Foreign countries sometimes offer tax inducements to investment by United States corporations in activities which will promote their economic development. The methods most frequently used are (1) tax exemption or rate reduction for a limited number of years, or (2) accelerated amortization. For the United States investor, the integration of these incentive measures with United States taxation may present difficult problems.

Both types of incentives serve to reduce the foreign rate of tax in the early years of a foreign investment. Since a reduction of the foreign rate results under the tax-credit system in an increase in United States tax, the value of such incentives depends upon the investor's plans with respect to reinvestment of foreign profits. If foreign earnings are to be reinvested abroad, the reduction in the foreign rate is a substantial inducement. On the other hand, an investor that planned to distribute currently foreign profits would not obtain any benefit from the foreign incentive.

The Secretary of the Treasury announced a year ago that he was willing to consider the alleviation of this problem in particular cases by tax treaties. Under his proposal, tax credit would be allowed for income taxes which had been waived by the foreign country as an incentive to investment. To date no treaties incorporating this proposal have been negotiated.

When the foreign-tax incentive takes the form of a provision for accelerated depreciation, further problems may arise. The effect of accelerated depreciation is to reduce the effective foreign-tax rate in the early days of the life of an investment and to increase the rate of

effective foreign tax in the later days when there is no longer any allowable depreciation on the property of the foreign corporation. The early foreign-rate reduction is simply offset by the impact of the high United States rate—by an increase in effect in the United States rate. Although the high foreign tax later may be credited against the nominal United States tax, this credit is not applicable to that portion of the foreign-tax rate in excess of the statutory United States rate. Thus, in the later days of an investment made under an incentive scheme, the total tax rate may be higher than it would have been in the absence of the incentive.

Because of these factors, there has been a tendency for American companies to prefer incentives in the form of elimination of direct taxes like import duties, of subsidized plants and buildings, and of low-interest loans, rather than through tax-rate reductions.

Portfolio investment by corporations.—While there are few United States industrial corporations which actively engage in foreign portfolio investment, many have funds available for considerable periods that could profitably be employed in this manner. Often in the course of their business operations abroad, United States companies came into contact with foreign firms which have good prospects for growth and require foreign capital. The present tax law, however, tends to discourage domestic corporations from investments of this type. If less than 10 percent of the voting stock of a foreign corporation is owned by a domestic corporation (or 50 percent in the case of an investment by a foreign subsidiary of a domestic corporation), no credit is allowed the domestic corporation for the foreign taxes paid by the foreign corporation. As a result, a domestic corporation that invests in a foreign corporation in which it holds less than a 10 percent voting stock interest is subject to full United States tax of 52 percent without any offsetting credit. An equivalent investment in the stock of an American corporation, on the other hand, is subject to a tax of only 7.8 percent (the dividend less the dividends received deduction of 85 percent of the dividend times the United States corporate rate of 52 percent). Double taxation, thus, puts a premium on corporate portfolio investment in United States corporations, rather than foreign corporations.

INDIVIDUAL FOREIGN INVESTMENT

Investment abroad by citizens or residents of the United States may take the form of direct investment, portfolio investment, or portfolio investment through regulated investment companies.

Direct foreign investment by individuals.—As in the case of corporate direct foreign investment, form is a major factor in the selection of the means by which such investments are made by individuals. Often an individual direct investor lives in the country in which he invests. As a result, his earned income from the foreign business is exempt from United States tax. If the business is operated as a sole proprietorship or partnership, a portion of the profits which represents earned income is exempt. By statute, earned income is limited to not more than 30 percent of the income if capital is an income-producing factor in the business. The balance of the profits in this case are subject to United States personal income taxes, but credit is allowed for the foreign tax paid by the investor. If the

corporate form is used, the investor's salary is tax free: but dividends are subject to United States tax without a credit for taxes paid by the foreign corporation. On the other hand, a foreign corporation may still be preferable because it is easier to establish the amount of the earned income, the investor's salary. Further, since a foreign corporation permits the deferral of United States tax, the level of profits available for reinvestment will be set by the foreign tax rate, rather than by the higher of the United States or foreign tax rate. A domestic corporation may be equally advantageous from a tax standpoint when, as in most European countries, there is not any significant difference between the United States and foreign tax rates.

Foreign holding companies are not generally used by individual direct or portfolio investors because of the foreign personal holding company provisions of the Internal Revenue Code. A foreign personal holding company is a foreign corporation 50 percent or more of the value of the stock of which is owned by 5 or fewer individuals who are citizens or residents of the United States and 50 percent or more of the gross income of which is derived from dividends, interest, and other specified types of investment income. If an individual owns stock of a foreign corporation which is a foreign personal holding company, the individual is subject to tax on his pro rata share of the corporation's income even if that income is not actually distributed to him.

Portfolio foreign investment by individuals.—Individual foreign investors are allowed a credit only for foreign taxes imposed upon them. Therefore, only taxes directly imposed by foreign countries, usually in the form of withholding, may be set off against United States taxes on dividend income. Until passage of the Internal Revenue Code of 1954, this approach resulted in the equalization of the tax consequences of investment in foreign securities with that of investments in domestic securities. Now, however, domestic stock investments are tax favored because the $50 dividend exclusion and the 4-percent dividend tax credit do not apply to dividends from foreign corporations.

For high-bracket taxpayers, who are probably the investors most likely to be in a position to take the greater risk involved in foreign investment, the denial of the 4 percent tax credit to dividends paid by foreign corporations can be a significant factor. For example, for an investor with an 80 percent marginal tax rate the 4 percent tax credit results in a 20-percent increase in his take-home after tax from an investment in domestic stocks. Despite this tax differential, however, foreign securities have continued to find a reviving market in the United States. In 1954 net purchases of Canadian stocks, other than the stocks of newly formed investment trusts, amounted to over $50 million. In the last 2 years there has been large growth in United States investment in European—mostly Dutch—securities. Net increases in United States investment in European stocks has been estimated at $100 million in 1954 and $55 million in the first half of 1955.

Portfolio foreign investment through regulated investment companies.—Since 1953 substantial United States capital has been invested in foreign investment companies organized for the purpose of converting dividend income into capital gains. Investments in stock of such companies is particularly attractive to high-bracket taxpayers who have no immediate need for dividend income. One hundred mil-

lion dollars was invested in Canadian companies of this type by individuals in the United States in 1954 alone.

The manner in which these companies operate is as follows: An investment corporation is established in Canada to invest funds in securities of Canadian and other foreign corporations. Under Canadian tax law dividends received by one Canadian corporation from another are not subject to tax. Moreover, capital gains are not taxed in Canada. If substantial income is derived from sources other than dividends on stock of Canadian corporations, the investment company can elect to be taxed at only 15 percent by choosing status as a non-resident-owned investment company. Thus, the tax on the accumulation of income by these companies is limited to 15 percent. Individual American investors realize the profits from the companies at capital-gains rates either by selling their shares to third persons or by the corporation redeeming them.

A substantial measure of protection is afforded investors by the registration of these companies with the United States Securities and Exchange Commission. The SEC permits distribution of the stock of these companies in the United States if they meet standards similar to those imposed on domestic investment companies.

Foreign portfolio investment by domestic investment companies has thus far been slight. At present, these companies regularly distribute all of their income and cannot pass on to their shareholders foreign tax credits unless 50 percent of their assets are invested in securities of foreign corporations. Moreover, the need to value their portfolio twice daily may make investment in attractive foreign securities with small markets impossible.

SUMMARY

United States taxation of foreign source income is cumbersome, formalistic and frequently inequitable. It is inequitable in that it imposes different tax burdens on similarly situated taxpayers conducting the same economic activities in a foreign country. The differences in tax burdens arise solely from variations in the legal form through which the business activity is conducted. Portfolio investors are similarly subjected to different tax burdens. Individual portfolio foreign investors are subject to higher taxes than investors in United States securities. Moreover, a foreign investor who holds stock directly is subject to substantially heavier taxation than one who holds his foreign securities through a foreign investment company.

The present system also tends to discourage foreign expansion of direct investing companies by taxing income withdrawn from one country for investment in another. The efforts of foreign countries to attract investment by tax incentives may also be frustrated because of the manner in which the tax-credit system operates.

Many justifiable technical criticisms have also been made of the present tax pattern. For example, the definition of an income tax for which credit will be allowed is narrow and frequently results in the denial of credit for foreign levies which have the effect of income taxes.

Overall, two additional observations are appropriate. The present tax provisions, because of their dependence on form, place an inordinant importance on the planning of the form in which an invest-

ment is made. In addition, the present law imposes operating handicaps on foreign corporate investors. Once a particular form is selected, it cannot later be changed without incurring substantial taxes. As a result, most companies which have been active in the foreign field are burdened with a complex and unwieldy corporate structure that bears little relation to the functional organization of their foreign operations.

REVENUE ASPECTS OF THE PRESENT TAX PATTERN

A major consideration in any legislation with respect to taxation of foreign source income must necessarily be its effect on revenue. While the Treasury Department has issued no statistics on the present tax collections from foreign source income, reasonable estimates can be made based on information from other sources. To obtain a concept of the magnitude of the revenue, income both from foreign investment and from export must be analyzed.

The most complete analysis of the revenue aspects of taxation of foreign source income was made in Barlow and Wender, Foreign Investment and Taxation, Prentice-Hall, New Jersey, 1955, pages 257–262. It was there estimated that in 1952 the total tax revenue was between $900 million and $1,000 million. Of this sum, $200 million was derived from taxes on items of investment income like dividends, interest, and royalties. The balance of $700 million to $800 million represented tax collections on income derived from export. In 1955, the total will doubtless exceed $1 billion due to the increase of both foreign investment and export.

The reason profits from export must be included in any estimate of tax revenue from foreign income relates to the definition of income from foreign sources. Under present law, income from the purchase of goods in the United States and their sale abroad is derived from the place where the goods are sold.[4] The place of sale is usually considered to be the country in which title to the goods passes from the buyer to the seller. Experience with the Western Hemisphere trade corporation provisions and Panamanian export corporations has demonstrated that if there is a substantial tax advantage to be gained by converting export income to foreign source income, sellers will arrange export shipments with title passing abroad.

As a consequence of the substantial revenue involved, tax legislation to provide an incentive to foreign investment raises a problem. The present level of national expenditures does not permit a tax incentive which results in large revenue losses. Thus, if an incentive is to be provided by a reduction in the rate of United States tax, a definition of foreign income qualifying for the reduced rate may be required which excludes export profits. The recommendations of the Randall Commission, as well as the provisions of section 923 of the House version of the Internal Revenue Code of 1954 and of H. R. 7725 introduced by Chairman Cooper of the House Ways and Means Committee in the closing days of the last session of Congress, are examples of this approach. They would grant a reduced tax rate of 38 percent

[4] In the case of manufacture within the United States and sale by the manufacturer abroad, income is apportioned between United States and foreign sources on the basis of the independent factory price of the goods in the United States; or, if none exists, of a formula contained in regulations. Since the formation of an export subsidiary is not interdicted, such a company is ordinarily set up when the classification of income as foreign serves an important purpose.

only to certain types of foreign income, so as to keep down the revenue loss.

3. THE EFFECT OF UNITED STATES TAXATION ON THE AMOUNT OF PRIVATE INVESTMENT ABROAD

The task of estimating the effect of taxation on investment abroad is particularly difficult, for so many imponderable factors normally enter into any decision to invest abroad. The number and complexity of these factors seem to rule out from the start any hope of measuring statistically the effect of taxation on investment abroad. There are available, however, two imperfect approaches for estimating the effect. One way is to conduct interviews and to circulate questionnaires asking businessmen what effect they think taxation has had or might have on the amount of their investment abroad. The other way is to analyze what would be the economic effect of various possible tax changes and then to estimate whether these effects would be the marginal consideration which tipped the scales in favor of investment abroad in any appreciable number of cases.

Interview and Questionnaire

THE COMMERCE STUDY

Under congressional direction contained in the Mutual Security Act of 1952, there was undertaken the most extensive effort thus far in the field of interrogation about foreign investment. The effort involved a combination of the questionnaire and the interview. Questions contained in a 22-page questionnaire were put to almost 400 companies by staff members of the Department of Commerce and the answers recorded. Later, the answers from 247 companies with direct investments abroad, 66 companies with no investment abroad, 27 banking institutions, and 26 investment institutions were tabulated and published as part 2 of Factors Limiting United States Investment Abroad.

Taxes did not come first in the answer to a question about the past. When asked, "What are some of the factors or impediments that would rule out any consideration of specific foreign investment projects by your company?", the officers of 55 percent of the companies mentioned inconvertibility of currency. In order of importance thereafter came instability of country, nationalism, fear of expropriation, limited market or source of supply, and then foreign and/or United States taxation, mentioned by 17 percent of the companies. In most cases, companies reported that they had made investments abroad only in fields closely associated with their principal fields of activity in the United States.

About a fifth of the replies indicated that one or more aspects of the present tax system are encouraging to investment abroad. When company officers were asked, however, what changes would have to occur as a minimum in the future before their companies would be interested in expanding or establishing investments abroad, 44 percent of the investors and 39 percent of all companies mentioned the necessity of more favorable taxes. This necessity was mentioned more

often than any other; in second place was the need for convertibility mentioned by 29 percent of the companies.

The same interest in taxation was shown in answers to the question as to what steps the United States Government should take. Some 43 percent of the investors and 39 percent of all companies recommended that the Government grant tax relief or incentives. The next most popular recommendation was the promotion of trade by reduction in tariffs, mentioned by 23 percent of the companies. In the tax field the Government was urged by various companies to eliminate or reduce the United States tax on foreign earnings, to negotiate more tax treaties, to extend the Western Hemisphere trade corporation provisions, to permit rapid amortization of foreign investments, to equalize the tax benefits of foreign subsidiaries and branches, to change the limitations on foreign tax credits, and to improve administration.

In summary, the Department of Commerce interrogation seemed to indicate that changes in taxation were not a prerequisite to increased investment abroad if enough other factors changed for the better. On the other hand, there seemed to be a general feeling that a change in taxation was the place where a sufficient improvement might most reasonably be expected. The strong recommendation for United States Government action in the tax field would seem to have been based on the expectation that such a change could to some extent offset other unfavorable factors and that tax changes were the most important action which the United States Government could take in its rather limited field of influence.

THE NATIONAL INDUSTRIAL CONFERENCE BOARD SURVEY

In 1951 the National Industrial Conference Board published a report on another survey, one which the board had undertaken at the request of President Truman's Committee for Financing Foreign Trade. This survey was made by mailing out a questionnaire which could be answered by checking one of the multiple choices of answers listed. Answers were received from slightly over a hundred firms, which were estimated to be responsible for 54 percent of United States direct private foreign investment.

When asked what might be done to encourage investment the largest group, that is, 24, suggested changes in United States tax laws. Nine others recommended elimination of double taxation. The next most important area of recommendation concerned guaranties against losses arising from expropriation and inconvertibility. As in the commerce study, however, taxation did not rank as high in the listing of investment impediments that had been met in the past. As leading postwar problems all the following were listed before taxation, with the most important being listed first: export or import quotas, limitations on remittance of profits, control of capital movements, burden of social-security legislation, lack of trained native personnel, lack of roads, etc., multiple exchange rates, inadequacy of facilities for employees, inadequate power facilities, foreign restriction on importation of personnel from home, instability of government, lack of health and sanitary facilities, and expropriation. Then came mention of special taxation of foreign enterprise, and further down the list was mention of discriminatory enforcement of tax laws.

In dealing with such questionnaires there is always danger that the answers will be prejudiced by the framing of the multiple choice answers, but in general the National Industrial Conference Board survey seemed to agree with the Commerce study that taxes may not be the major source of trouble but are at least a factor, a change in which could effect a partial cure.

THE BARLOW AND WENDER STUDY

More recently a survey has been made which appears at a first glance to challenge the conclusions which follow from the Commerce and Conference Board tabulations. In August of this year there was published Foreign Investment and Taxation by E. R. Barlow and Ira T. Wender. Included in the book are case studies and general discussion based upon 4 months of interviews of United States companies, investing and noninvesting, large and small. The authors tried to learn in detail why and how some companies invest abroad and why some other companies do not invest abroad. From their interviews Messrs. Barlow and Wender conclude:

> We found no evidence to suggest that United States taxes had been an impediment that had prevented particular investments in foreign countries. More important, we found no instance where executives believed that total exemption of foreign income from United States taxes would have tipped the balance and changed a decision that had been made against a particular investment. There was no indication that the greater return that lower taxes on foreign income would allow would counterbalance the influence of certain factors limiting investment. Where a company was reluctant to invest in a particular country because of the exchange situation, or the opinion of management about the climate in the particular country, the higher return on the investment from lower taxes would not be sufficient to overcome this reluctance.

This general conclusion was modified somewhat in a later paragraph:

> Therefore, as a straight offset to the factors limiting investment * * * we believe that changes in United States taxation of foreign income will be ineffective. We conclude, however, that changes in the methods of taxing foreign income can stimulate more United States investment, but primarily through increasing executives' interest in foreign opportunities and making it easier for companies to invest abroad.

As a result of this modification it is evident that there is not as great a conflict between the Barlow-Wender conclusions and the previous studies as might have appeared at first glance. All three studies suggest that tax changes can be effective in increasing investment abroad. Barlow and Wender add the qualification that the changes are likely to be effective through making companies more active in investigating opportunities. Their interviews led them to believe that the principal reason companies do not invest abroad is that their chief executives are not interested in foreign investment. Substantial tax changes could overcome the lack of interest. They did not encounter any cases, however, in which the decision against a thoroughly investigated investment proposal was so close that the removal of United States taxes on the income from the proposed venture would have reversed the decision. In some cases the possible errors in the estimation of other factors, such as extent of market, were so great that companies did not feel it worth while to make a detailed tax analysis.

THE LIMITATIONS OF QUESTIONNAIRES AND INTERVIEWS

The question naturally arises as to how much reliance can be placed on the results of these systematic interrogations. There are, of course, the normal dangers inherent in any sampling process: That the sample is not truly representative, that the phraseology of the questions or the suggested answers affects the responses received, and that the preconceptions of the interpreters of the responses affects the conclusions drawn. In addition there are a number of special considerations which probably limit somewhat the reliance which can be placed on investigations in the field of foreign investment.

When businessmen are asked what would be the effect on their investment abroad of a reduction in the rate of total tax on income from abroad, they necessarily speak from a limited experience. In the past, generally speaking, there has been little occasion for businessmen to consider the relative height of tax rates between the United States and abroad and among various foreign countries, since the United States rate was the effective rate except when a foreign rate was even higher. There were two important exceptions to this general rule: in the case of investment through Western Hemisphere trade corporations and in case a fine calculation was made as to the increased eventual return which could result from the reinvestment abroad of foreign income which had been diminished only by low foreign taxes.

Even when businessmen, in answering questionnaires, could mentally project themselves into a future situation in which foreign taxes were generally the ruling rates, there would be another difficulty. They would probably think in terms of the tax rates in those countries which had been the primary recipients of investment in the past. In those countries the tax rates have been generally high, so that a shift in the effective tax rate from the United States rate to those foreign tax rates would not involve a strong investment attraction. It is possible, however, that the removal of United States taxes would prove particularly encouraging to investment in countries with very low tax rates—and possibly low levels of government services—countries which investment had avoided when the same total tax had been imposed on income from those countries as on income from within the United States.

A further difficulty is that taxation might have indirect effects which would not be felt directly by any one businessman and which, therefore, would not be reported by him. This consideration is relevant, for example, to the observations made by Barlow and Wender. They reported that they encountered no case in which in the opinion of the company executives the removal of United States tax would have reversed a decision against any fully investigated investment project. Possibly, in this world where so many considerations are matters of degree, there have been other projects in which the decision against investment was so close that a sizable tax saving could have reversed the decision, especially since initial consideration must have shown some possibility of investment to justify full investigation of the projects. Nonetheless, if the cases encountered by Barlow and Wender are truly representative of all cases, it is still possible that there were indirect tax effects on these cases. Their investigation led Barlow and Wender to conclude that the principal reason some companies

didn't invest abroad was the lack of interest on the part of the executives of the companies. But what lies behind that lack of interest? The Barlow-Wender observations are consistent with the possibility that one factor indirectly responsible for the lack of interest has been the fact that the same tax rate has applied in the past to income from underdeveloped countries and to income from within the United States. Conceivably a substantial change in tax treatment of income from abroad could, not only arouse individual curiosity, but also alter entire group attitudes toward foreign investment.

For this reason it is appropriate to supplement a study of what businessmen now say would be the effect of tax changes with a certain amount of basic economic analysis of the changed profit possibilities which would confront the businessmen after tax changes.

Economic Analysis

THE EFFECT ON TAKE-HOME OF EXEMPTION OR SIZABLE REDUCTION IN THE UNITED STATES TAX RATE FOR FOREIGN INCOME

Some United States corporations are allowed at present to take home 48 cents out of each dollar earned by investment abroad, that is, they retain 48 cents for reinvestment, debt amortization, or dividend distribution after they pay 52 cents combined foreign and United States income tax. If those same corporations invested in a foreign country which had a 30 percent tax rate--and there are a fair number with even lower rates--the take-home would be 70 cents if the United States did not superimpose a tax on the foreign tax. The increase in take-home from 48 cents to 70 cents would represent a 46 percent increase in investment yield. The increase in yield would be even greater, that is, 52 percent, if the United States corporation were paying a 2 percent consolidation penalty as many United States investors do; and the increase would be 58 percent if the corporation were paying the 7.8 percent upstream dividend tax instead of the consolidation penalty. Of course, the increases in yield would be still higher if the foreign tax rate were below 30 percent.

It is hard to see why such large increases in investment yields would not attract considerable investor interest if United States taxes on foreign income were removed. Additional income taken home as a result of a tax change is just as valuable as additional after-tax income resulting from increased sales or lower costs. Even if an investing corporation were not subject to a consolidation penalty and were interested only in an investment in a country with a 40 percent tax, then there would be a 25 percent increase in investment yield. One would not expect an investment return differential of even this magnitude to be ignored by corporate managers.

THE EFFECT ON TAKE HOME OF TAX DEFERMENT

If the only change in United States law were to make generally available the opportunity to defer United States tax, what then would be the effect on investment return? The answer, of course, depends on the amount of reinvestment abroad which a United States corporation were willing to make from the income of its foreign branches and on the period for which the reinvested funds were to be left abroad. If there is no reinvestment the deferment privilege is not

relevant; at the other extreme if there is never a withdrawal of earnings the investing corporation cannot serve its stockholders by foreign investment. If, for example, there is assumed a situation in which a corporation annually reinvests abroad 50 percent of its earnings from abroad after all taxes on the income, what would be the effect of deferment in a case in which the United States tax rate were 52 percent and the foreign rate only 30 percent? An answer to the question can be suggested by contrasting the results of two corporations following different policies under present law.

Suppose the 2 corporations both operated abroad through foreign subsidiaries in 30-percent tax-rate countries, but the first company reinvested income only in the same subsidiary which produced the income while the second company brought all its income home and then reinvested in other countries. The first company would thus not be subject to a current United States tax on its reinvested income, while the second company would have all its income subject to United States tax. In these circumstances the eventual increased rate of return for the first corporation as contrasted to the second indicates the effect of the opportunity to defer United States tax. If it is assumed that the rate of return abroad before tax is 20 percent in each year and in each of the countries in question, then the amount of annual take home after taxes and after reinvestment would be higher in the first case by 1.4 percent in the second year, by 6.1 percent in the fifth year, and by 14 percent in the 10th year of operations.

The effect of deferment would be less if the foreign-tax rates were higher. On the other hand the effect would be greater if the foreign tax were less, or even zero. In most cases the income earned by United States exporters is not taxed abroad, so that the consideration of zero tax rates becomes relevant if thought is given to allowing deferment of United States tax on income from exports. Of course, United States companies can obtain complete deferment of the tax on their income from exports under present law if they are willing—as many companies do not seem to be—to conduct their export business through a corporation of a foreign tax-free haven. If the deferment for United States companies is of a large tax percentage it might serve to promote investment through a consideration other than an increased rate of return. Sometimes companies are willing to enter into investment abroad but are not willing to put up the minimum sum necessary to establish a going concern abroad. In these circumstances the availability of tax-deferment funds might enable a company to invest the minimum required without exceeding the maximum it was willing to risk from its own funds. The difference would be advanced, in effect, by the Government as an interest-free, nonrecourse loan.

THE EFFECT ON TAKE-HOME OF THE METHODS OF CALCULATING FOREIGN TAX CREDITS

A third tax change, which would presumably be introduced in combination with rate reduction and deferment of United States tax, would be to allow United States corporations to calculate their United States tax on the income from their foreign branches on the same basis as their income from their foreign subsidiaries. Under present law the tentative United States tax, from which is deducted the allowable

foreign tax credit, is calculated against foreign income before tax in the case of income from a branch and against income after tax in the case of income from a foreign subsidiary. As a result the investment return from conducting a foreign venture through a foreign subsidiary is higher than the income from conducting the same venture through a branch. In the case again of a corporation paying a 52-percent rate in the United States and 30 percent abroad, but with no reinvestment, the take-home is 13.8 percent higher if a foreign subsidiary is used.

In addition to the rational effect on investment motivation of the prospective increases in take-home which have been illustrated for the most important tax changes under discussion, there may also be some irrational effect. Though a dollar is a dollar whether it was earned at home or abroad, it may be easier in some cases for a company to invest abroad dollars which came from abroad. Barlow and Wender have suggested that companies sometimes look upon foreign earnings almost as gambling winnings which can be subjected to more risk than dollars earned in the course of domestic business. There is undoubtedly truth in this observation for some companies new in the foreign field, with their foreign activities not integrated into the business, but the argument that irrationality rules in foreign investment can be carried too far, for example, in the argument that some types of investments abroad are immune from tax considerations.

ARE SOME TYPES OF INVESTMENT IMMUNE FROM TAX CONSIDERATIONS?

The contention is sometimes heard that the great bulk of United States investment abroad is of a type which would have been made regardless of any deterrents present either in foreign or in United States tax laws. It is further contended that this investment is of such a nature that tax incentives could not appreciably increase its amount. These arguments are not relevant in discussions of tax changes which are being considered in fairness to the investor, but they are relevant to changes primarily justified as a means of encouraging increased investment abroad. Often mining and petroleum investments are said to typify the investments immune from tax factors. Sometimes, too, it is suggested that investments for manufacturing behind trade barriers in order to retain sales outlets is a form of investment for special purposes, a form little affected by tax considerations.

The Department of Commerce questionnaire was worded in such a way that it might unintentionally suggest these explanations to the businessmen for their investments. The questionnaire was not phrased to ask through what means the companies expected to earn their profits abroad. Rather, the companies were asked what benefits other than profits they expected from their foreign investments. In many cases, however, the answers were not responsive; the answer "profit" was given despite the instructions. Even where "source of supply" was the answer given, it does not follow that a careful profit calculation was not made before the decision was taken to exploit the particular source of supply.

It is certainly true that many investments in natural resources have been made in out-of-the-way places where the investment climate was far from good. Nonetheless, this fact cannot be taken to indicate

that a close profit calculation, in which taxes are an important factor, is not made for such investments. The locations of likely mineral prospects are usually well known for years before some company decides to take the risk of investing the large sums required to prove the deposits. Usually, too, a long period of negotiation precedes such investments. The fact that an oil company invests millions in a desert where there may be oil does not indicate that oil companies are less rational than the retailers who do not invest in the desert, where there is no market. There are some locations which even oil companies won't invest in unless the taxes are right. This is illustrated, for example, by the recent action of the Government of Colombia which has reduced from 50 to 40 percent its required share of the profits of an oil producing venture in eastern Colombia. Colombia is thus seeking to attract sizable investments to its inaccessible plains across the Andes. A further consideration in interpreting the figures for so-called petroleum investments abroad is the fact that a sizable proportion of the investment is not for oil production but, rather, for manufacturing and marketing, which are clearly not so geographically determined as is production.

In a similar vein it can be pointed out that a good number of United States firms have invested abroad to retain sales outlets behind trade barriers, despite their reluctance to make the investments and despite their belief that the foreign governments were harming themselves by requiring the consumption of more expensive goods. The particular circumstances of such investments does not prove that tax factors have not or could not affect the volume of the investments. The number of such investments have been relatively small considering the large number of countries with high trade barriers. The success of some countries, such as Holland, in attracting such investment also indicates that climate and investment incentives are important in determining in just which country the manufacturing investments are made.

THE IMPACT OF THE ANNOUNCEMENT OF TAX CHANGES

Regardless of the extent to which investment abroad is motivated by rational or irrational considerations, it is likely that any significant change in the United States tax treatment of income from abroad would increase investment abroad to some extent just because of the attention which would be attracted to the subject. The careful calculators might sharpen their pencils for a new analysis of possible investments under the new tax rules. Those who invest on the basis of their analysis of general trends might be moved to reconsider their general conclusions. But possibly most important of all, some investors who had paid little attention to the opportunities abroad in the past would have their attention attracted and their curiosity aroused. These last businessmen might be most likely to spot new investment opportunities abroad since they would be looking for the first time at the prospects as related to their particular specialties. This possibility is consistent with the Barlow-Wender conclusion that lack of interest is the principal explanation why many companies haven't invested abroad.

THE INDIRECT EFFECT OF THE UNITED STATES TAX SYSTEM IN DETERRING INVESTMENT ABROAD

In addition to the direct effects of changes in United States tax law in attracting the attention and affecting the decisions of United States businessmen, there could be important indirect effects.

The high United States tax rates combined with the tax credit system offer encouragement to foreign governments to raise their tax rates on the income of United States investors. There are various ways in which the effective rates may be raised: Rates may be raised generally; rates may be made more progressive so as to hit only the large foreign companies; rates applicable only to certain industries having large foreign investments may be raised; and taxes may be collected in a manner which discriminates against the foreign company. Foreign governments may conclude that the raising of rates in these ways will not increase the total effective tax on income distributed to the United States unless the foreign rates are raised above the United States rates. The foreign governments may hope, therefore, that they can raise their rates without adversely affecting the interest of United States investors in their countries. Probably the United States tax credit system has in no case been the single cause of a foreign rate increase. However, the belief that the tax credit system would neutralize the effect of a rise in tax rate may have been the marginal factor which determined the outcome of many governmental deliberations on rate increases.

The conclusion that increases in foreign tax rates do not affect the investor needs several important modifications, and it is possible that the tax credit system has hampered investment abroad because foreign governments have given insufficient weight to these qualifications. Raising the foreign rate does affect the total tax paid on the income earned by a foreign subsidiary; by the arithmetic of the system whereby tentative United States tax is calculated on the dividend income rather than the income before foreign tax of a foreign subsidiary, an increase in a foreign tax rate from 26 percent toward 52 percent, does increase the total tax paid in the case of a United States corporation not subject to the consolidation penalty. To the extent, too, that a company wishes to reinvest the earnings of a foreign subsidiary a higher foreign tax rate reduces the profit prospects. Finally, investors may be deterred by an increase in foreign tax rates because of a hope that United States rates will decline substantially in the future and because of an accompanying fear that foreign rates once raised will not fall again.

Another important but somewhat indirect effect of the United States tax system is to give a competitive advantage to investors from some other countries, thereby creating a barrier to United States investors. Lower tax rates on foreign producers increase the competition also for domestic producers in the United States but distance, market affinities, and other factors reduce the importance of this competitive advantage. For the investor abroad the competition is sometimes severe from local investors and from investors from other countries. Though it is often pointed out that the underdeveloped countries of the world need all the private investment they can attract, it is still true that individual investors often face active competition in supplying the investment for particular projects in the limited markets of the underdeveloped countries.

As examples of the tax advantages afforded by some governments it may be pointed out that the Swiss Government does not tax the foreign income of Swiss companies. Belgium and the Netherlands impose special low tax rates on income from abroad. France exempts from tax the income of foreign branches but taxes income from foreign subsidiaries. Canada exempts from tax the dividends of a foreign subsidiary owned to the extent of 25 percent and exempts also the income of a special type of Canadian corporation which operates wholly outside Canada. In some cases the British tax system is more onerous than the United States system; in other cases a tax advantage is given. The British Government taxes currently, not only the income of British companies operating abroad and managed from the United Kingdom, but also the income of foreign corporations managed from the United Kingdom. On the other hand, British taxes are not now applied to the foreign income of a British company which is managed abroad, and consideration is presently being given to a liberalization of the British tax treatment of income earned abroad. It is also true that the rates of corporate tax in the United Kingdom are at present somewhat below the United States rates when calculated on a comparable basis. The corporate rates are also lower in many of the underdeveloped countries; in these countries there is therefore a tax advantage relative to United States investors for any local entrepreneurs who may be available.

These various foreign tax provisions can result in lighter tax burdens on the foreign investor in comparison to the United States investor. To the extent of such tax disadvantage for the United States investor the United States tax system creates an indirect impediment to private United States investment abroad.

4. PROPOSALS FOR CHANGES IN UNITED STATES TAX TREATMENT OF FOREIGN INCOME AND OPERATIONS

The more imporant proposals for changes in the United States taxation of foreign income and operations manifest belief that taxation affects commercial decisions in matters of domestic and international importance, and that adjustment of the burden of taxation by laws of general applicability is an appropriate means for achieving desired ends. The extent to which considerations of fairness to investors are given weight, apart from the standpoint of directly affecting decisions on current and prospective investments, varies considerably.

The following discussion will consider these proposals only as they involve the more usual kinds of commercial activities.

Corporate Business

The proposals typically concern one or more of the following legal factors: exemption from United States tax or rate reduction; deferral of payment of United States tax; depletion and similar allowances to members of extractive industries; utilization of foreign losses; use of various foreign taxes as credits against United States tax; amortization or other form of writeoff of foreign investments; and the tax consequences of changes in form of a business unit which are required to meet formal requirements for tax benefits.

The proposals specify what shall be done in respect of one or more of the following operating factors: a venture may be a branch of a domestic corporation, or a separate domestic or foreign corporation; it may have profit or loss; it may pay foreign taxes of different kinds; it may conduct an active business or simply hold portfolio investments; and its business may have more or less direct relation to business domestic to the United States.

EXEMPTION AND RATE REDUCTION

Given a profitable foreign venture, exemption from United States income tax would eliminate about every problem of United States taxation except the usually large one of what income is to be exempt.

Some who propose exemption as a matter of principle recommend rate reduction as a presently practicable alternative. The recommended rate differential usually approximates the 14 percentage points allowed to Western Hemisphere trade corporations under existing law. The mechanics of some proposals would ultimately provide for benefit of substantially more than 14 percentage points; and others, of less.

DEFERRAL

Various proposals would extend to operations of domestic corporations, the right of foreign corporations to defer payment of United States tax on foreign income until receipt in the United States. Some proposals would extend this privilege to branches of domestic corporations which would be treated much the same as foreign subsidiaries, and others would extend it to a new and special kind of domestic corporation.

TESTS OF QUALIFICATION FOR EXEMPTION, RATE DIFFERENTIAL AND DEFERRAL

Some proposals would exempt from United States tax, any income attributable to a foreign permanent establishment. The lack of such an establishment has been made a requirement for exemption under tax treaties. But entitlement to exemption from United States tax is hardly a necessary corollary to disentitlement to exemption from foreign tax. Any relationship between the two would be more in the control of the taxpayer than the taxgatherer; the cost of maintaining a permanent establishment might be insignificant in relation to the potential United States tax benefits; and a foreign permanent establishment might be but an arm of a predominantly domestic venture, as where it serves as a sales outlet for articles manufactured in and exported from the United States.

Other proposals would limit the kinds of foreign source income qualifying for preferential treatment, by means ranging from the relatively simple requirement that the foreign activity shall have paid foreign taxes in due course, to elaborate specifications of particular attributes, as in the House version of the Internal Revenue Code of 1954.

On the other hand. it has been strongly urged that such efforts can never be wholly effective, and that, to the extent they are, they cannot but exclude important activities which should receive treatment as favorable as activities which do qualify. They would take a more

expansive view of qualification, permit little if any rate differential, and make deferral of United States tax the principal means for encouraging foreign investment. Some urge that it would be impracticable and unwise to try to exclude from such limited incentive treatment, profits from exporting from or importing into the United States. Others concede difficulty, but would attempt to make the distinction, in the hope of making some, if imperfect, progress.

SPECIAL ALLOWANCES

The special allowances of present law to domestic taxpayers in extractive industries would frequently outweigh advantages of rate reduction and deferral. Use of a domestic corporation is then indicated. But foreign law may require use of a foreign corporation. To preserve the special allowances in these circumstances, it has been proposed that there be an election to include the foreign corporation in a consolidated return.

There is the further question, whether special allowances should be granted to an operation qualifying for rate reduction or deferral. Some would permit this and others would not.

TREATMENT OF LOSS

Existing law permits current foreign loss to reduce current taxable domestic income where the loss is incurred by a branch of a domestic corporation; and where it is incurred by a corporation which, although foreign, is allowed in exceptional circumstances to file a consolidated return with a domestic corporation. It seems generally recognized that it would be somewhat incongruous to give free choice to take losses into account where tax on income would have been deferred; but there is substantial support for expanding opportunities for including foreign corporations in consolidated returns in order to permit current utilization of foreign loss experience.

On the whole, the level of interest in treatment of loss seems to be less than in treatment of income, which is the normal expectation of those who plan to make investments.

The Internal Revenue Code of 1954 did give some increased effect to current foreign loss, by abolishing the overall limitation on foreign tax credits, which had made loss in one foreign country disqualify foreign tax of another foreign country.

FOREIGN TAX CREDIT

As has been said, the 1954 code eliminated the overall limitation on credit for foreign taxes. There is a substantial body of opinion that it would have been better to eliminate the per-country limitation, since advantage in respect of losses is usually less of an incentive to investment than advantage in respect of income; and since under existing law, foreign incorporation can defeat operation of that limitation.

It has also been proposed that the taxpayer be given an election between the two limitations.

Another proposal would permit carryback and carryforward of unused foreign tax credits. This would do much to solve the plight of taxpayers who often cannot accommodate to different ideas of dif-

ferent sovereigns on what is income and when it is to be accounted for—e. g., a stock dividend by a foreign corporation, taxed on issuance by a foreign country but not by the United States.

There is much support for the position that the categories of foreign taxes qualifying for credit ought to be broadened to include any tax, including excise tax, imposed on income items; and property taxes which affect the rate of income or excess-profits tax. The House version of the 1954 code attempted to cover this area, but the attempt was abandoned in view of uncertainty as to how it would apply in practice.

There is also much support for the view that the corporate relationships required to enable one corporation to take credit for foreign taxes paid by another are too narrowly drawn, with the result that portfolio investments in foreign corporations are discriminated against. Accordingly, some proposals would permit a domestic corporation to take credit for foreign taxes paid by a foreign corporation from which it has received a taxable dividend in a substantial amount such as $1,000 or more, and abolish the requirements of ownership of specific percentages of stock interest imposed by present law—10 percent in the case of a foreign subsidiary of a domestic corporation, and 50 percent where the investment in the foreign corporation is by a foreign subsidiary of a domestic corporation.

WRITEOFF OF FOREIGN INVESTMENT

There have been proposals for amortization or writeoff of foreign investment. Bearing little relation to the results of operation of the foreign enterprises, such treatment would seem to require case-by-case discretionary application of standards in a manner which cannot practicably be set out in terms of generally applicable law.

CHANGES IN LEGAL FORM OF BUSINESS UNIT

Present law gives substantial tax consequences to foreign incorporation. On otherwise identical facts, the place of incorporation can control when and at what effective rate income shall be taxed by the United States.

The very fact that foreign incorporation would provide incentives may make them unavailable. To avail of provisions of United States tax law for tax-free corporate changes, it is necessary to get advance administrative approval where a foreign corporation is involved, and such approval is seldom given. The cost of change in corporate form of a substantial business without such approval often appears to be prohibitive, if only because questions of valuation which cannot be determined until after the event appear to admit of a wide range of judgment.

The result of all this is that companies have frequently been denied tax incentives under existing law, by virtue of what is often the historical accident of place of incorporation. There is much support for the view that incentives should be available on equal terms to commercially comparable businesses.

HOUSE VERSION OF 1954 CODE

In response to general recommendations made on high authority, the House version of the 1954 code provided for a 14-point rate dif-

ferential for some kinds of foreign income; and also for taxation of some foreign branches of domestic corporations much as though they were foreign corporations. The benefits were provided for income derived directly, or in some cases as dividends or even as interest, from activities which constituted either the operation of special kinds of foreign establishments or the provision of technical aid from information typically obtained in domestic operations.

Affected industries found the tests for qualification for these benefits less than fully satisfactory.

The bill provided the combined benefits of rate differential and deferral of tax for income from technical aid, and for income from the conduct of a "factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country." There was specific exclusion of "an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise," and of an agent, other than a retail establishment, to import goods or merchandise. It appeared, however, that importation and sale of goods or merchandise as an incident to a principal activity which otherwise qualified would not disqualify that activity. Under the terms of the bill, the tax consequences of a commercially unitary activity would vary widely, according to the legal forms employed.

The committee report construed the provision for benefits to income from technical aid as excluding patent royalties.

H. R. 7725

In the closing days of the last session of Congress, Chairman Cooper of the House Ways and Means Committee introduced a bill, H. R. 7725, which adheres to the fundamental ideas of the House version of the 1954 code, but would remove many areas of doubt, principally by restricting the kind of qualified foreign establishments.

The new bill specifies, somewhat more broadly than the earlier bill, "technical, managerial, engineering, construction, scientific, or like services." It remains to be seen whether there will be an attempt to exclude patent royalties, as in the case of the earlier bill. It had been urged in opposition to the narrow construction of the bill, that such views would impede accommodation to policies of some foreign governments which permit dollar exchange only for royalty payments; that they failed to recognize that disclosures protected by patents often are essential to technical aid; and that patent licensing may be an active business, involving continuing commitments of capital and personnel, and intense commercial activity.

The new bill does not seem altogether consistent in its orientation toward what may be called problems of economic nationalism.

The provisions concerning services seem intended to foster exportation of technical information derived in domestic research and operations.

Elsewhere, the bill has provisions which would seem to militate against United States export or import trade, and even against important kinds of foreign trade in articles of purely foreign origin. These provisions, and the exceptions to them, would fix a new and unfamiliar pattern for the operation of businesses which would avail themselves of the incentives of the new bill. Although that pattern cannot now be fully perceived, the following observations seem warranted.

The new bill provides that disqualification of a foreign establishment would be occasioned by derivation of gross income "to any extent" from the sale or rental of an article not "produced" (i. e., "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged") in a foreign country. And even if an article were entirely of foreign origin, its sale would disqualify if it had been produced by someone other than the taxpayer or an "affiliated corporation"—defined as either a foreign corporation or a foreign branch of a domestic corporation elected to be treated like a foreign corporation.

It appears, then, that disqualification would be occasioned if, for example, a foreign manufacturing subsidiary of a United States company were to derive any gross income at all from sale of replacement parts purchased from the United States parent, from a subsidiary taxed as a domestic corporation, or from an independent foreign concern. Thus a foreign business which would avail itself of the new incentive provisions would often be put to the choice of refusing to supply needed replacement parts, or of buying them and selling them at prices so low as to obviate any risk of gross income, or of uneconomic foreign manufacture abroad either by itself or by an affiliated corporation, or of setting up another legal entity in the hope that it would be recognized to have separate existence for purposes of attribution of gross income from the sale.

It is not clear just how such a choice—and years of doubt whether a particular course of action constituted an effective exercise—would promote healthy competition.

Indeed, many businesses might find the choice so impracticable that they would not try to get incentive treatment even for operations involving large foreign investments and contributing importantly to the economy of foreign countries.

Although any amount of gross income from sales even of articles manufactured abroad by a competitor could disqualify, it is expressly provided that for this purpose "the term 'sale' * * * shall not include the sale of articles or products in retail stores." Literally read, this exclusion is broad enough to cover any sale, even a wholesale sale of an export from the United States, if the sale is made in a retail store.

The new bill also contains provisions which would seem to discourage imports, but not as severely as the provisions concerning exports.

To disqualify, gross income from sales of articles manufactured in a foreign country and sold by the manufacturer for ultimate use, et cetera, in the United States, must be more than 10 percent; and even that limit apparently may be exceeded where it can be established that the articles did not reach the United States in regular channels of trade.

The restrictions on importation are further relaxed to an uncertain but probably important degree by a provision that for this purpose "manufacture" shall not include those processes normally applied to agricultural products, minerals, et cetera, in their raw or natural state in a foreign country, prior to the state where the first commercially marketable product common to the industry has been reached. Thus, an operation which in itself might require the major part of foreign investment might actually serve to disqualify otherwise qualified income.

The provision concerning receipt of any gross income from sale of exports otherwise than in a retail store has the effect of a penalty, in the sense that receipt would disqualify otherwise qualified income. So also, as to gross income of more than 10 percent from articles manufactured abroad and imported into the United States. On the other hand, permission to derive up to 10 percent provides not only a margin of error but also a limited incentive.

In similar connections, it has been urged that failure to comply with percentage tests of qualification for incentive treatment of foreign income should work only proportionate disqualification. On a parity of reasoning, and assuming that incentives are not to be given to export or import profit, it would be urged that the new bill should provide means for measuring those profits, and that profits so measured should reduce incentive treatment in the proportion they bear to the total profits of the activity.

The new bill would deny to foreign branches, any right of tax-free reinvestment in other foreign entities like that accorded foreign corporations by present law.

There are other important difference in the treatment of branches. The new bill apparently contemplates tax-free election of the new foreign branch treatment without prior administrative approval such as would be required in the case of a foreign subsidiary. It would permit tax-free transfers of property other than inventory and the like, to and from a foreign branch, in circumstances where tax would be incurred if a foreign subsidiary were involved. It also sets up standards for determining withdrawals from branches which differ in some respects from the rules for taxing receipts from foreign corporations.

In other respects, the new bill generally resembles present for taxing foreign corporations.

It would give no more than capital loss treatment to the domestic corporation in respect of losses of elected branches, and then only in circumstances comparable to liquidation of a foreign subsidiary. It would deny depletion and similar allowances in the computation of taxable income from qualified establishments.

And, like present law applicable to foreign subsidiaries, the new bill would not only permit deferral of United States tax, but also permit foreign tax qualifying for credit against United States tax to serve not only as a credit, but also partly as a deduction. In this way, the eventual rate differential would be nearly 18 percent in the ideal circumstance of foreign tax qualifying for credit at an effective rate of 19 percent.

The new bill would permit current retention of 81 cents on a pretax dollar of foreign income subject to tax at 19 percent. A commercially comparable operation conducted by an ordinary domestic corporation taxable at 52 percent would retain only 48 cents. If taxable as a Western Hemisphere trade corporation, it would currently retain 62 cents. Thus, in comparison to the ordinary domestic corporation, the current retention would be increased by 68 percent, and in comparison to a Western Hemisphere trade corporation, by 31 percent. The corresponding percentages after distributions from the foreign corporation to the domestic parent would be 38 percent in

comparison to the ordinary domestic corporation and 6 percent in comparison to the Western Hemisphere trade corporation.[5]

While the percentages given in the illustration are subject to changes on various assumptions as to effective foreign tax rates, and as to special allowances to corporations taxed as domestic corporations, it seems clear that in many cases the relative advantages of the new bill would be so great as to occasion considerable strain on its rules for determining who shall and who shall not get its benefits.

As has been indicated, some would reduce the strain by reducing the advantages and increasing the opportunities for availing of the benefit of them. In general, their proposals would follow already familiar patterns of United States taxation, and would tend to minimize differences in the consequences of various legal forms. They would give to a specially organized kind of domestic corporation treatment generally comparable to that which present law provides for foreign corporations, with little, if any, advantage of rate differential. It is of interest that Canada has for some time made generally similar provisions in its law, and that a recent report of the Royal Commission on the Taxation of Profits and Income recommends that Great Britain do likewise.

THE BARLOW-WENDER PROPOSAL AND VARIANTS

The Barlow-Wender proposal—a product of the Harvard Law School international program in taxation—is for a special class of domestic corporations to be known as "United States foreign-business corporations." Its principal incentive would be deferral of United States tax to permit foreign expansion out of foreign earnings. It would abandon attempts to make sharp distinctions between different kinds of economic activity, such as found in the bills discussed above. A United States foreign-business corporation could engage in export business, receive patent and similar royalties, lend money, and so on; and it could operate directly or through foreign subsidiaries. With exceptions for items such as interest on funds which it would be allowed to accumulate for limited purposes, it would have to derive all its gross income from foreign sources, with source determined by the place of destination in the case of exports. Transfers of property to it could be made tax free without administrative approval.

This proposal has the merit of relative simplicity, and corresponds closely to the frequently encountered unitary concept of foreign operations. The means of deferral seems closely linked to the end of in-

[5] Retained earnings:

	Before dividend distribution		After dividend distribution	
Foreign corporation	81	81	66	66
Domestic corporation	48		48	
Western Hemisphere		62		62
Increase	33	19	18	4
Percent of increase	68	31	38	6

creased foreign investment. As was said of the proposal in the proceedings on the House version of the 1954 code:

> To the extent of deferral of tax, there will be correspondingly increased opportunity for foreign investments determined, as they should be, by foreign market considerations * * *. Both sovereign and subject would abide the commercial outcome of the foreign venture, and both would benefit from freeing the subject of the burdens of frustration and uncertainty occasioned by present law.

Discussion of the Barlow-Wender proposal has evoked a number of suggested variants, ranging from a proposal that tax be imposed on the recipient of distributions from the special class of corporation, rather than on the corporation itself, to a proposal that would couple with it the benefits of a 14 point differential and exclude export profits from the benefits of that differential.

Individual Business

Although there has been recognition of the desirability of providing tax incentives for foreign investments by individuals, there have been few specific proposals.

One proposal would permit individuals to credit against their own United States taxes foreign taxes paid by foreign corporations on earnings distributed to them as dividends. In view of the progressive rates of surtax on income of individuals, the significance of this proposal would vary according to the individual circumstances, in some cases to an extent which seems hardly likely to be acceptable from the standpoint of the revenues and policies on the taxation of individuals.

Other proposals range from relatively modest ones, such as for extending the dividend exclusion and dividend tax credit to dividends from foreign corporations, and for easing further the arbitrary statutory limitation on the amount of earned income which will be recognized as being derived from a foreign business operated by an individual, to the extreme of one for exempting from any United States tax the income of individually operated foreign permanent establishments.

The Internal Revenue Code of 1954 did enable regulated investment companies to pass on to their shareholders credits for foreign taxes on their income, if the holdings of stock or securities in foreign corporations comprise more than half the value of the total assets of such companies.

This new provision has been significant principally with respect to some companies formed for investments in Canada. It does not provide for investments by the large, unspecialized regulated investment trusts whose foreign holdings do not meet the test provided, and also poises mechanical problems where there are many small shareholdings in the companies. Proposals concerning these matters have in turn involved problems. For example, a proposal that the investment companies be permitted to redeem their foreign tax credits, rather than pass them on, has met with the objection that there would not be a corresponding recovery of tax at the shareholder level, since many of the shareholders are exempt institutions and individuals who pay taxes at rates less than the rates of foreign taxes involved.

On the whole, it seems likely that solution of the basic problems of taxing individual income will not be found until solution of the

relatively simple, yet very difficult, problems of taxing corporate income.

5. THE AREA OF AGREEMENT

In this section we present briefly the recommendations on which there is agreement among the panelists. This portion of the joint paper should be considered together with the separate papers by the panelists.

The panelists agree a major defect of the present system of taxing income from abroad is that variations in tax burden depend on the form rather than the substance of foreign economic activities. Consequently, an important consideration in the recommendations is that changes in the tax treatment of foreign income should be directed toward the development of a tax system which imposes the same tax on a given economic activity whatever its legal form.

The areas of agreement concern firstly the type of foreign income for which separate tax treatment should be provided and secondly a number of technical changes which would increase the equity of the tax system.

Qualified Foreign Income

There has been general agreement that separate tax treatment should not be provided by new legislation for foreign income which is not derived from substantial economic activities abroad. There has, however, been diversity of opinion on how this objective could be attained. As has been discussed in section 4, in 1954 and again in 1955 legislation was submitted, the result of which would have been the exclusion from benefits of much income derived from the conduct of substantial foreign business activities. In the opinion of the panel, the provisions of these proposals would be unduly restrictive and inequitable.

In distinguishing the income which should qualify for separate tax treatment, the crucial consideration in new legislation should be the extent to which the income is derived from the assumption of risks in economic activities abroad. Of course, in many cases, income clearly is derived solely from either domestic or foreign activities. In those cases in which income is derived from a combination of domestic and foreign business activities, we believe that a fair and workable apportionment could be made on the basis of the relative expenses incurred here and abroad in the production of the income. For example, if an American firm incurred $45,000 of expenses in wholesale distribution in Brazil of goods purchased in the United States and $5,000 of expenses in the United States (not including the purchase price of the goods), then at least 90 percent ($45,000/$50,000) of the income from the sales should qualify for separate tax treatment.

It is further agreed that the recipient of such qualified foreign income should be entitled to segregate that income and to defer the payment of the United States tax on that income until that income is used in the United States. Also, United States tax should not be payable on that income merely because it is withdrawn from one foreign country and invested in another.

On the question of whether there should also be a reduction in the rate of tax on such foreign income, the panel was not able to agree. This issue is discussed in the separate papers.

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EQUITABLE TECHNICAL CHANGES

There are a number of technical changes, involving little revenue, which should be made to increase the equity of the present tax system and to remove minor impediments to investment abroad. These are:

1. THE 10 PERCENT LIMITATION ON TAX CREDITS

Under present law, a United States corporation must own at least 10 percent of the voting stock of a foreign corporation in order to obtain credit for its appropriate share of the foreign income taxes paid by that foreign corporation. This provision has deterred portfolio foreign investment by United States corporations. It is, therefore, recommended that credit be allowed, regardless of the percentage of stock ownership, provided reasonable reports required by the Treasury are submitted.

2. CREDIT FOR TAXES PAID BY "GREAT-GRANDCHILDREN"

Credit is now allowed for income taxes paid by a 10-percent-owned foreign corporation, "child," and for taxes paid by a 50-percent-owned foreign subsidiary, "grandchild," of the 10-percent-owned foreign "child." However, no credit is allowed for the taxes of a foreign subsidiary of the "grandchild." Such "great-grandchildren" are usually conceived to meet exigencies of foreign law and their use should not, therefore, be penalized by United States tax laws.

3. SIMPLIFICATION OF FOREIGN HOLDINGS

The foreign corporate structures of many corporations with substantial investments abroad are complex and unwieldly because at various times the need arose to create special foreign corporations as a result of requirements of foreign law. Often the need for these foreign corporations has passed and the United States companies would prefer to eliminate them by transferring their functions to other companies. Corporate simplifications of this type are, however, often barred under present law by the imposition of substantial taxes on such transfers. We recommend that reorganizations of this type be permitted without imposition of tax.

4. CARRYBACK AND CARRYFORWARD OF UNUSED FOREIGN TAX CREDITS

Because of the differences in timing and definitions between the United States tax system and those of foreign countries, situations arise in which countries having lower tax rates than those of the United States on the average over a few years, impose in particular years rates of tax in excess of the United States rate on the income involved. In those particular years, credit can be taken by a United States taxpayer only for a portion of the foreign taxes paid. In fairness to investors caught in this situation, consideration should be given to the feasibility of giving permission for limited carryback and carryforward of the unused tax credit of the years in which high foreign taxes are imposed.

5. REGULATED INVESTMENT COMPANIES

At present, the large United States regulated investment companies, which are large sources of new equity capital domestically, have found the United States tax system a barrier to the investment of even a small portion of their funds in foreign securities. While the members of the panel did not feel sufficient familiarity with the technical aspects of this area, the consensus was that a study should be made of the possibility of amending United States law so as to permit these companies to invest abroad.

These recommendations have been presented in skeleton form. Additional comments on them are contained in the separate papers which follow.

UNITED STATES TAXATION OF CORPORATE INCOME FROM INVESTMENT ABROAD

EMILIO G. COLLADO [1]

Throughout the postwar period, in the presence of the abnormally high corporate tax rates, there has been a need for changes in the United States tax treatment of income from corporate investment abroad. These changes have been needed in fairness to investors, in the interest of United States foreign policy, and as a contribution to the United States economy. Last year appropriate measures were recommended by the Randall Commission and by President Eisenhower. This year the President reiterated his recommendations.

It is unfortunate that there has been the delay in implementation. The original House tax bill last year included the major recommendations, albeit in what turned out to be an unsatisfactory form. The provisions were dropped in the Senate bill, but not because of any basic disagreement with the changes proposed by the House. Senator George has stated recently:

> I favored the provision in the code last year, which was not adopted, to give all of our American investors a slight differential * * *. We put it over and we thought that the House would come up and give us a chance to discuss it with them, and they accepted what we did to knock it all off, which wasn't what we wanted.

The apparent reason for the Senate delaying its decision was the desire to give time for further reconsideration of some difficulties raised by the wording of the House bill.

There is now before the House a new bill, H. R. 7725, dealing with the taxation of income from abroad. The bill was drafted by the Treasury and transmitted by Secretary Humphrey to Mr. Cooper, chairman of the Ways and Means Committee, in a public letter which set forth some well-chosen general principles. Unfortunately, the wording of the new bill itself would seem to have replaced the difficulties of last year's bill with new difficulties of a serious nature. As a result the danger arises that technical difficulties will again stand in the way of the needed revision of our tax treatment of income from abroad.

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[1] Mr. Collado wishes to record his appreciation for the expert assistance received from several of his associates, in particular, Mr. Arthur M. Hayes and Mr. Jack F. Bennett, during the preparation of this paper.

In these circumstances it seems wise for some attention to be devoted to tax considerations that might at first glance be dismissed as merely technical. This attention to details is necessary, not only because the details may be crucial in the consideration of the new bill, but also because there are an appreciable number of features in our present tax framework which are inconsistent with the objective of our Government to facilitate private investment abroad. The removal of any substantial number of these inconsistencies from our tax system would greatly increase the fairness of the system and at the same time would remove important impediments to private United States investments abroad.

The Need To Remove Tax Impediments to Private Investment Abroad

An attempt is made below to describe briefly the principal inconsistencies in our tax law which deter private investment abroad. In each case a remedy is proposed. In most cases the remedy would make generally available the tax treatment already available to those taxpayers who can make the requisite choice in the corporate vehicle for their activities abroad. In most cases it would not be necessary to revise existing provisions of the law; rather it would be necessary merely to supplement existing provisions with additional provisions.

The remedies suggested would bring our law closer to the desirable state in which the same tax is imposed on a given economic operation whether that operation is conducted through a corporate division, through a domestic subsidiary corporation, or through a foreign subsidiary corporation.

1. The problem of the tax treatment of income from exports

"For purposes of needed tax changes, what should be considered to be income from abroad?" This was the question that confounded the House last year and that prevented the reform in the tax treatment of even that income which was clearly from abroad.

There are probably some basic disagreements on this question since some exporters would argue that all their income should be treated as income from abroad. Nonetheless, the problem last year was one of technical detail rather than of principle, since there was general agreement in the legislative and executive branches that income from exports should be treated as income from abroad for the purposes of the proposed tax reliefs only to the extent approximately that the income resulted from risk, that is to say, investment abroad.

As was noted earlier in the joint factual paper, there are three principal methods by which income related to exports may be qualified as income from abroad under present law and regulations. All three methods require at least that the sale take place in such a manner that title to the products passes abroad. Of the three methods, the one which normally would in practice qualify the largest percentage of income as income from abroad is for the United States producer to sell his products to a subsidiary corporation before those products are sold abroad.

In the Treasury view this present system of classifying income from exports as income from abroad is satisfactory so long as the tax consequences of such a classification are limited, as they are under present

law. The Treasury position is, however, that the President's recommendations cannot be applied to all income from abroad if a large proportion of income related to exports is to be considered income from abroad. The Treasury is opposed in principle to tax benefits for income from the simple activity of selling goods for a foreign destination when the United States exporter is not really involved in the foreign economy. This position on principle may be buttressed in the Treasury view by compelling revenue considerations. For a recent year the total United States tax revenue from income from investments abroad was estimated to be on the order of $200 million. The tax revenue from income related to exports was estimated to be in the neighborhood of $800 million. There might be a current revenue loss of a good proportion of this latter sum if export income could in practice be qualified as income from abroad merely by the organization of subsidiaries. For this reason the Treasury proposes in the new tax bill to set up, in effect, a separate and new set of definitions of what is income from abroad for purposes of the tax benefits recommended.

The Treasury bill would disqualify from its benefits the income from any foreign subsidiary corporation or any branch operating abroad if that income was derived to any extent from the wholesaling of goods other than those produced abroad by that corporation or that branch or by an affiliate abroad. An affiliate would be defined as another branch or another foreign subsidiary of the parent United States company receiving the income in question. These provisions would certainly exclude all income from exporting from the United States for wholesale abroad, and they would do far more. All the income from a million-dollar investment in a company abroad would be disqualified if that company sold at wholesale even $1 worth of goods produced in the United States. The income would still be disqualified if that dollar's worth of goods were bought from a stranger who produced it abroad. The income would even be disqualified if the dollar's worth were produced abroad by an affiliated United States corporate subsidiary, for the bill would recognize only affiliated foreign corporations. It is understood that the Treasury now feels that the exclusion of the income derived from the selling of products produced abroad by affiliated United States corporations was a drafting error. It is to be hoped that this error will be corrected. But, even with this one restriction removed, it seems doubtful that the remaining array of restrictions on the wholesaling business are necessary to a fair and workable definition of income from abroad.

At the same time it is not easy to be satisfied with some of the simple alternative solutions which have been most often discussed. Some have suggested that any income from a permanent establishment abroad should qualify. While a permanent establishment should probably be a necessary condition for qualification, it may not be felt to be a sufficient condition by itself, since some have contended that a small nominal office could always be set up if enough income were at stake and the Treasury would have a hard time deciding when that office was substantial enough to be called an establishment. Others have suggested that the payment of income tax abroad should be sufficient grounds for qualification, but again the contention has been made that if sufficient income were at stake, the payment of nominal foreign tax might possibly be arranged. Finally, others have suggested that a workable distinction between export income

and investment income is not feasible and that, therefore, all export income should qualify at least for deferment of United States tax. Of course this last suggestion may not be acceptable to the Treasury from a revenue point of view. In support of the suggestion it is argued that United States firms simply selling abroad now from a United States office would be encouraged to invest abroad since the tax on their income could be deferred only so long as they reinvested the income abroad. The deferment would be a particular significance to such firms since, unlike investors abroad, they do not normally pay foreign taxes at all. However, any provisions to increase investment abroad should be available generally and not just to those who happen to be purely in the export business. There is a likelihood, moreover, that some exporters would use a large proportion of their retained earnings, not for the usual type of investment abroad, but rather for the financing of existing or expanded exporter credits. Possibly an existing institution, the Export-Import Bank, should be used for such exporter credit assistance as the United States Government sees fit to provide. It is true, undoubtedly, that tax deferment for all exporters would lead to some new investment abroad, but it would be preferable for tax reliefs to be given, not on the chance that some investment will be made, but rather to the extent that investment is actually made. This is the basis of the two alternative proposals to be put forward here.

While these proposals differ from the text of the Treasury's new bill, they are in accord with and would implement the Secretary's statement of principles which should govern the definition of income from abroad. "It would not be desirable or wise for this country to subsidize exports." "Small businesses should have the same potential advantages as large businesses." "The standard selected should not be subject to manipulation."

To embody these principles the new bill should be amended to provide that, for the purposes of the tax changes proposed in the bill and in the absence of an independent method of determining the portion of income which is from abroad, the portions of a company's income which is from the United States and from abroad should be determined by reference to the relative extent to which the income is attributable to expenses in the United States by a permanent establishment in the United States and to expenses abroad by a permanent establishment abroad. The relevant foreign expenses would include the costs of the maintenance of inventories abroad, of foreign sales forces, of advertising abroad, of services and supplies required in processing goods abroad, and of the depreciation and interest on plant and property abroad. In a direct manner these are the expenses giving rise to the foreign income. Comparable domestic expenses would give rise to domestic income. A comparison of such expenses can give a rough but adequate indication of the relative extent to which a company's income has resulted from the assumption of risk at home and abroad.

To be more specific, one satisfactory way to treat the income from wholesaling abroad of products made in the United States would be to classify an entire income stream in accordance with its predominant nature. If only minor foreign expenses were incurred in sending United States goods abroad, then none of the resulting income would

be considered to be from abroad. If, on the other hand, substantial foreign expenses were incurred, then the whole of the income would be from abroad. Under this system there might be some difficult borderline cases but the nature of most income would be easily determined.

Alternatively, a formula might be employed to give a more exact determination; income from wholesaling United States products abroad would be divided between the domestic and foreign classifications in proportion to the domestic and foreign expenses involved in producing the income. For the purposes of the formula the purchase price of goods to be resold would not be included in the expenses. The use of the formula would involve somewhat more paperwork than the alternative method, but the formula would avoid the possibility that the necessity or lack of necessity for large tax payments would turn on the difficult interpretation of how much is "substantial." If a formula is to be used, a new provision is needed. The rarely used formula now in the tax regulations gives disproportionate weight to the sales element and no weight at all to expenses abroad.

The alternative suggestions provide workable equivalents in the international field for the apportionment formulas in general use by the States within the United States. In various combinations the States make use of the elements of property, payroll, sales, and manufacturing cost within a State as the determinant of the percentage of a company's income which is subject to tax within the State. Each of these elements is given recognition in a theoretically justifiable manner in the suggested approaches.

The approaches would not qualify as income from abroad the income from selling goods to a foreign destination without any substantial form of foreign investment being involved in the process. At the same time the approaches would not disqualify investment income just because it was earned by a company that also had some export income. The approaches would also void discrimination against the business of wholesaling. They would, moreover, avoid putting the United States Government in the inconsistent position of setting up a tax incentive for companies operating abroad to shun buying from companies producing in the United States.

2. DISCRIMINATION AGAINST THE BRANCH OF A UNITED STATES CORPORATION

A second inconsistency in our law is a form of discrimination against the corporation which operates abroad through branches of a United States company. Such a corporation is taxed currently by the United States on its income from abroad. The same company could not be taxed by the United States on its foreign earnings if it chose to carry out the same foreign business through a foreign corporation which retained its earnings in the foreign business. All other factors being equal alert managements would undoubtedly choose the latter form. But sometimes, for reasons not relevant to United States tax policy, there are overriding reasons why a company cannot make the choice. Foreign government policies toward domestic corporations may, for example, prevent the choice.

Another reason is that there sometimes are, as will be discussed in the next section, other United States tax disadvantages to operating through a foreign corporation. It has even been suggested that there

are tax advantages and disadvantages to each form and that the inequities in each form should be kept to counterbalance its advantages. Bad as this reasoning is in general, it is worse when specific cases are considered since often the advantages and disadvantages of a particular form do not apply to the same industries. No satisfactory reason has been put forward why United States law should discriminate against United States corporations operating abroad.

On this account, Secretary Humphrey recommended to the Congress in July that, in line with the President's recommendations, permission should be granted for United States corporations to defer paying the United States tax on the foreign income of their branches until that income "is finally repatriated." Unfortunately, the text of the Treasury's bill falls far short of an attempt to remove the discrimination in favor of the foreign corporation by permitting the tax on the income of a branch to be deferred to the same extent as the United States tax on the income of a foreign subsidiary. The new bill would allow the United States tax on foreign branch income to be deferred only so long as that income is invested in the country where earned or in—

> assets having a temporary situs within any other foreign country if such assets * * * will be transmitted in due course to the foreign country in which the * * * branch is situated.

Such restrictions cannot be applied to the investments of a foreign subsidiary. Why, then, should they be applied to a United States branch abroad? If a foreign subsidiary operating in an underdeveloped country wishes to keep its working cash balances in a London or New York bank, United States law doesn't try to impose a tax penalty. It is not clear that a penalty wouldn't be imposed under the wording of the Treasury bill if a United States branch abroad tried the same thing. Similarly, a subsidiary corporation in Canada can freely invest its earnings in one of its subsidiaries in Latin America. Why should not a Canadian branch of a United States corporation be equally able to invest in Latin America?

To eliminate these inconsistencies, the Treasury's bill should be amended to provide that a United States corporation should not be required to pay tax on its income from abroad until that income is used by the corporation in its domestic operations or for the payment of dividends to its stockholders.

3. DISCRIMINATION AGAINST THE FOREIGN SUBSIDIARY OF A UNITED STATES CORPORATION

In the joint paper it was noted earlier that there is in our present tax law a form of discrimination against those United States firms which are required to conduct their foreign operations through subsidiaries incorporated abroad. For these United States companies it is slight consolation to know that there are, as noted in the previous section of this paper, attractions in the use of foreign subsidiaries for other companies which are interested in large-scale reinvestment of their foreign income. Sometimes United States firms are more concerned about the prospects of sizable operating losses abroad than with the possibility of supplementing a large initial investment with reinvestment of earnings. These firms are, therefore, put at a disadvantage when foreign governments require them to operate

through companies incorporated locally; their operating losses abroad in foreign subsidiaries cannot be deducted currently from taxable United States income as they could be if the use of foreign branches were allowed. In addition, United States tax law has imposed another disadvantage by denying the use of two tax allowances employed in the calculation of the taxable income from investments by branches in the minerals field. In determining the taxable income from a foreign corporation for United States purposes, there is not only a disallowance of current United States deductions for some development expenses and of percentage deductions for depletion of mineral deposits, there is also a negation in some cases of these allowances when allowed by foreign governments.

It seems unfortunate that United States law should serve to offset depletion provisions which foreign governments after careful study may have modeled on the provisions in United States law. It seems especially unfortunate when it is realized that the provisions may be fully applicable to foreign competitors. Moreover, it seems unfair that tax deductions generally allowed under United States law and used in the calculation of the taxable income of branches operating abroad should not enter into the calculation of the United States tax to be paid on income from foreign subsidiaries. Possibly the income of a foreign subsidiary should be calculated with full use of the depletion deductions provided in United States law for the purpose of determining what portions of the subsidiary's distributions should be taxed by the United States as ordinary dividend income.

Alternatively, on a broader basis, to remedy this discrimination against United States companies operating abroad through foreign subsidiaries, serious study should be given to the desirability of amending United States law to provide the possibility for United States companies to consolidate their domestic incomes and the income of selected foreign subsidiaries for United States tax purposes. This is one of the recommendations put forward by the Randall Commission last year. United States law already provides for inclusion in United States consolidations of subsidiaries formed in Mexico and Canada to comply with the requirements of local law. Possibly this geographic limitation should be removed. Also, because the need for foreign incorporation sometimes arises from foreign governmental attitudes rather than from positive legal requirements, the permission to consolidate should probably be available whether or not foreign incorporation is legally required. Of course, United States companies should not be allowed to defer United States tax for a number of years on the income of a foreign subsidiary and then to consolidate and to deduct a current loss from United States tax when a bad year comes along. Rather, consolidation when elected for a foreign subsidiary should apply equally to the income or loss of the current year and all previous years for that subsidiary. Under reasonable regulations, however, a company should be allowed to discontinue an election to consolidate the income of any particular foreign subsidiary.

Permission for consolidation as described would remove to a considerable extent the present discrimination against foreign subsidiaries. The new tax bill takes no steps in this direction. On the contrary, the new bill would aggravate the situation by extending some of the disabilities of foreign subsidiaries to the branches of United States corporations. A corporation which wishes to have any

of the benefits of the new tax bill for the income of its branches would be required to "elect" to have those branches treated as foreign subsidiaries. The bill states, "Any deduction allowed by this subtitle in the case of a domestic corporation shall not be allowed, if such deduction would not be allowed in the determination of the earnings and profit of a foreign corporation." For this discrimination against United States companies employing foreign subsidiaries or segregated foreign branches there seems to be no justification. At the very least the bill should be amended by striking out the offending clause which has been quoted. As presently drafted the Treasury bill would introduce inconsistent provisions into the United States tax law. United States Western Hemisphere trade corporations, whose income has the benefit of a 14 point tax rate reduction, have never been denied the full depletion deductions allowed by United States law. The Western Hemisphere provisions have proved to be a success in encouraging private investment abroad. In carrying out the United States policy to encourage investment on a broader basis, the United States Congress should not now restrict the Western Hemisphere type provisions but rather should extend those proven provisions to other areas.

4. THE CANCELLATION OF FOREIGN TAX INCENTIVES

It is now generally recognized that the United States tax system operates to cancel tax incentives introduced by foreign governments for the purpose of attracting private investment from abroad. When foreign tax rates are lowered the effective rate of United States tax is raised since there is less foreign tax to credit against United States tax. It is probably not so well known that, as explained in the background paper, the United States tax system may even convert a foreign provision for accelerated amortization into an increase in the total tax burden on a United States investor. This operation of the United States tax system results in direct harm to foreign governments, by blunting their incentive programs, and in direct harm to United States investors, by taking away the opportunities purposefully created by the incentive programs. Indirectly, United States investors and the United States Government are harmed to the extent that foreign governments are encouraged to increase their tax rates and, therefore, their percentage share of the total taxes paid by United States private investors.

In an attempt partially to alleviate these results, Secretary Humphrey announced at the Rio Economic Conference last year that the United States Government was willing to consider modifying the United States tax system by treaty in particular cases to provide that the effective United States tax rate on income from investments in a country would not be raised when that country lowered its tax rate for a limited period to attract investment. To date, no such treaties have been negotiated, and where incentives are necessary, foreign governments and United States firms are still left to find methods which the United States Government does not tend automatically to counteract.

Quite possibly the announced program of alleviation of United States tax by treaty will continue its lack of success. In the past the United States has been able to negotiate tax treaties, with few

exceptions, only in the more developed countries. The governments of the underdeveloped countries have been unsympathetic to tax treaties for a number of reasons. Most important, perhaps, has been their unwillingness to appear to condone the United States tax system, which, in their view, unjustly taxes income having its source in their countries.

Because of the importance of the relief to United States objectives, and because of the poor prospects of the treaty approach, United States law should be amended to provide automatically that effective United States tax rates will not be raised to offset foreign investment incentive programs which meet certain criteria.

5. THE DISALLOWANCE OF TAX CREDIT ON SMALL HOLDINGS ABROAD

United States corporations which are primarily producing or managing companies sometimes have funds available for considerable periods of time for investment in corporations which are not to be controlled or managed as a result of the investment. Present tax law erects a barrier which deters such investment from going into foreign corporations. The Revenue Code states that a United States corporation must own at least 10 percent of the voting stock of a foreign corporation if the United States corporation is to receive credit for its pro rata share of the foreign income taxes paid by the foreign corporation. As a result, a United States corporation receives no credit for foreign taxes paid by a foreign corporation whose shares are bought as a portfolio investment. By contrast, an 85 percent credit would be received in effect on a comparable portfolio investment in a United States company. Double taxation thus puts a premium on investment in United States companies.

This discrimination seems contrary to the expressed United States policy to encourage investment abroad. To remedy the situation, a United States corporation should be allowed credit for foreign taxes paid by foreign companies in which it has invested, regardless of the percentage of ownership, so long as reasonable reports required by the Treasury are submitted. This is the same recommendation which was given to the President by the Randall Commission last year.

6. THE DENIAL OF CREDIT FOR FOREIGN TAXES PAID BY "GREAT-GRANDCHILDREN"

Under the restrictive conditions which have just been noted, a United States corporation is now allowed to credit an appropriate share of the income taxes paid by a foreign corporation. The income taxes paid by a foreign subsidiary of the foreign "child" corporation may also be credited by the United States parent if the "grandchild" is owned to the extent of at least 50 percent. No provision is made, however, for the crediting of the income taxes of a foreign "great-grandchild" corporation even if it is beneficially owned 100 percent for the United States parent company.

The exigencies of dealing with foreign government laws and with foreign minority interests sometimes makes it desirable to create foreign "great-grandchildren" or even more distant descendants. There seems to be no reason to penalize firms which find themselves in this position. For this reason United States law should be amended to

allow credit for taxes paid by "great-grandchildren" corporations so long as reasonable reporting conditions established by the Treasury are fully met. This change would remove an additional undesirable influence of the United States tax system on the choice of corporate vehicle to be used by United States businessmen in their operations abroad.

THE AVOIDABLE WASTE

The six recommendations which have been given would contribute to a reduction in the enormous and avoidable waste in those managerial, legal, educational, and governmental talents which are now devoted to study of the complex tax aspects of the alternate forms in which corporate investment abroad may be made. At the same time these recommendations would remove serious inequities and impediments in the United States tax treatment of income from abroad. These recommendations are an important supplement to the rate reduction which should be the central element in the reform of the United States tax code as it relates to foreign investment.

THE NEED FOR A GENERAL RATE REDUCTION

Last year President Eisenhower and the Committee on Foreign Economic Policy both recommended that there should be a reduction in the rate of United States taxation on income from investment abroad. The recommendation was adopted by the House and, as Senator George has said, would have been adopted by the Senate but for some technical difficulties. This year the President has resubmitted his recommendation, and in July Chairman Cooper introduced a bill drafted by the Treasury to implement the recommendation. There are defects in the drafting of the bill but its basic principle is right. Adoption of the President's recommendation in the next session of Congress is in the general interest for several reasons.

IN FAIRNESS TO THE INVESTOR

In fairness to the United States firm which invests abroad the change is needed. In Secretary Humphrey's words, "The purpose of this recommended legislation is to facilitate the investment abroad of capital from this country. At present, our business firms are at a disadvantage in countries with lower taxes than our own when they have to compete with local capital, or capital from countries which impose lower taxes on foreign income than we do." The granting of the recommended tax credit equal to 14 percent of the taxable income from abroad would reduce the disadvantage of the United States investor.

The change is also needed to remove a competitive disadvantage of some United States investors in relation to other United States investors. The recommended rate reduction is now available to some United States companies which are able to conduct their foreign operations through United States Western Hemisphere trade corporations. But such corporations may operate only in the Western Hemisphere. This geographic limitation arose in 1942 at a time when large areas outside the Western Hemisphere were under enemy occupation. The discrimination should now be removed.

IN THE INTEREST OF UNITED STATES ECONOMY

The rate reduction is clearly in the interests of the United States economy in several ways.

Secretary Humphrey recognized one important way when he wrote Mr. Cooper, "Foreign countries are also under an incentive to increase taxes on United States enterprises up to the level of United States tax rates." The resulting increases in foreign taxes sometimes do not hurt the United States enterprises very much but the increases always do hurt the United States Government and United States economy by reducing the United States share of the proceeds of a profitable venture abroad. Because of this incentive for foreign rate increases, there might well develop a long-run tendency for the already small revenue from United States taxes on corporate income from investment abroad to disappear if the present tax system is unchanged. A corporate rate reduction now could actually serve to increase the total revenue in the long run by increasing the revenue from the personal taxation of income which had its origin in an increased United States share of income earned abroad.

By removing the competitive disadvantage of United States firms operating abroad, the rate reduction will also aid the United States economy by allowing United States firms to undertake potentially more profitable investments.

Finally, and most importantly, a rate reduction will benefit the United States economy by facilitating investments which will provide the United States with the most economical supplies of those basic industrial raw materials which the growing United States economy will find it increasingly necessary to buy from abroad. United States investors should not be hampered in placing their skills and resources at work in the productive expansion of the other areas of the free world. Of course, the tax changes should not be such as to induce United States firms to transfer their operations from the United States to foreign countries just in order to receive tax benefits. This eventuality was guarded against in last year's bill by a provision that the tax benefits would not apply to a company whose gross income was derived to the extent of 25 percent from the sale of articles manufactured in the foreign country and intended for use in the United States. This 25 percent was, if anything, too low a figure and created the danger of forcing foreign investors to engage in the uneconomic transport of unfinished materials to the United States. The new bill has, unfortunately, lowered the percentage to 10 percent and would build a hidden tariff into the Revenue Code. This provision of the new bill should be amended in the interests of the United States economy.

TO PROMOTE THE ECONOMIC STRENGTH OF THE FREE WORLD

The overriding reason why a rate reduction is needed with such urgency at the moment is the importance of an increased flow of United States private investment abroad to the security of the United States and the free world. In the words of the President's message to Congress this year:

> The Nation's enlightened self-interest and sense of responsibility as a leader among the free nations require a foreign economic program that will stimulate economic growth in the free world through enlarging opportunities for the

fuller operation of the forces of free enterprise and competitive markets. Our own self-interest requires such a program because (1) economic strength among our allies is essential to our security, (2) economic growth in underdeveloped areas is necessary to lessen international instability growing out of the vulnerability of such areas to Communist penetration and subversion * * *. In that light, the flow of capital abroad from our country must be stimulated and in such a manner that it results in investment largely by individuals or private enterprises rather than by government.

TAX INCENTIVES AND FOREIGN INVESTMENT

By Ira T. Wender

If the premise is accepted that the United States Government ought actively to encourage private foreign investment, tax incentives are clearly one of the principal methods available to the Government. As section 5 of the joint paper indicated, there is general agreement among the panel members that deferral of United States tax on qualified foreign income would be a desirable incentive and on how qualified foreign income should be defined. Many believe that, in addition, qualified foreign income should be subject to a 38-percent rate of United States tax instead of 52 percent. This paper will discuss briefly these three aspects of tax measures to encourage foreign investment.

QUALIFIED FOREIGN INCOME

To a considerable extent, the question of what foreign income should qualify for special tax treatment is a revenue problem. If income from export sales is included, the United States receives now probably in excess of $1 billion in revenue from taxes on foreign income. Of that sum, about $200 million is from investment and $800 million from export. Accordingly, a reduction in the rate of tax on all foreign income to 38 percent might cost over $350 million in revenue. Since in many countries tax rates exceed 38 percent, it can be assumed that $150 million of taxes now collected on income from investments would be lost plus about 25 percent of the $800 million of revenue from export income.

To eliminate this revenue loss, the Treasury in 1954 and again in 1955 offered legislation which attempted to restrict the foreign income qualifying for the incentive to that derived from activities other than the sale abroad of goods manufactured in the United States. That legislation is unsatisfactory. Not only is income from export excluded, but so is much of the income from foreign investment.

The basic difficulty of the approach adopted by the Treasury is that it fails to take into account the varieties of ways in which business is done abroad by companies. A typical American investor will have a foreign subsidiary which manufactures 1 or 2 of its products, assembles another, and acts as a distributor of several other products manufactured by the parent company in the United States. Moreover, the investor's income will not be derived entirely in the form of dividends. If patents or processes are involved in manufacture, or if trademarks or trade names are valuable, royalties will be received. In addition, fees are often charged the subsidiary for technical, management, and research services. It is patently impossible to

divide such a business unit for tax purposes and apply differing tax treatment to the parts.

In contrast, the approach recommended by this panel recognizes that business activities abroad are conducted in a variety of ways and does not attempt to impose artificial restraints on methods of foreign business operation. The determination of qualified foreign income would be based on the expenses incurred in earning the income. As a result, all types of income from foreign activities other than the sale abroad of goods manufactured in the United States would clearly qualify. In the case of sale abroad of United States produced goods, the income would be apportioned in a fairly equitable way into its foreign and domestic components. While much export income would qualify, the extent of its qualification would be in proportion to the amount of risk assumed abroad by the exporter.

It is submitted that the approach suggested by the panel would be satisfactory to most business groups and would protect the Treasury against revenue loss on income which had no greater connection with foreign activities than mere passage of title abroad.

The extent of the revenue loss, of course, depends on the type of incentive selected. The balance of this paper will deal with the two main types of tax incentives which have received support.

Tax Incentives

As the joint paper indicates, recent public discussions of tax incentives have centered on deferral of tax and rate reduction. The panel members who prepared the joint paper were in agreement on the desirability of deferral. Opinion was not unanimous, however, on rate reduction.

DEFERRAL OF TAX

Deferral of tax means that United States tax would be imposed on foreign income at the time it is brought back for use in the United States, rather than at the time it is earned. Accordingly, profits from one country could be invested in another country without first being reduced by United States tax.

As an incentive, deferral has the unique advantage of giving benefits only to those who are expanding abroad. Such companies could take profits on which substantial United States tax was due and defer the payment of that tax by reinvesting the money abroad. The actual cost of a new investment thereby would be reduced by the amount of the tax deferred. On the other hand, a company which was currently withdrawing all of its foreign earnings would not benefit, since in that event the income is subject to United States tax.

Recent research in the field of foreign investment [1] indicates that deferral would be an effective incentive to increased foreign investment. Most companies prefer to expand abroad from foreign earnings instead of through new dollar investment. If foreign profits were not first reduced by United States tax, more capital would be available for expansion. Further, the fact that withdrawing funds from abroad would result in United States tax might encourage some companies to examine the possiblities of new investment opportunities.

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[1] Barlow and Wender, Foreign Investment and Taxation, Prentice Hall, New Jersey, 1955

The techniques by which this deferral could be accomplished will not be discussed here. Most proposals have suggested the establishment of a domestic subsidiary to engage in foreign business. The United States income tax of that subsidiary would be deferred until it made a distribution or a loan to its parents. Technically, legislation of this type would not be difficult to draft.

The revenue loss through deferral would be proportional to the new investment which it stimulated. If it did not operate as an incentive, the revenue from foreign source income would not be seriously affected.

RATE REDUCTION

The case for an incentive by means of a rate reduction is not as strong as that for deferral. Where deferral gives a benefit only if foreign investment is increased, a reduced tax rate benefits investors that are contracting or failing to expand their foreign holdings. Thus, as an incentive it is unselective in its effect.

The incentive effect of a rate reduction is open to question, while the fact that it would result in a revenue loss is certain. As described in section 3 of the panel's joint paper, the study made by Mr. Barlow and me of the relationship of taxation to foreign investment disclosed no cases in which a decision against a specific foreign investment opportunity would have been reversed even if no United States tax were imposed on the income.

While this conclusion at first seems startling, an examination of the reasons companies invest abroad supports the fact that United States taxation is not a substantial factor. Investments are made not because it is more profitable to invest abroad than to invest in the United States. Rather investments are generally made to maintain a market which can no longer be supplied by exports from the United States. Threats to the market may arise from high tariffs, exchange controls, import quotas, or local competition. Faced by these threats, a company must then decide whether the market is sufficiently large and has enough potential for growth to support partial manufacture in the country. Compared to uncertainties like the size of the market and the cost of manufacture in a foreign country, the role of United States taxation is slight.

In addition to the argument that rate reduction is required as an incentive, it is also often urged that American companies are at a competitive disadvantage abroad because of United States taxes. It should be pointed out that the force of this argument depends upon a number of assumptions. For the disadvantage to be operative the non-American investor must require no higher a rate of return than, and have the same cost structure as, the American investor. Moreover, it is also necessary to assume that the non-American investor is not subject to tax in its home country. If the American investor is a more efficient producer, the additional tax would not result in a disadvantage. Similarly, an American firm is not at a disadvantage if it is satisfied with a lower rate of return than the non-American investor. Finally, not all other capital-exporting countries exempt foreign income. The United Kingdom, which next to the United States is the largest exporter of capital, taxes foreign income. Sweden taxes foreign income and does not allow a tax credit. France taxes dividends

from foreign subsidiaries, but exempts income of branches. Canada, on the other hand, exempts dividends of 25-percent-owned foreign subsidiaries and in some cases taxes branch income. The Netherlands and Belgium do generally provide more favorable treatment for foreign income than does the United States. In view of these factors, the scope of the competitive disadvantage may be far less broad than has been suggested. Moreover, American firms have experienced great success abroad which suggests that the competitive disadvantage is more theoretical than real.

It is sometimes said that rate reduction is justified by the greater risks in foreign investment. Within the United States the risks vary in different geographical sections and in different industries. Yet it has not been suggested that the cure for these differences in risk is to vary the rate of tax on a geographical or industrial basis. The precedent set by a rate reduction based on risk would be most unfortunate.

Finally, while it is undoubtedly true that the United States system has in a few instances and in certain industries encouraged foreign countries to raise rates, this is not a problem for the majority of foreign investors in most of the countries of the world. This may be a justifiable criticism of a system based on allowing credit for foreign tax, but it does not justify a rate reduction. As long as there is any United States tax on foreign income and credit is allowed for foreign taxes, foreign countries can raise their rates to the level of the United States tax to take advantage of the higher United States rate. The only solutions to this problem would be to eliminate United States tax on foreign income or to abolish the foreign-tax credit and substitute a nominal rate of tax on foreign income.

TAX POLICY TOWARD INCOME EARNED ABROAD

ROY BLOUGH

A substantial increase in the volume of United States private investment and business operations abroad, if placed in the right countries and the right industries, could make an important contribution to accelerating the economic development of friendly but underdeveloped countries. If the further easing of the taxload on income earned abroad gave reasonable promise of bringing about such an increase in investment, the action might be justified as a method of implementing the foreign economic policy of the United States, despite the resulting revenue loss. The revenue loss would arise from granting the tax benefits to the income on the large volume of already outstanding private investment, much of which is in such areas as Canada and Western Europe, which are not usually thought of as underdeveloped, and in industries—for example, the petroleum industry—which seem to be doing rather well under existing law.[1]

[1] As of 1954 the accumulated total United States direct investment abroad was $17.7 billion: of this amount, $5.9 billion, or one-third, was in Canada, and $2.6 billion in Western Europe. Of the $9.2 billion invested in the rest of the world, two-fifths was in the petroleum industry. In 1954 the earnings on United States direct investment abroad totaled $2.3 billion: of this amount, earnings in Canada and Western Europe were $0.8 billion, or a little over one-third. Of the $1.5 billion of earnings in the rest of the world, three-fifths were earned by the petroleum industry. The direct investment outflow from the United States in 1954 totaled $0.8 billion: of this amount, two-thirds went to Canada and Western Europe and one-third to the rest of the world. (U. S. Department of Commerce, Survey of Current Business, August 1955.)

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While some stimulation of the desired investment undoubtedly would result from easing the taxload, the studies and figures that have come to my attention indicate that in all probability the resulting increase in investment would be small, in view of the numerous other more crucial factors that enter into decisions to invest or operate abroad.

If, as a means of implementing foreign policy, Congress decides to grant some further tax relief on income earned abroad, care should be taken to apply the relief only to income from investment and operations that contribute to the economic development of foreign countries and that can actually be stimulated by tax relief. This would mean excluding from tax relief income which is derived from the exportation of goods from the United States, as distinguished from income derived from operations abroad that add to the usefulness of the goods. Exporters, of course, perform a highly important function, but since the total volume of exports from the United States is dependent on our policy toward imports and on our governmental grants and loans, it would be futile as well as expensive to give tax relief in an effort to stimulate exports. While I am not fully satisfied with the formula which several of us on this panel have suggested for distinguishing export income from investment and operations income, this formula seems to be more logical and practical of application than any other with which I am familiar.

If tax benefits are to be granted, I would urge that this be done not by reducing rates, but by deferring the payment of the tax until the income is distributed or put to use in the United States.[2]

Tax deferment is already enjoyed by foreign subsidiaries; extending it under appropriate safeguards would remove an existing inequity. Tax deferment focuses the incentive on the reinvestment of earnings abroad. The stimulus is thus on investment, since the deferment ends when the income is brought home. Tax deferment affords a privilege of very substantial value to taxpayers. During the period over which the income is reinvested abroad the company is permitted to treat the deferred tax as an addition to its capital for the purpose of earning a return. If income is left abroad for several years or more, earnings on the deferred taxes would be the equivalent of a substantial reduction in the rate of tax. Generally speaking, the distinction between income from exports and income from investment and other operations would not be a very important matter under tax deferment, since the exporter ordinarily would wish to have his income for use in the United States.

The objections to using rate reductions as a tax-incentive device with respect to income earned abroad seem to me persuasive. Rate reductions do not place the incentive at the right point, namely, on increasing the investment abroad. They would make very important the accurate distinction between income from exports and income from investment and other operations. Once the principle of rate reduction was accepted, political pressures almost certainly would be applied over the years to extend the scope of the income entitled to benefits and to decrease the tax rates applied to income qualifying for

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[2] The proposal made by Barlow and Wender in Foreign Investment and Taxation (New York, 1955) seems to have been worked out rather carefully.

benefits. This would not be conducive to a favorable climate in which to maintain the strength and integrity of the Federal tax system.

TAX ENCOURAGEMENT FOR FOREIGN INVESTMENT

JOHN F. COSTELLOE

In the words of President Eisenhower:

> The flow of capital abroad from our country must be stimulated and in such a manner that it results in investment largely by individuals or private companies rather than by Government.

The President has repeatedly recommended two principal means for accomplishing this end. One would encourage private foreign investment by permitting related income to be taxed at rates somewhat lower than are applicable to domestic income. The other would permit deferral of payment of United States tax on foreign income earned by a domestic corporation.

The new bill would employ both means recommended by the President, but in very narrow area, as brought out in the discussion under section 4.

The panel are in agreement that the limits of the new bill are too narrowly drawn, and that separate tax treatment should be provided for all income resulting from the assumption of risks in economic activities abroad.

The panel agree that qualified foreign income should get the benefit of deferral of United States tax until the income is used in the United States, but do not agree on whether it should also get the benefit of a rate differential.

I believe that it should get the benefit of rate differential as well as the benefit of tax deferral.

Provisions of present law intended to limit the combined burden of foreign and United States tax to not more than would be incurred in a purely domestic operation are ineffective all too often.

Foreign business has commercial and financial risks not encountered in domestic business.

Relatively high United States rates occasion pressure to increase foreign rates applicable to United States interests to the point where the foreign tax will usually be absorbed by credit against United States tax. It would be better to close any gap between United States and foreign rates by lowering the United States rate, thereby permitting foreign countries to determine their own tax policies free from pressure of the United States rate than to have such pressure make foreign rates approximate the United States rate.

However such views may be accepted, I think it important that some progress be made, even if not perfect. The limited incentive of deferral of tax on income until it is used in the United States would be better than none at all. So also, do I think it desirable that Congress makes the agreed equitable technical changes set forth in section 5, particularly as to simplification of foreign holdings. And

there should be provision for carrying over unused foreign tax credits.

As a result of differences in views of sovereigns as to when taxes are to be imposed, foreign tax credits are often lost despite the best efforts of taxpayers to accommodate to those different views. Although this matter was not considered by the panel in detail, because some members lacked firsthand experience, I consider remedial legislation necessary to avoid grave and frequent injustice.

XV. THE ECONOMIC SIGNIFICANCE OF DEFERRED COMPENSATION AND PENSION PLANS

EQUITY OF TAX TREATMENT OF RETIREMENT ALLOWANCES

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I. Introduction

This paper is concerned with the equity considerations in the tax treatment of retirement allowances. That it should be presented to the Subcommittee on Tax Policy of the Joint Committee on the Economic Report is a healthy factor. Here we can be concerned with the simple issue of whether different but comparable classes of taxpayers are being afforded equal facilities under the tax laws to achieve economic security. Such an inquiry differs in point of view from the attitude of certain fiscal committees of the Congress whose primary concern is to raise revenue. The question in this instance is primarily: "What is right?"—let the tax chips fall where they may.[1]

II. Tax Treatment of Savings

Our first inquiry is, what are the equity considerations with respect to the differential in tax treatment of savings by individuals in different employment circumstances, such as (*a*) those covered in formal retirement programs, (*b*) employed individuals not covered by qualified retirement plans, and (*c*) the self-employed and the professional. This necessarily involves a consideration of what tax considerations, if any, have been granted to each of these classes of individuals.

A. EMPLOYEES COVERED BY FORMAL RETIREMENT PLANS[2]

For over 30 years there have been specific statutory provisions for the tax treatment to employees of amounts put away for them by their employers. While the initial treatment was surprisingly naive in its simplicity, the Revenue authorities implemented it with regulations and rulings which covered most of the tax consequences to the

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[1] That these problems are not indigenous to the United States is evident from recent studies considered in Great Britain. See Report of Committee on Tax Treatment of Providing for Retirement, presented by the Chancellor of the Exchequer to Parliament, February 1954; Journal of Institute of Actuaries, vol. 80, pt. II, No. 355, Cambridge University Press, London (1954).

[2] These employees are also covered by social security up to the first $4,200 of their earnings, all the benefits of which are tax-free (I. T. 3447, 1941-1 Cum. Bull. 191; I. T. 3194, 1938-1 Cum. Bull. 114; I. T. 3229, 1938-2 Cum. Bull. 136). As to the dollar value of these benefits if purchased by an individual from an insurance company, see Fager, Retirement Programs for Attorneys and Accountants, 11 New York University Institute of Federal Taxation 1121 (1953).

employee and the employer. Since 1942[3] the Internal Revenue Code has contained highly articulated provisions governing the tax consequences to employers and employees under qualified retirement plans.[4]

If an employer establishes a plan for a qualified group of employees,[5] the tax consequences are these: The employer gets an immediate deduction for the amount so contributed.[6] The employee is not taxed currently on the amount so contributed by the employer on his behalf.[7] The fund (i. e., the trust) does not pay any tax on the income earned on the contributions.[8] When the employee retires, he pays tax on the amounts distributed to him in the year he receives them.[9] If the total amount credited to the account of an employee is distributed in 1 taxable year on account of his termination of service (whether by reason of severance, retirement, death, or otherwise), it is taxable as capital gain.[10] If the total amount is distributed by the qualified plan in 1 taxable year on account of the death of an employee, then the first $5,000 is exempt from income tax.[11] If the distribution consists of stock of the employer corporation, then the unrealized appreciation in the value of such stock is not taxed on distribution, but is taxed only when, as, and if the stock is sold by the employee.[12] The value of the amount contributed by an employer to a qualified plan or trust is not subject to estate tax on the death of the employee if paid to a beneficiary other than the estate.[13]

It is obvious that these are extremely valuable tax concessions available to an employee who works for an employer with a qualified retirement plan. While it is difficult to estimate the exact number of qualified plans in effect and the number of employees covered at the present time, it is estimated that there are about 15 million employees receiving benefits under approximately 28,000 qualified plans.[14]

But these are not the only advantages available to an individual who is employed. The corporate executive may be able to secure deferred compensation arrangements over and above those provided by social security and a qualified privately financed retirement plan. It is becoming increasingly common in the employment pattern of corporate executives to adopt contractual arrangements whereby specified amounts per annum are credited contingently to the executive while he is employed and the amounts so accumulated during his period of active employment are distributed to him over a period of time after

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[3] For description of growth of corporate retirement systems in the United States and the reasons for such growth, see H. R. Hall, Some Observations on Executive Retirement 13 (Harvard School of Business Administration, 1953).

[4] Secs. 23 (p) and 165, 1939 I. R. C., as amended by sec. 162 of Revenue Act of 1942; secs. 401–404, 1954 I. R. C. These apply not only to plans which are primarily pension systems, but also to profit-sharing, stock bonus, and other plans which provide a method of deferring income to the employee.

[5] The statute requires a plan to cover either a specified percentage of the employees or a class of employees which does not discriminate in favor of the highly compensated, stockholder, officer, type of employee. Sec. 401 (a) (3) (A) and (B), 1954 I. R. C.

[6] Sec. 404 (a), 1954 I. R. C.

[7] Secs. 402 (a) and 403 (a), 1954 I. R. C.

[8] Secs. 401 (a) and 501 (a), 1954 I. R. C.

[9] Secs. 402 (a) (1) and 403 (a) (1), 1954 I. R. C.

[10] Secs. 402 (a) (2) and 403 (a) (2), 1954 I. R. C.

[11] Sec. 101 (b) (2) (B), 1954 I. R. C.

[12] Sec. 402 (a) (2), 1954 I. R. C.

[13] Sec. 2039 (c), 1954 I. R. C.

[14] See P-H Pension and Profit-Sharing Service, Rept. Letter No. 13 (Sept. 30, 1955), par. 18.5; P-H Pension and Profit-Sharing Service, Rept. Letter No. 5 (June 10, 1955), par. 5.8; Rapp, hearings before the Committee on Ways and Means, 84th Cong., 1st sess., on H. R. 10 at 51 (1955).

he terminates service.[15] While the tax consequences of such extra-statutory arrangements are not spelled out with precision in the Internal Revenue Code, they are, when properly drafted, effective to siphon off earnings from the period of the employee's highest earning power (when presumably they would be taxed at the highest rate) and postpone them to a point of time in which his earnings are less and the tax rate is correspondingly smaller.[16]

Furthermore, the top executive of the corporate employer has available to him as a compensation device the restricted stock option whereby he may acquire an interest in his corporate employer under favorable circumstances in which can be converted into a capital gain after the expiration of a reasonable period of time.[17]

Finally, the top executive of a corporate employer has available to him a number of other relatively clean cut devices for securing the equivalent of compensation in nontaxable forms. Quite common in this regard are group life insurance, group health insurance, a salary continuation plan in the event of sickness or nonoccupational injury, medical checkups at company expense, legal services provided by the company, the use of company owned clubs or other facilities, etc.[18]

In short, the present tax laws provide three broad and rather well-defined areas for savings by an employee under favorable tax conditions:

First, complete exemption from tax on amounts paid by his employer for certain economic benefits such as health and life insurance, sickness and hospital plans, etc.;

Second, a spreading of income along horizontal lines in point of time (e. g., by means of qualified deferred plans and individual deferred compensation arrangements) so that amounts of compensation are deferred from the current period of highest earnings (and therefore highest tax) to future periods of lower earnings (and presumably lower tax); and

Third, a transmutation of what might otherwise be regarded as ordinary income into capital gain, with the consequent substantial reduction in tax rates e. g., as a result of restrictive stock options and lump-sum distributions from qualified retirement plans.

It becomes pertinent, therefore, to inquire what the situation is with respect to comparable individuals who are self-employed or members of partnerships.

B. THE SELF-EMPLOYED AND PROFESSIONAL

The self-employed and professional is at a serious tax disadvantage so far as saving for retirement is concerned. In the first place, while social security has been greatly extended to cover many classes of the

[15] See Lasser and Rothschild, Deferred Compensation for Executives, 33 Harvard Business Review 89 (1955).

[16] See Washington and Rothschild, Compensating the Corporate Executive (revised edition 1951); Diamond, Tax Aspects of Nonqualified Pension and Deferred Payment Plans, 32 Taxes 615 (1954); Biegel, Some Deferred Compensation Plans, 3 American University Tax Institute Lectures 253 (1951); Bryson and Lefevre, Tax Aspects of Executives' Compensation, Monograph, Practicing Law Institute (1955).

[17] Sec. 121, 1954 IRC. See also, articles supra note 16, and Leake, Compensating Executives and the Latest in Stock Options, 32 Taxes 488 (1954).

[18] See Biegel, How to Compensate Executive Employees, P-H Tax Ideas, par. 7007 at par. 7007.7, and Tax Advantages of Fringe Benefits, P-H Tax Ideas, par. 8014.

self-employed,[19] there are still excluded certain very significant groups of self-employed, such as physicians, lawyers, dentists, osteopaths, veterinarians, and chiropractors.[20]

In the second place, regardless of whether the particular type of self-employed or professional is covered by social security, they cannot under the present tax laws be covered by a qualified privately financed retirement plan. The latter type of plan is available only to employees. The individual who operates his business in the noncorporate form (e. g., as a proprietorship or a partnership) or the professional who cannot operate except in the individual proprietorship or partnership form cannot qualify as his own employee. Accordingly, he cannot participate in qualified retirement plans.[21]

Moreover, if the individual proprietorship or partnership maintains fringe-benefit programs for its employees, such as life insurance, medical insurance, sick pay, and so forth, the proprietor or partner must pay with after-tax money for the portion of those benefits attributable to himself. Furthermore, the areas in which they can convert any of the earned income into capital gain is extremely narrow (and, in the case of the professional, practically nonexistent).[22]

Finally, in view of his status as self-employed, obviously this class of taxpayer cannot resort to the extrastatutory type of deferred compensation contract described above. Instead, the individual proprietor or partner must report currently his share of the firm's profits whether or not he withdraws them from the business.

Accordingly, in good years the individual proprietor or partner pays a high tax on his earnings; in less prosperous years he pays less tax; but, absent any loss years, the tax laws provide no method of averaging the good earning years against the below average years. This situation has been described most graphically in a report of the committee on taxation of earned income of the section of taxation of the American Bar Association for September 1948. Referring to the earnings pattern of professional people, the report states:

> Most of these individuals enjoy a parabolic income—after years of training with low or no income, the cycle moves slowly upward, flattens out at a peak, and then drops more or less sharply as the retirement period arrives. In some professions, such as architecture and engineering, this overall parabola is infected with sharply fluctuating cycles all along the line. In all cases, illness generally produces a sharp dip in the parabola anywhere along its course (p. 99).

It has been estimated that there are about 10 million self-employed persons in this country, such as farmers, professional people, shopkeepers, and so forth, who cannot secure any of the advantages of the tax-favored plans available to employees.[23] If these people wish to provide their own retirement benefits, they must do so without any tax deduction or preferential tax treatment for the money set aside for that purpose. Obviously, in view of the current tax rates

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[19] See sec. 201 (c) (5) of Public Law 761 (1954), which included under social security for the first time certain classes of self-employed, namely, architects, certified public accountants, other types of licensed accountants, and professional engineers.

[20] Sec. 1402 (c), 1954 IRC as amended.

[21] I. T. 3268, 1939 1 Cum. Bull. 196; I. T. 3350, 1940-1 Cum. Bull. 64; PS No. 23; Rev. Rul. 33, pt. 2 (b) (1), 1953 1 Cum. Bull. 267. See also sec. 1361, 1954 IRC, which permits unincorporated businesses to elect to be treated as corporations but proprietors and partners may not be considered employees for purposes of participating in a qualified plan.

[22] See, e. g., *Doyle v. Comm'r*, 102 F. 2d 86 (4th Cir. 1939); *Helvering v. Smith*, 90 F. 2d 590 (2d Cir. 1937); *James W. McAfee*, 9 T. C. 720 (1947); *Est. of Frederic C. Bellinger*, 5 T. C. Memo Dec. 90 (1946).

[23] See Rapp, hearings supra n. 14 at 51.

on individuals, by the time such persons get through paying taxes and providing the necessities of life at the current inflationary levels, little, if anything is left to put aside for retirement purposes.[24]

The plight of the self-employed—especially the professional who cannot adopt the incorporated form of doing business—insofar as tax equality on savings for retirement is concerned, is a serious one. There has been a marked exodus of the younger professional men from the field of private practice to that of an employee of a large corporation.[25] One of the major factors accentuating this trend is the inequality in tax treatment available to the professional in private practice.

C. Possible Solutions

What solutions are available to equalize the tax burden on the self-employed and the professional?

One equalization measure would be to cover these taxpayers under social security. As indicated above, this has been done in the 1954 amendments to the Social Security Act with respect to certain classes of self-employed and professionals.[26] But, rightly or wrongly, lawyers and certain other classes of professionals have resisted social security coverage.[27] Even if the remaining classes of self-employed and professionals were included in social security, however, that would only be part of the answer to the problem. Social security at present applies merely to the first $4,200 of compensation. There still remains the problem of how to provide supplemental benefits on the balance of the self-employed and professional's income.

To solve this latter problem several suggestions have been made. Since the major discrimination against the self-employed arises because of their exclusion from the highly tax-favored provisions of the Internal Revenue Code relating to qualified retirement plans, one obvious solution is to amend those present provisions of the code so as to permit proprietors and partners to participate.[28] Strangely enough, the most articulate objections to this proposal come from one of the classes to be benefited—namely, the lawyers.[29] Perhaps the most serious defect with the proposal is that since most self-employed have few or no employees, it would be difficult, if not impossible, to qualify a plan for those individual's under the Internal Revenue Service's construction of the applicable statute.[30]

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[24] The difficulty individuals will encounter in creating an estate out of income is illustrated by Lasser and Rothschild, supra, n. 15, at 96. See also, hearings, supra, n. 14, at 133-134.

[25] About 73,500 lawyers (35 percent of the profession) are salaried. See report dated July 22, 1952, Office of Business Economics, U. S. Department of Commerce; and Fager, supra, note 2 at 1124. See also Roberts, hearings before the Committee on Ways and Means, 82d Cong., 2d sess., on H. R. 4371, etc., at 25 (1952).

[26] See note 19.

[27] See Oliver, Lawyers and Social Security: No Need for a Change (40 A. B. A. J. 586 (1954)), for a recital of the history of the official position of the American Bar Association.

[28] Nicholson, Pensions for Partners: Tax Laws Are Unfair to Lawyers and Firms (33 A. B. A. J. 302 (1947)); see also, The Association of the Bar of the City of New York, Report of the Commission on Taxation (25 et seq. (December 1947)).

[29] Rudick, More About Pensions for Partners: A Better Solution Than Pension Plans? (33 A. B. A. J. 1001 (1947)); Nicholson, Rejoinder to Rudick (33 A. B. A. J. 1005 (1947)); and Silverson, Earned Income and Ability To Pay (3 Tax L. Rev. 299, at 314 (1948)).

[30] See statement of Treasury Department, hearings supra n. 25 at 39 et seq.

Another solution to this problem was offered by a tax practitioner, Harry Silverson, of the New York bar, in an almost casual manner.[31] While the Silverson plan was attacked initially, both in principle and in form,[32] a literal ground swell has developed among representatives of professional people and Members of Congress for some variation of the plan which would permit the self-employed to defer a portion of his current income to a later period.[33] Approximately a dozen bills have been introduced into Congress incorporating this principle,[34] and extensive hearings have been held on some of these bills by the Committee on Ways and Means in 1952 and again in 1955.[35] Literally dozens of professional groups have testified in favor of the proposal.[36] The President of the United States has endorsed the principle.[37] Both Democratic and Republican Members of Congress have supported it and sponsored it. The Treasury Department itself has shifted its attitude from one of firm opposition to the proposal[38] to one favoring it in principle, but recommending that its adoption be deferred until such time as general tax relief is possible.[39]

In brief, the suggested solution is this: Each qualified individual would exclude from gross income each year a portion of such income. The amount so excluded cannot exceed 10 percent of the individual's earned net income or $7,500, whichever is the lesser.[40] The aggregate lifetime exclusion for any taxpayer cannot exceed $150,000.[41] For an individual who reached his 55th birthday on or before January 1, 1955, the permissible exclusion would be increased by the lesser of 1 percent or $750 for each year in excess of 55, but not more than 20. In the case of a person who reached his 65th birthday on January 1, 1955, the permissible exclusion would be 20 percent instead of 10 percent, with the annual ceiling increased by $7,500.[42]

Carryover provisions are incorporated for years in which an individual doesn't contribute up to the maximum exclusion, thus permitting him to make up the difference in future good years. Conversely, for years in which the individual contributes in excess of the maximum permitted, that excess can be carried forward and absorbed in future years when he contributes less than the maximum.[43]

The funds so excluded from income must be invested in a restricted retirement fund or a restricted retirement annuity contract. Under

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[31] Silverson, A New Tax Proposal (44 Am. Mercury 345 (1947)); Silverson, supra, n. 29.

[32] Rudick, Where the Silverson and Rudick Plans Differ (3 Tax L. Rev. 384 (1948)); Report of the Association of the Bar of the City of New York, supra n. 28; American Bar Association, Dissenting Reports of Committee on Taxation of Earned Income (100 et seq. (1948)); Vernon and Molloy, Retirement Benefits for the Self Employed (12 Fed. Rules (Dec. 1952)); Goldstien, Security for the Professions: A Plan for More Equitable Tax Treatment (37 A. B. A. J. 409 (1951)); Brayman, Security for the Professions: A Plan for Equitable Tax Treatment—A Reply (38 A. B. A. J. 111 (1952)).

[33] See hearings supra n. 14.

[34] H. R. 4371, H. R. 4373, H. R. 8390, H. R. 8456, H. R. 1173, H. R. 5847, and H. R. 7426, 82d Cong.; H. R. 10, H. R. 11, H. R. 2533, H. R. 2692, H. R. 120, 83d Cong.; H. R. 9, H. R. 10, and H. R. 2092, 84th Cong.

[35] See hearings supra n. 25 and hearings supra n. 14.

[36] See, e. g., list of witnesses in hearings supra n. 14.

[37] See statement of President Eisenhower, October 20, 1952.

[38] See statement of Treasury Department in hearings supra n. 25 at 39.

[39] See statement of Treasury Department in hearings supra n. 14 at 14. A general reduction in rates, as the Treasury has suggested, is not a solution. For until equality in treatment is accorded all taxpayers, any reduction in rates merely accentuates rather than alleviates such inequalities.

[40] Thus earnings in excess of $75,000 per year are disregarded. It should be noted that no such ceiling is placed on annual salaries recognized for purposes of sec. 401 of the 1954 Internal Revenue Code.

[41] No such aggregate limitation is placed on amounts funded for any employee under a qualified retirement plan under sec. 401 of the 1954 Internal Revenue Code.

[42] These provisions are designed to permit the older individual at the time the system is installed to build up a competence in his remaining years.

[43] Cf. sec. 404 (a) (3), 1954 Internal Revenue Code, providing similar carryovers for contributions to qualified profit-sharing plans.

both the individual may not withdraw the sums until he is age 65 except in the case of permanent and total disability. Nor are the funds assignable except for the designation of a beneficiary under a joint and survivor type of annuity, or in the event of death. Distributions from either the restricted retirement fund or annuity contract would be taxed as ordinary income when, as, and if received, except that, if the distribution is made in a lump sum, it will be taxed as capital gain.[44]

Thus the attempt has been made to grant treatment to self-employed individuals under a restricted retirement fund or contract comparable to that accorded the employed individual covered by a qualified retirement plan installed by his employer. Complete equality has not been achieved, for, in addition to the above tax benefits, the employee covered by a qualified retirement plan is entitled to have the value of the employer's contribution excluded upon his death from Federal estate tax[45] and the first $5,000 of such payment excluded from the beneficiary's income for Federal income-tax purposes.[46]

D. EMPLOYEES NOT COVERED BY QUALIFIED PLANS

Obviously, not all employees are covered by formal retirement systems of the qualified or nonqualified type. It has been estimated that there are about 30 million employees whose employers are either unwilling or unable to set up private pension plans.[47] These employees at present must depend upon the benefits they may receive under social security to the extent of their coverage thereunder. What should the tax laws provide in those instances?

It has been suggested that such employed persons be covered by the same legislation recommended above for the self-employed and the professional.[48] Under such legislation they would be permitted to set aside in a restricted retirement fund or restricted retirement annuity contract 10 percent of their income, but not in excess of $7,500 per year, subject to the other requirements noted above.

At first blush it would appear that there is considerable merit in the suggestion. This group, too, does not have the advantages of the qualified retirement plan. Moreover, it is difficult for them to save for retirement out of their own funds after taxes.

But there are several reasons for going slow in that regard:

In the first place, the tax laws should be concerned not with actually providing every individual with adequate retirement income, but with providing the opportunity for comparable classes of taxpayers to be treated equally. The present tax laws already provide adequate incentive to employers for the setting aside of funds to retire their employees. True, not all employers have availed themselves of these inducements and therefore not all employees reap the benefits. But the medium for doing so via favorable tax incentives is there.

In the second place, collective bargaining is available for many employees to compel or rather induce the reluctant employer to become

[44] Cf. secs. 402 (a) and 403 (a), 1954 Internal Revenue Code, providing similar benefits for distributions from qualified plans.
[45] Sec. 2039 (c), 1954 Internal Revenue Code.
[46] Sec. 101 (b) (2), 1954 Internal Revenue Code.
[47] See Rapp, hearings, supra, note 14 at p. 52.
[48] See testimony of American Bar Association and related organizations in hearings, supra, note 14.

more enlightened about the welfare of his employees.[49] The increase in the number of negotiated plans, in the number of employees covered, and in the amounts of pensions provided for them has been phenomenal since World War II. In that connection, too, the desire to get and keep competent help soon compels one employer to meet the blandishments of his competitor in the labor mart and extend comparable retirement benefits to his employees.[50] It is merely a matter of time before practically all corporate employers will have qualified retirement plans covering their employees.

In the third place, this particular class of taxpayers possesses two attributes which the professional does not have: (*a*) To a large extent, social security will take care of a good deal of the retirement problem, both in coverage and in amount, and (*b*) he has to a certain extent the advantage of employment mobility. Within limits, such an employee can move from the employer without a pension plan to another with one; the professional's chance in that respect is practically nil.

Finally, there is a very serious administrative reason for so restricting this proposal; namely, the adverse impact on the extent of qualified retirement plans.[51] Under existing law a qualified plan must cover a representative group of employees and must not discriminate in favor of so-called key employees. An employer who wishes to establish such a plan cannot, therefore, pick and choose his employees. Nor may he vary the retirement benefits for each as he sees fit; his formula for contributions and benefits must be nondiscriminatory, too.

However, if the Silverson plan or any facsimile therof were adopted, a ready device for avoiding the restrictions of qualified plans is available. The employer would not have to adopt a qualified plan for the requisite number of employees, nor would he have to provide benefits on a nondiscriminatory basis for those employees. Instead, he could pick and choose the few individuals he wished to benefit and increase their compensation in a given year by a bonus in such an amount which they as individuals could put aside in the restricted retirement fund or restricted retirement contract. The bonus would be tax free to the individual and currently deductible by the employer. Moreover, since contributions to the restricted retirement fund would not have to be made annually, the employer could vary his bonus each year to suit himself, his profit picture, or his attitude toward the particular employee.

Such an employer would hardly find it necessary or desirable to embark on a qualified retirement program with its long-term commitments, its restrictions on the employees to be covered, the amounts to be paid therein, etc. Instead, he would adopt the method suggested above for taking care of a selected few employees on a year-to-year basis and in such fashion as he feels expedient. The whole structure of the qualified retirement plan provisions of the code would be seriously undermined and might well crumble.

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[49] See note, Employee Pensions in Collective Bargaining, 59 Yale Law Journal, 678, for excellent description of development of labor unions' attitude toward pensions and the effect of collective bargaining thereon.

[50] See C. A. Hall, Effects of Taxation: Executive Compensation and Retirement Plans, p. 55 (Harvard School of Business Administration, 1951).

[51] See Ain, Pensions for Self-Employed, Trusts, and Estates, April 1955.

III. Conclusions

Much has been written on the subject of providing pensions for the self-employed via special tax consideration. The Committee on Ways and Means has on at least two occasions held extended hearings on the subject at which representatives of the Treasury and of interested organizations have testified at length.[52] It would be presumptuous to assume that any one person has the complete answer to the problem. It is, therefore, with considerable reservation that the following program for relief is suggested:[53]

(1) *Amend social security to cover all classes of self-employed and professionals.*—Many of the arguments advanced against this are, it is submitted, emotional. They might well be applied against the entire social-security system rather than against its coverage of professionals.

There is, however, at least one valid objection to this proposal, i. e., that the benefits would be lost if the individual earns more than $1,200 in any one year.[54] Obviously, the professional does not cease all activities after age 65; rather he generally tends to reduce the scope of his activities. Thus the present limitations on outside earnings might make social-security coverage a snare and a delusion.[55]

It is suggested, therefore, that at least for the professional the ceiling on outside earnings either be raised substantially or eliminated entirely. The history of the Social Security Act demonstrates that this limitation has been raised from time to time. In view of that development, it may even be advisable to eliminate it entirely for all covered employees.

(2) *Amend the present statutory provisions relating to qualified retirement plans so as to permit individual proprietors and partners to be included in plans for their employees.*—This would permit the use of an extensive body of well-defined law, both statutory and administrative, as guideposts. There would be available to install and administer such plans an experienced corps of technicians both within and outside the Revenue Service.

One of the major objections to this approach has been that in view of the very nature of individual proprietorships and partnerships, most plans for them would run afoul of the nondiscrimination tests in the statute.[56] There are several answers to this: In the first place, the problem is no more unique than in the case of the closely held corporation. Secondly, the law could provide that a plan would not be deemed discriminatory merely because it provided annual contributions on behalf of the proprietor or partner of 10 percent of his earnings but not in excess of $7,500.[57] Moreover, to prevent the plan from being topheavy in favor of the proprietor or partners, a ceiling on the annual contribution on behalf of all those could be adopted.[58] Finally, a lifetime ceiling of $150,000, comparable to that of the Silverson plan, could be imposed as a restriction on the total accumulation permitted under such a plan for any one proprietor or partner.

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[52] See hearings, supra, note 14, and hearings, supra, note 25.
[53] A program similar to this was suggested by Fager, supra note 2, at p. 1142 et seq
[54] Sec. 203 (e) of Social Security Act, as amended.
[55] See Oliver, supra, note 27.
[56] Sec. 401 (a) (3) and (4), 1954 Internal Revenue Code. See also Rudick, supra, note 29, at p. 1002; Silverson, supra, note 29, at p. 314.
[57] See an analogous set of presumptions in sec. 401 (a) (5), 1954 Internal Revenue Code.
[58] Cf., sec. 404 (a) (1) (B), 1954 Internal Revenue Code.

(3) *Adopt a restricted form of the Silverson plan for taxpayers not covered by the foregoing.*—Such a plan would be available for those who cannot establish a qualified plan because, for example, they have no employees. Since under the suggestion made in paragraph (1) above they would be covered by social security, the benefits which they could accumulate under the so-called Silverson plan would be limited only to the earnings not covered by social seurity (at present, earnings in excess of $4,200 per annum) and in amount which would integrate with social security.[59] For example, the Treasury assumes that social security provides a benefit of approximately 37½ percent of the employee's compensation up to $4,200.[60] Accordingly, an individual could provide via the modified Silverson plan similar benefits on his compensation in excess of $4,200. To protect the revenues and minimize the administration of this provision, the 10 percent $7,500–$150,000 ceilings in the present Silverson plan might be adopted.

Again caution is suggested with respect to making this proposal available to any individual who is not actually covered by a qualified plan, rather than merely to those classes of taxpayers who cannot adopt a qualified plan. For if the proposal is so broadened, it may, as indicated above, provide a tax-avoidance vehicle which would undermine the entire structure of the qualified plan.[61]

RETIREMENT FUNDS, CAPITAL MARKETS, AND GROWTH

ELEANOR S. DANIEL, Mutual Life Insurance Co. of New York

Economic dependency in the United States seems likely to increase in the next half century. Particularly striking is the projected increase in numbers of older persons who may be either wholly or partially retired from active employment. This burden will be more readily sustainable if provision for its support is made in such a way as to enhance (or, at very least, not diminish) the total productive capacity available to satisfy all the competing demands recognized by our economy.

Retirement schemes do not merely assure the orderly transfer of claims from economically productive to economically unproductive groups at the necesary time. These mechanisms may also, in themselves, influence the overall effectiveness of the factors of production and the allocation of resources. Both affect the long-term growth and stability of the economy. Two other papers in this panel will discuss effects with respect to labor efficiency and mobility, and the distribution of income between spending and saving, in each case with special reference to the influence of tax policy. The analysis here will further explore the implications of (1) the growing volume of accumulated retirement savings, (2) the manner in which they are administered, and (3) the uses to which they are put. Tax considerations exert

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[59] Cf. mimeograph, p. 6641, 1951-1 Cum. Bull. 41.

[60] See sec. 1.401-3 (d) (2) of Proposed Regulations under secs. 401-404 of 1954 Internal Revenue Code, 20 Federal Register 6455 (1955).

[61] See Aln, supra, note 51.

some direct influence on this process, but are a major factor only at a few points. Therefore this paper is concerned largely with some of the ultimate effects of the general tax encouragement given to private deferred compensation systems.

The Volume of Private Retirement Funds

Funds have been earmarked for retirement purposes under a wide variety of auspices:

1. In industry, sponsored either by employers alone, or jointly with employees or labor unions.
2. By State and local governments for their employees.
3. By individuals directly through annuities and an unknown portion of other forms of savings.
4. By the Federal Government for its employees.
5. By the Federal Government for the general working population under OASI (now incorporating the railroad retirement systems as well) and also under veterans' programs.

The first category is the main focus of this investigation.

The relative importance of private programs in relation to the total volume of funds accumulated for retirement purposes differs greatly from that in terms of current benefit or workers covered. The bulk of current benefits is derived from the Federal programs and this situation will continue, both because of their broader coverage and because of the comparative immaturity of the private plans. Only 13 percent of the $7.6 billions[1] paid in 1953 originated in private and State and local plans. The Federal plans also predominate in coverage, blanketing virtually all of the 70 million persons in the labor force, with minor exceptions. Coverage under the other systems, therefore, necessarily overlaps. Private plans at the end of 1953 covered perhaps 12 million persons, or about one-fifth of the working population,[2] and State and local retirement systems included another 3 million members in October 1952.[3] However, the private and State and local plans make greater advance financial provision for both past and current liabilities. Therefore, at the end of 1954, the funds underlying these arrangements approximated $30 billions which was also the approximate combined total for the OASI trust fund, the railroad retirement fund, and the civil service retirement fund, despite their much broader combined coverage. The non-Federal funds increased more rapidly, adding about $4½ billions in 1954 as against $2.3 billions for the Federal systems.

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[1] Miriam Civic, Pension Payments—A Stabilizing Influence, American Statistical Association, Proceedings of the Business and Economic Statistics Section, September 1954.

[2] Fundamentals of Private Pensions, Pension Research Council, 1955, p. 28.

[3] Retirement Protection for State and Local Employees: 10 Years of Growth, Dorothy McCamman, Social Security Bulletin, May 1953, p. 5.

Assets of private long-term institutional investors, and State and local pension funds, 195[illegible]

[In billions of dollars]

	Assets Dec. 31	Increase during year	
		Amount	Percent
Private pension and retirement funds:			
Uninsured corporation administered	[illegible]	[illegible]	[illegible]
Insured reserves	[illegible]	[illegible]	[illegible]
State and local pension funds	[illegible]	[illegible]	[illegible]
Life companies except insurance pension reserves	[illegible]	[illegible]	[illegible]
Mutual savings banks	[illegible]	[illegible]	[illegible]
Savings and loan associations	[illegible]	[illegible]	[illegible]
Fire, casualty, and marine insurance	[illegible]	[illegible]	[illegible]
Investment companies	[illegible]	[illegible]	[illegible]
Total	[illegible]	[illegible]	[illegible]

[1] Estimated.
[2] Influenced by market appreciation [illegible] stock [illegible] market value. Distortion [illegible] for the casualty, marine and investment companies.

In general, only private, and State and local, funds flow into the regular capital markets. Some measure of their overall importance in this setting is given by the fact that the two combined now account for one-sixth of the accumulated assets of the major long-term institutional investors and one-fifth of the annual net increase in this supply. Assets of the uninsured and State and local funds are currently growing somewhat faster than any of the institutions except investment companies and savings and loan associations, and the latter reflect the unusually strong cyclical influence of the stock market and home construction booms. The relative increase in insured funds is smaller but exceeds that of mutual savings banks and life company assets other than pension funds.

The future growth of pension funds has been the subject of some stratospheric projections.[4] These have generated fears that investment outlets may be so inadequate as to endanger both the cyclical stability and longer run growth of the economy. Against these amounts required to fund all pensions "from here to eternity" (as Roger F. Murray has put it so wittily) more temperate estimates of probabilities indicate that around 1960 aggregate private pension reserves might range from $33 to $39 billions[5] and State and local funds might aggregate $19 billions.[6] At that time, private funds might be growing at a net annual rate of perhaps $4 to $5 billion and State and local funds at about $2 billion.

These are crude guesses, of course. Two factors which could raise them considerably would be higher benefits geared to higher wage rates, and more liberal vesting provisions; both have strong union pressure behind them. On the other hand, benefit payments, now less than one-fifth of contributions for the uninsured plans, according to a recent SEC study, may be expected to rise as plans mature; this will act as a damper on asset accumulation. Furthermore, the spurt of the

[4] For example, the estimated $700 billion for the ultimate fund required to provide pensions on a reasonable scale to all persons over 65. Impact of Pension Plans Upon the National Economy, George B. Buck, the Journal of Commerce, New York, June 17, 1955.
[5] Pensions in the United States, a study prepared for the Joint Committee on the Economic Report by the National Planning Association, 1952.
[6] Dis-que Dean, Survey of Public Employee Pension Funds, Union Securities Corp., 1955.

last decade reflects several nonrecurring sources of growth. These include new plans adopted by very large corporations and, presumably, a relatively rapid amortization of past service liabilities in a period of prosperity and high corporate taxes.[7]

Actually, little is known about one of the most significant determinants of pension fund growth; the rate at which pension plans amortize past service liabilities. The IRC (sec. 404 (a) (1) itself limits the rate at which plans can be funded. No more than 10 percent of the initial past service liability may be deducted in any 1 year (deductions may, however, be carried over); since the initial past service liability is a discounted value, liquidation at this rate would require 11 to 12 years, depending on the rate of interest assumed. The employer must in general adhere to the basis he selects rather than shifting to obtain maximum tax deductions; however, contributions for any particular year may be reduced or omitted entirely, as long as, in the aggregate, accumulated contributions are adequate to meet the normal costs of the plan plus interest on the intial past-service liability. It would seem that these provisions, although designed to forestall an undue loss of tax revenue in any 1 year, also work against the concentration in 1 period of any exaggerated increase in pension savings. At the same time they permit greater flexibility on the downside in the event of economic strain for either a particular business or the general economy.

It seems reasonable, then to suppose that, while pension accumulations will mount in the years ahead, and perhaps more rapidly than other forms of institutional savings, they will by no means dwarf the other institutions. Their growth tends to be contingent on the general growth of the economy and the continued profitability of business, both of which, in themselves, generate added investment outlets. Therefore, even for those who feel generalized oversavings may be a potential problem, it would be illogical to view pension funds as the crux of the difficulty.

Despite the variations possible[8] in the rate of funding past-service liabilities, pension savings are relatively inflexible since they are largely tied savings, not dependent on the saver's decision, which, once begun, must, if possible, be carried through to termination of the contract. This has been cited as a potential threat to economic stability in periods of business downturn. However, there is no assurance these amounts would otherwise have been spent. In part, they represent merely a transfer from corporate to institutional savings, or a bringing to the capital markets of funds which might have been ploughed back directly into business investment. In part, they represent a reduction of tax revenues which, depending on the state of the budget, may necessitate additional Federal debt, thus simultaneously increasing investment outlets in the financial sense. Even individual contributions may not entirely represent a net addition to savings.

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[7] Employer contributions to uninsured plans covered by the recent SEC study, although not allocated between past and current service liability, dropped slightly from 1953 to 1954. The latter was a year both of business recession and lower corporate taxes (the excess profits tax expired in January 1954).

[8] Removal of the IRC limitations on funding has been advocated to encourage still greater flexibility. See J. W. Myers, Governmental and Voluntary Programs for Security, Harvard Business Review, March 1950.

In any case, the pressure of interest assumptions requires that pension funds be invested without much delay. This may drive interest rates lower than would otherwise be the case and contribute to investment recovery. In the more extreme case of incipient financial disintegration, the immunity of pension funds to sudden dissaving means that those who administer them are under no compulsion to aggravate the situation by liquidating investments, and may conceivably provide some reservoir of liquidity for other lenders.

Retirement funds also constitute a steadying influence in capital markets in periods of inflation when their relatively stable, predictable flow provides a kind of "floor" of savings.

The forms of investment into which these continuing flows are channeled varies with the institutions chosen to administer them, with their customary policies, and the statutory and administrative regulation to which they are subject.

HOW RETIREMENT FUNDS ARE ADMINISTERED

Pension plans may be insured or self-administered; the latter may or may not utilize the services of a trust company. The choice hinges on a number of conditions. In insured plans, the insurance company assumes the ultimate risk which is trusteed plans is still carried by the employer. (This is compelling for small employers, with too few employees for the law of averages to work.) On the other hand it is generally asserted that insured plans cost more. This difference is partly explainable by the need to prefund expenses and provide for a contingency reserve to assure fulfillment of the guaranteed benefit, as well as by certain technical differences. Part, however, results from the fact that insurance companies pay certain taxes for which there is no counterpart in trusteed plans. These include taxes on group annuity premiums, levied in 17 States, and the Federal income tax, currently fixed at approximately 6½ percent of net investment income. The former reportedly amount to under 1 percent of group annuity premiums.[9] The latter, which reduces yield at present interest levels by about one-fifth percent, increases the cost of an insured plan by about 5 percent. This presumably involves some tax discrimination against small business which is more prone to use insured plans. It has also influenced larger employers to use trusteed plans or to switch to trusteed plans after starting under insured plans.[10]

Thus tax policy has had some influence in the more rapid recent growth of trusteed, as compared with insured, plans. The Mills-Curtis bill, now pending, however, would remove the discriminatory impact of Federal income taxes on insured plans by gradually exempting investment earnings on insured pension reserves.

Public control of retirement-fund investments

Life-company investments are subject to public control through State insurance laws; to assure compliance the companies are examined by the State insurance departments every 3 years. Super-

[9] Fundamentals of Private Pensions, p. 183.
[10] Statement of Carrol M. Shanks, president of the Prudential Insurance Company of America, hearing before a subcommittee of the Committee on Ways and Means, House of Representatives, Dec. 15, 1954, pp. 316, 324.

vision of uninsured funds is less uniform. Many trust instruments specify the investments which may be made, e. g., only in investments legal for life companies, that a certain percentage shall be held in governments or that the percentage in common stocks or securities of one issuer shall be limited. Others provide that the trustee shall be guided by an advisory committee. Barring such express directions, the trustee is subject to State laws governing trust investments generally. These were formerly much more restrictive than the insurance codes, limiting selection to a legal list. However, recent amendments grant broader discretion than is generally allowed life companies. The "prudent man" rule for trust investments now prevails in whole or in part in 36 States.

The trust laws are enforced through a variety of agencies, including State banking departments, the Federal Reserve System and the FDIC. Their examiners check compliance with trust instruments and applicable laws and regulations, including those of the Internal Revenue Service. However, bank supervisory authorities have no responsibility for discretionary actions like investment. Where the bank merely acts as custodian, with no investment discretion, the supervisory authorities have negligible influence. To quote Vice Chairman C. Canby Balderston, of the Board of Governors of the Federal Reserve System: "To a considerable degree the possibilities of abuse stem from the provisions of the trust instruments themselves." [11]

The area of least public supervision is found in funds self-administered by employers, unions, or a combination of the two. Nearly half the States do not even require trustees to account at regular or frequent intervals, much less require items to be so presented as to bring out the significance of the transactions. The only remedy for abuse of beneficiaries' rights is through the courts.

However, it is difficult to see how such funds might be supervised appropriately. Certainly it would not be through a backtracking to the more rigid trust-investment statutes of earlier days. It is not statutory investment restrictions but skillful investment management which assures good investment performance. (Fortunately, the bulk of these funds is administered by responsible institutions skilled in investment matters.) Nor, on the whole does it benefit the economy to have artificial barriers to the free flow of funds. Probably the most hopeful approach is the law just adopted for independent welfare funds in the State of Washington, requiring mandatory disclosure of finances to the State insurance department, together with examination of such funds at least once each 5 years. The same approach has been considered in other States (New York enacted stopgap, factfinding legislation in 1954 giving the superintendent of insurance similar authority. For a recommended program of further action see Whose Welfare? a report by Adelbert G. Straub, Jr., former deputy superintendent of insurance in New York). The Revenue Service could also make a contribution to full disclosure through compilation and publication of the information submitted by plans claiming tax exemption.

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[11] Statement before the Subcommittee on Welfare and Pension Funds of the Senate Committee on Labor and Public Welfare, July 20, 1955.

INVESTMENT POLICIES OF INSURED AND SELF-ADMINISTERED PENSION FUNDS

Tax questions have only a limited effect in pension-fund investment, except in special situations. More important are the prejudices of those directing financial policies, the operating necessities of the institutions involved, and the uneven impact of laws and regulations.

Investment distribution: Retirement funds, Dec. 31, 1954

[Percent]

	Insured[1] plans	Uninsured plans
Cash	1.5	2.4
Governments (United States)	10.7	17.8
Corporate bonds	40.5	53.5
Preferred stocks	2.5	3.7
Common	1.4	18.6
Own company		(2.9)
Other company		(15.7)
Other assets	43.5	4.0
Mortgages and real estate	(33.5)	
Other governments, policy loans, miscellaneous	(10.0)	
Total	100	100

[1] Distribution of all life company assets.

Source: Institute of Life Insurance, SEC. The latter's recent study, on which the uninsured distribution is based, covers only corporation administered retirement funds and profit sharing plans with retirement provisions. Bonus, savings, welfare, and union-administered funds are not included. In addition, funds of railroads and financial institutions are substantially excluded.

Investment channels differ strikingly for insured and uninsured plans as shown in the following table. This seems, at first, surprising in view of the like philosophies of investment officers and the similarity of the flows available for investment. The major divergences consist of—

1. A much greater emphasis on securities in uninsured plans. Conversely, one-third of the insured funds went into mortgages and real estate, whereas mortgage holdings by uninsured plans were negligible.
2. A much greater emphasis on equities, particularly common stocks, in uninsured plans.
3. Another difference, not revealed by the above data, but generally known, is that a somewhat larger proportion of life-company security holdings is obtained through direct placements. At the end of 1954, life companies, representing over 80 percent of the total assets of all United States life companies, had obtained 67 percent of their corporate bond holdings through direct placement.[12]

Many factors underly these differences. Life companies commingle pension funds with those from other insurance operations. Within the regulatory framework they invest these large aggregate amounts to maximize yield. Traditionally they have been substantial mortgage investors: they are familiar with the problems in this field and have established facilities to handle them. Banks, on the other hand, may be subject to the investment direction of the trust instrument, an

[12] Direct Placement, Joint Investment Bulletin No. 248, American Life Convention and Life Insurance Association of America.

advisory board, or both. Such boards tend to favor better-known corporate borrowers and, therefore, corporate securities or commercial real estate rather than the residential mortgages so important in recent years. Furthermore, banks have traditionally been restricted to local areas in mortgage lending; they have never created servicing facilities comparable to those of the nonbank institutions.

To the extent that uninsured funds go into residential mortgages at all, then, they tend to be FHA's and VA's, which are more like securities.

Since trust companies generally administer each trust as a separate unit[13] their inflow of new money tends to be somewhat less predictable than the aggregate inflow of life companies. Because insurance companies know in advance what funds they can bank on, they can provide borrowers with the same kind of "line" of long-term credit that banks have always furnished in the short-term field. Their ability to make longer forward commitments has given life companies an advantage in direct placements and mortgage lending over trusteed plans.

Thus trusteed plans have turned to equities for the higher yields which life companies have sought in mortgages and private placements. Common stocks of the trusteed funds, at cost, rose from 11.3 to 18.6 percent of assets between 1951 and 1954. This trend was aided by liberalization both of pension trust instruments and of laws governing fiduciary investments.[14]

Life company investment in common stocks has been severely restricted. The New York insurance law, which exerts a restraining influence on all companies doing business in the State, prohibited such investment from 1907 until 1951. (Even preferred stocks were taboo until 1928). At present it permits investment in common stocks only up to 3 percent of admitted assets, or one-third of surplus, whichever is less. Life companies have not even fully availed themselves of this privilege, since they face the further stumbling block of having to value equities at market (the IRS generally accepts trust-fund valuation at cost). Market fluctuations can thus, until further development of the recently established mandatory security valuation reserve, exert a disconcerting influence on their published surplus figures which, in turn, are limited in many States to approximately 10 percent of liabilities requiring interest.

Equity investments and direct placements undoubtedly raise the questions of greatest significance for the growth and stability of the economy. These can be given only the most cursory treatment in the space allotted here. In a few other minor instances, the lending practices of these institutions may also alter market relationships.

The problem of equities: "damned if they do, and damned if they don't"

"If they don't" invest in equities, retirement-fund administrators are accused of (1) neglecting opportunities for their beneficiaries of larger income, wider diversification, a share in the benefits of national growth, and perhaps a hedge against inflationary tendencies; and (2)

[13] Common trust funds for pension funds have recently been established by banks in several cities.

[14] The New York law, for example, was amended in 1950 to permit investment of up to 35 percent on a prudent-man basis outside the limitations of the "legal list."

contributing to a presumed shortage and higher cost of equity capital with attendant undesirable effects for the economy (e. g., greater cyclical vulnerability of rigid corporate capital structures, discouragement of longer-run industrial expansion). Related to this is an alleged scarcity of financing for new, risky, and small enterprise—the "venture capital" problem.

"If they do" invest in common stocks, the specters are raised (1) of losses resulting from the greater volatility of common-stock values; (2) of a creeping concentration of economic power; (3) of a peculiar variation of this in independently administered funds where corporate managements acting as trustees could secure control of their own or other companies by using money held in trust for employees; (4) of an unremitting inflationary pressure on stock markets while "young" retirement funds are building up and, conversely, of possible selling pressure if they have to liquidate in a deflationary period. Coupled with this is the contention that such funds will go largely into "blue chips," creating yield distortions and giving older established companies an unfair advantage in equity financing.

The merits of common-stock purchases from the standpoint of investment results have been the subject of intensive investigation in recent years, as trust companies, life-insurance companies, and mutual savings banks have sought liberalization of State investment laws. The general conclusion seems to be that, for long-term investors, able to pursue a steady, diversified, investment program, common stocks should provide at least as attractive long-run return as more traditional forms of investment.

At least one segment of the general public agrees, and agrees also with the further contention that common-stock investment offers retirement funds some opportunity to share in economic growth and hedge against inflation. These are the 19,000 school and university personnel who are directing the maximum 50 percent of their total annuity premiums into the college retirement equities fund established by TIAA in 1952 to provide annuities with fluctuating values tied to the value of the common stocks in which their reserve funds are invested. In 1955, the Variable Annuity Life Insurance Corporation of America was chartered in the District of Columbia to provide similar facilities for other annuitants, and bills to permit like institutions are pending in several States.

Scarcity of equity funds—or too much in institutional hands?

With reference to the broader economic issues raised, the facts are less clear. Over the last 25 years American business has tended to rely increasingly for equity funds on internal, in preference to external, sources. This may be undesirable because it gives the financing edge to large, well-established firms and does not subject the financing demands of competing firms to the test of the market.

External financing in recent years has taken the form of debt issues to a greater extent than in earlier periods of comparable activity. Encouragement has been given debt financing by the long-term downtrend of interest rates and the fact that interest charges are expenses deductible from ever-mounting corporate-tax bills. Whether greater institutionalization of savings, including retirement savings, should be included in the list of factors which have led to the swing away from external equity financing is a moot point. It may be that insti-

tutionalization of savings and the relatively high cost (until recently) of equity capital, have merely been symptoms of certain common underlying causes. These are, of course, the long-run redistribution of disposable income and savings, to the detriment of the upper income groups and in favor of the middle and lower income groups. Tax policy, as well as social change, has promoted this redistribution.

The economy cannot readjust to such structural changes overnight. If lower income savings are channeled, both voluntarily and involuntarily, through intermediaries, as they seem to be, it is unrealistic to assume that these would, in turn, immediately step in to fill the precise holes left in capital markets by the dwindling large private investor. The process is more gradual and uneven. The institutions first tend to expand investments in traditional areas and push these to the margins of attractive return. This is exactly what did happen, beginning in the thirties. Financial institutions on balance began acquiring debt securities from individuals and other holders; they added more to their portfolios than the increase in public and private debt outstanding. In some areas, e. g., bonds legal for trust and savings bank investment, this pushing out finally resulted in taking a lower return than that warranted by actual investment performance.[15] Since the war, greatly expanded mortgage borrowing has provided attractive outlets for some institutions but not, as noted above, for uninsured pension funds.

It was inevitable, in time, that, as these possibilities were more fully exploited, the institutions would turn to new methods and avenues of financing. Even the barriers interposed by legal limitations could not stand indefinitely in the face of investment pressures. If the form in which savings are held has placed any drag on external equity financing it seems likely to disappear [16] in time as a result of the combined influence of more common stock investing by traditional savings institutions and pension funds, by mutual funds, and by such new devices as variable annuity companies. Profit sharing and stock bonus plans are additional equity sources.

Tax policy can either facilitate or hamper the readjustment leading to a greater flow of institutional funds into common stocks. In the case of retirement funds the present system probably sets up conflicting currents. Uninsured funds may furnish equity capital on more favorable terms than would an individual investor subject to tax since they can charge losses against total income rather than against yield after tax; nor are they subject to taxes on capital gains. On the other hand, the IRS has thus far frowned on the accumulation of loss reserves or any considerable surplus, a fact which discourages investments with fluctuating market values and high risk rates, no matter how attractive the yield. (This is true even though, barring the need to liquidate, stocks may customarily be held at cost.)

Insurance company earnings on stocks are taxes at the 6½ percent rate, but only after the 85 percent intercorporate dividend deduction. This gives stocks a yield advantage over other investments of 20 basis points at the present gross yield of around 3.75 percent. (This deduc-

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[15] A Report by the Trust Investment Study Committee, Trust Division, New York State Bankers Association, 1949.

[16] It seems highly unlikely, however, that any of the trustee-type institutions could ever appropriately provide venture capital for new and riskier enterprises. Solutions to this question might come from specialized types of mutual funds, economic development groups, and tax revision to encourage individual risk taking.

tion would be eliminated by the Mills-Curtis bill, but since income attributable to group annuities would at the same time be gradually relieved of tax, the position of insured retirement funds in this respect would then be like uninsured.) On the other hand, since 1951, State laws have permitted life companies to set aside security valuation reserves above their limited surplus. With respect to common stocks, however, the amounts seem grossly inadequate, particularly since these must be carried at, what is, in its action on surplus, the lower of cost or market. Even an increase in the legal limits would probably not induce much additional stock investment until such difficulties are ironed out. (The companies have placed only 2.5 percent of their assets in preferreds although these are subject to no formal legal limit and have been relatively high yielding.)

Influence on stock-marketing functioning

To the extent that pension funds do flow to the equity markets they may create new problems of readjustment. Net common-stock purchases by institutions are estimated to have risen from $100 millions in 1940 to $1.5 billion in 1954.[17] Pension funds and life companies account for about 40 percent of the latter figure, with pension funds alone representing 30 percent. Undoubtedly, as noted above, these institutions will take lower yields than large private investors; undoubtedly, also, their buying will go largely into "blue chips" as it once went only into highest quality bonds. One likelihood, not wholly desirable from an economic standpoint, is that industry may adjust to this demand, creating more blue chips via merger or consolidation. (This process may already be going on.) For another, it is unrealistic to assume that the funds will push their buying until they pay ridiculous prices for blue chips. In time their direct buying should spill over into other issues.[18] Even before this, however, the usual processes of market readjustment should lead the individual investors who are bought out of higher quality stocks to transfer their interest to more venturesome outlets. In any case, if a greater total volume of funds is directed into the market the general lowering of equity yields should be a solace and not a worry to those who have feared a shortage of equity capital. One cannot have the argument both ways.

Much more disturbing for those who believe that market evaluations, however imperfect, play an important role in the functioning of the economy is the prospect that the investment-for-keeps approach of institutional investors will progressively narrow the floating supply in the stock market as it has already done in the bond market. (Purchases by the uninsured plans aggregated $1.7 billion from 1951–54, with sales of only $228 million.) The key to this probably lies in the hope that more favorable terms for equity financing (and perhaps other more deliberate encouragements) will of themselves induce an expansion of total volume that will more than keep pace with institutional purchases.

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[17] Factors Affecting the Stock Market, p. 93. This represents 70 percent of the 1954 increase in common stock outstanding.

[18] Unquestionably the actuarial basis underlying much of today's pension accumulations, uninsured as well as insured, tends to require investment in securities providing a regular income at a satisfactory rate, rather than in so called growth stocks. For this reason any major expansion of pension-fund investment beyond the traditional blue chips may wait upon the development of such new devices as variable annuities. The only point being made here is that if the pressure of circumstances, including investment needs, is sufficiently strong, such devices will, in time, be perfected (and a start is being made at the present time).

The control problem

If common-stock investment by pension funds and other institutions continues to gather momentum will it lead to undue concentration of business control? For life companies the 1951 common-stock amendments in New York set up safeguards against the recurrence of abuses disclosed 45 years earlier in the Armstrong investigation. Investments in stocks of financial institutions like banks and insurance companies was forbidden altogether. (This may be an extreme provision under present conditions.) Investment in other common stocks was limited to the lesser of 2 percent of the outstanding common or one-tenth percent of the life company's assets. (The latter was designed not only to provide diversification but to prevent an unduly large holding of the common stock of a corporation like A. T. & T. with very large equity capitalization and widely scattered ownership.)

In trusteed plans similar limitations may be imposed by trust instruments themselves, although to what extent is unknown. State fiduciary investment laws generally impose no restrictions comparable to those in the insurance codes. The original version of the 1954 Internal Revenue Code passed by the House would have withheld tax exemption if the trust placed more than 5 percent of assets in securities of any company other than the employer (!) or owned more than 10 percent of the combined voting stock of such other company.

The economic reasons for legal restrictions on control like those in State insurance codes, but perhaps with some modification, are compelling and do not seem to impose an unduly onerous burden on investment discretion. These would still leave unanswered many questions about control to which there is no pat answer. However, some of these are not wholly peculiar to stock ownership by institutions; in the event of default on debt obligations, creditors as a group have traditionally assumed a very large voice in the affairs of the borrower.

The specialized case where employee trusts invest substantially in the common stock of the employer is even more difficult to evaluate. This practice is most common among the increasingly popular deferred profit-sharing, thrift, and stock-bonus plans, which are frequently designed to supplement inadequate benefits under pension plans established when price levels were lower. Such investment is permitted now to trusts qualified for tax exemption if it does not divert funds to the employer through purchase of stock from the firm for more than adequate consideration (sec. 503, 1954 I. R. C.). At the end of 1954 only about 1 out of every 6 funds covered by the SEC study owned stock of their own company and only a handful (including the oft-cited Sears, Roebuck profit-sharing fund) had as much as 20 percent of their assets so invested. While this practice raises questions not only of control, but of a captive source of capital, it may not be wholly undesirable; to the extent the employees' retirement future is bound up with the welfare of the employing company, productivity may benefit.

Other issues

Quantitatively only direct placement of corporate securities, ranks as an additional investment question worthy of discussion. This has already been well reviewed in December 1949, before this same committee. No tax question is involved, and this earlier review seems to have demonstrated that such arrangements offer advantages of su-

perior flexibility and certainty to both borrower and lender (comparable to the relationships banks have always had with their customers), greater accommodation for smaller borrowers, and no more risk of undue control by the lender than any other method of financing under present conditions.[19] On the other hand, direct placements do create difficulties for smaller investors and further evidence the constriction of public markets which seems inevitably to accompany greater institutionalization of savings in any form.

Other minor types of pension-fund investment involving tax alternatives could alter market relationships which would otherwise exist. These include loans to employers, real estate lease-purchase or lease-backs, and unrelated business transactions. Of these, life companies can invest only in leasebacks and the total investment of uninsured funds in these forms is blanketed in the 4 percent of other assets. Misuse of the tax privilege in making such investments seems effectively prevented by section 503 of the 1954 Internal Revenue Code. A trust which engages in prohibited transactions, including loans to the employer without adequate security and interest, or purchase of property from the employer for more than adequate consideration, can lose its tax-exempt status.[20]

If the purchase of a business produces unrelated business income such income is subject to tax to avoid giving the purchased business an unfair advantage vis-a-vis its competitors. A business lease also produces taxable income to the extent that the property is financed with borrowed funds. This prevents the trust from pyramiding a tax-exempt income on borrowed funds as well as its normal accumulations.

Even when pension trusts and life companies make lease arrangements solely by investing their own funds, however, the question arises whether tenants receive some indirect tax subsidy to the extent that the deductible rental exceeds the depreciation permissible if they owned the property. This is a valid question only if the sale is a subterfuge. Barring this, a higher rental, providing a higher return to the investor than on a direct loan, seems justified since the investor's claim in the event of bankruptcy is limited at most to 3 year's rental, and the salvage value of what is often a limited purpose structure, whereas a bondholder claims the entire unpaid principal.

One other influence of the special tax situation of pension funds and life companies might be noted. In times of unusually high capital demands, like the last 2½ years, restriction of commercial bank credit throws State and local government borrowers into the arms of nonbank lenders. Federal tax exemption offers little attraction to such lenders and, therefore, these obligations must offer a return competitive with corporate obligations to attract these marginal funds. This means that State and local borrowers must pay higher rates than they would if their needs were entirely met by individuals and commercial banks. A corollary is that intramarginal buyers, to whom tax exemption is important, reap a windfall.

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[19] Volume and Stability of Private Investment, December 6-16, 1949. See also George Conklin, Direct Placements, Journal of Finance, June 1951.

[20] Conversely, sale on a basis which gives the trust an unduly high rental return may mean that the employer's deductions, but not the trust's tax-exempt status, would be denied. The implication would be that the deal was designed to give the employer greater deductions than he would be allowed for direct contributions to the plan. The trust's tax-exempt status wouldn't be affected because the investment would not harm the employees' interests.

Conclusions

1. Funds earmarked for retirement under private, State, and local auspices are growing more rapidly than other forms of institutional savings but the rate of growth seems likely to level off. If the American economy continues to expand at its present pace there seems little prospect of an oversavings difficulty originating in this area. Present tax laws work satisfactorily in the direction of spreading out savings to fund past service liabilities and are also flexible, permitting some reduction when business earnings fall.

2. Uninsured funds are growing more rapidly than insured; their relatively more favorable tax situation has been one factor in their more rapid growth; the Mills-Curtis bill would remove this advantage. Public control of uninsured funds is less uniform and detailed than for insured funds, but no evidence has been found of any widespread abuse. State legislation requiring mandatory disclosure and periodic examinations would be desirable.

3. The investment of retirement funds is not significantly affected by tax influences.

Equities are the chief problem area. For life companies, State investment restrictions plus valuation problems have thus far precluded any substantial common-stock investment. Trusteed funds, however, are flowing into equities in substantial volume. The funds may be willing to invest at lower yields than wealthy individual investors who have been partly displaced since they can recoup losses out of gross income without deduction for taxes.

While this may remedy the relatively high cost of equity capital which has prevailed for the last several decades, and also contribute to a beneficial diffusion of ownership in American industry, it may, at the same time, raise other problems. The normal processes of market readjustment should, in time, alleviate, but perhaps not entirely remove, distortions produced by the concentration of pension fund buying in blue chip corporations. However, economically significant questions will still remain, having to do with (1) possible concentration of corporate control (or, alternatively, abdication of active direction, which might be equally disturbing) and (2) possible reduction in the floating supply of stocks necessary for an active market, because of the long-run view inherent in pension fund investment operations.

Short of eliminating completely the tax encouragement given to pension plans, none of these problems seem to be of a nature which could appropriately be dealt with through changes in corporate tax policy. A reduction, and lesser degree of progressivity, in individual income taxes would probably make the greatest possible contribution to a better balance in the supply of equity funds (and of investment funds generally), assuring (1) a larger proportion of venture capital, (2) better diffusion of corporate control, and (3) greater breadth in equity markets.

RETIREMENT CONTRIBUTIONS, THE SPENDING STREAM, AND GROWTH

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Within the past decade the net inflow of funds into private plans which defer the payment of currently earned compensation has become large enough to influence materially the rate of saving and capital formation for the whole economy. These institutional savings are accumulating in retirement and deferred distribution profit-sharing plans for eventual distribution as retirement income or deferred payments to employees.[1] To explore the importance of these funds and the extent to which they represent additions to the total rate rather than mere diversions of saving which would have occurred without these plans is the primary purpose of this paper.

Federal tax treatment of deferred compensation payments has been a significant force stimulating the growth of retirement and profit-sharing plans. Under the high tax rates which have prevailed for many years, various tax advantages accorded these plans have increased the economic advantages of deferred compensation relative to current cash payment for both employers and employees, and the parties at interest have been quick to recognize and to utilize these advantages. To prevent widespread tax avoidance and to check the loss of revenue, the Congress through statutory provisions and the Treasury through administrative regulations have surrounded these tax benefits with rigid and complicated restrictions which, in effect, grant the associated deductions and exemptions for firms and their employees largely to approved, or qualified, plans maintained by corporations. The volume of funds flowing through these qualified plans is now so large that apparently minor changes in the tax treatment accorded these plans may generate very important changes in the amounts and sources of funds, and in their effects on economic growth.

This significant area of tax policy promises to become even more important in the future. Expanded coverage of employees and liberalization of benefits will increase the absolute and relative importance of these plans. Moreover, the tax benefits granted under qualified plans may be extended to areas and sectors of the economy now denied them. Signs of this development are already evident in the increasingly insistent demand by the excluded groups to be allowed on grounds of equity tax deductions and exemptions for retirement savings. To project the possible growth of qualified plans under existing law and the attending influences on saving and to indicate briefly the effect of certain deferred payment tax proposals are secondary purposes of this paper.

EXTENT AND CAUSES OF PAST AND PROSPECTIVE GROWTH OF PLANS

Growth in the number of private retirement and profit-sharing plans and in the contributions made to them has occurred largely in the last 15 years. Available statistics yield only rough clues to the

[1] Other types of deferred compensation plans, such as individual arrangements between key executives and their companies, are not considered in this paper, because the flow of funds through them is relatively small.

course and present status of this development. The first period of rapid rate of growth coincided with the World War II years, when high and temporary income-tax rates, intensified competition for labor and management, exemption from wage and salary controls of compensation deferred through approved plans, and favorable tax treatment of approved plans combined to make these forms of compensation especially attractive.[2] The number of plans qualified for favored tax treatment increased from about 659 at the end of 1939 to 9,370 by August 31, 1946, with 7,423 of this number initiated after September 1, 1942.[3] By 1946, corporate contributions to qualified plans, accounting for almost all approved employer contributions, amounted to roughly $758 million, with retirement plans receiving roughly $654.[4] Corporate contributions to all plans qualified through August 31, 1946, were three times as large as those for qualified plans in existence before 1940.[5]

Though both the number of qualified plans and contributions to them have continued to grow steadily since 1946, the most rapid rate of growth has occurred since 1949, when the provisions of retirement plans became definitely subject to mandatory collective bargaining and organized labor initiated a drive for negotiated private retirement benefits. Union pressure, combined with the reintroduction of the excess profits tax, higher income-tax rates and other wartime economic characteristics of the Korean war, drove the number of plans and contributions sharply upward. On June 30, 1949, 12,154 qualified plans were in existence; by the end of 1954, 26,573 plans were operating.[6] Corporate contributions climbed from somewhat less than $1,216 million in 1949 to an estimated $3,068 in 1954.[7]

Private retirement plans have emerged as a major form of saving institution and the dominant kind of deferred-type compensation plan in this growth. At the end of 1954 reserves of private retirement plans (largely qualified plans) were about $20.3 billion (cf. table 1), as compared with total assets of saving and loan associations and life-insurance companies, respectively, of $31.7 billion and $84.1 billion.[8] There are no reliable data on funds in profit-sharing plans, but one estimate places these assets at $2 billion to $2.5 billion on December 31, 1954.[9]

The yearly addition in reserve funds of these plans, or the amount of gross inflow left after payment of administrative expenses and benefits to participants, has been increasing rapidly. For retirement plans this is largely due to funding requirements imposed by actuarial tests of soundness, tax qualification rules which require funding of

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[2] For a more detailed analysis of these factors and their force cf. Challis A. Hall, Jr., Effects of Taxation on Executive Compensation and Retirement Plans (Boston, Harvard Graduate School of Business Administration, 1951), ch. 3.

[3] Internal Revenue Service.

[4] Internal Revenue Service compilation of annual employer contributions (at varying date) to 9,370 plans qualified through August 31, 1946.

[5] Ibid.

[6] Internal Revenue Service.

[7] Both figures represent corporate contributions under all deferred-type plans, including relatively small amounts under nonqualified plans. These contributions are shown without breakdowns by type of plan in Statistics of Income, pt. 2, for the most recent year of tabulation, which lags about 3 years behind the current year, and each prior year through 1945. The 1954 estimate was derived by extrapolating to 1954 the ratio of such contributions to wages and salaries other than governmental and agricultural, and applying this ratio to the corresponding wage and salary total for 1954.

[8] Federal Reserve Bulletin, July 1955, p. 783. Reserves of retirement plans, insured with life companies, reflected in both retirement plan reserves and life companies assets, were $9.8 billion, cf. Institute of Life Insurance, Life Insurance Fact Book, 1955, p. 33.

[9] Memorandum from Analysis Staff, Debt Division, Treasury Department dated July 13, 1955.

approved plans, and the rapid increase in new plans. As table 1 shows, reserves were growing at the rate of about 14 percent yearly in 1954. A large fraction of this growth is attributable to employer contributions, which accounted for $2.6 billion of a gross inflow of $3.6 billion. Comparable data for profit-sharing plans are not available, but the increase of reserves in such plans was roughly $300 million in 1954.[10]

TABLE 1.—*Estimated financial data for private retirement plans*

Year	Contributions		Interest earnings on assets	Contributions + interest earnings	Payments to beneficiaries	Increase of reserves during year	Total reserves end of year (billions)	Personal saving (billions)	Increase of reserves as percent of personal saving
	Employer	Employer + employee							
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1946	$650 $700	$750 $800	$180	$930 $980	$70	$790 $840	$6 6	$12 6	6 2 6 6
1951	1,900	2,200	400	2,600	350	2,074	14 0	17 7	11 7
1954	2,600	3,000	600	3,600	538	2,822	20 3	18 3	15 4
1964	5,100	5,900	1,800	7,700	1,800	5,400	62 6	23 0	23 6

Sources: Cols (2) through (8) for 1946, author's estimates based upon data from Internal Revenue Service and Raymond W. Goldsmith, A Study of Saving in the United States (Princeton, Princeton University Press, 1955), vol I, p 486

Col. (9), Department of Commerce.

Cols (2), (3), (4), (5), (6), and (8) for 1951 and 1954 from Chief Actuary, Social Security Administration; col. (7) computed on assumption that administrative and other expenses are 8 percent of contributions.

1964 personal saving from staff of the Joint Committee on the Economic Report, Potential Economic Growth of the United States During the Next Decade, 83d Cong , 2d sess. (Washington, U. S Government Printing Office, 1954), p. 20

Other data for 1964 derived by author on the assumptions that (1) average annual increase in employer contributions equals the average annual increase in corporate deductions under sec. 23 (p) of the Internal Revenue Code (now sec. 404) for 1946 52; (2) employee contributions are 13 3 percent of employer contributions; (3) interest earnings on assets are equal to payments to beneficiaries after 1954; (4) administrative expenses are 8 percent of total contributions, (5) interest earnings on reserves are equal to 3 percent of midyear book value.

Continuation of recent economic and social trends through the next decade would substantially enhance the absolute and relative importance of private retirement plans. These fundamental forces have operated in varied and complex ways to spread the private retirement movement. High and progressive individual income-tax rates have made it profitable for employees, especially the highly compensated, to defer the receipt of compensation from the earnings period to the retirement period. Deductions allowed employers for contributions to qualified plans have placed such payments taxwise on a par with cash compensation. High and sustained employment has served to maintain competition for labor and to stimulate funding of plans, especially for past service. Union pressure to initiate retirement plans and to improve employer benefits by collective bargaining has been vigorous. Under similar conditions in the next decade, the resulting extension of retirement coverage and liberalization of benefits could increase total contributions over the 1954 level by almost 100 percent to $5,100 million and expand reserves to $62.6 billion, or over three times their 1954 level (cf. table 1).[11] To some extent profit-sharing contributions would also be stimulated by these forces, but the scarcity of available data forestalls projections of their growth.

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[10] Analysis Staff, Debt Division, Treasury Department, op. cit.

[11] One estimate of total contributions to industrial retirement plans alone places them at $2.4 billion in 1950–51 and $6.6 billion in 1960. Cf. Charles L. Dearing, Industrial Pensions (Washington, the Brookings Institution, 1954), p. 166.

The Rate of Total Saving

Private retirement and profit-sharing plans influence the rate of capital formation and economic growth primarily by altering the amount of total saving available for investment. Total saving is the sum of Government saving and private saving. Government saving is the excess of tax collections over Government transfers and expenditures for real resources; private saving is the amount of income saved by the private sector, including corporate saving. Since the rate of private investment actually achieved in any period is identically equal to the rate of total saving, both Government and private saving release resources which must be utilized in capital formation if a given level of output and employment is to be maintained. If these resources are used in capital formation, the rate of economic growth at this output level is increased; if the enhanced rate of saving does not lead to increased investment, then output, employment, and probably the rate of investment are reduced. Significant changes in total saving through the growth of deferred payment plans would be an important element in economic growth.

Both the flow of funds through these plans and government fiscal policy induced by the plans affect the rate of saving.[12] Employer and employee contributions, interest earnings on reserves, and payments to beneficiaries exert their force through complicated channels and with frequently conflicting results. Indeed, the net effect of a particular force is often uncertain, and the relative weight of various forces is not precisely identifiable. Government fiscal actions taken to compensate for the fiscal effects of deferred payment plans will significantly affect total saving. Tax treatment of deferred compensation operates for the most part to diminish tax collections both in the present and over the time span of deferral; if tax rates are increased or government expenditure reduced to compensate for this revenue loss, or if other fiscal actions are taken, the rate of saving and capital formation will be significantly altered. The net effect on saving reflects the combined influences of all these factors—the flow of funds through plans with tax rates and amount of resources used by government constant, and compensatory government fiscal action.

Employer contributions

Contributions of employers are a form of wage income whose costs must be covered by changes in the amount of income flowing or accruing to the various productive resources, by price movements which alter the real value of such shares, or by increased output from greater efficiency.[13] Since these adjustments produce different economic effects, the routes through which employer contributions become a part of the income stream are of great significance. In my opinion, the costs of these contributions have been met largely from reductions in real cash wages and salaries, lower corporate net profits, and reduced

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[12] It is possible that the amount of accumulated assets may affect the rate of saving by imparting to covered employees a sense of security. This extension of the wealth effect (or Pigou effect) to accumulated saving is vulnerable to attack on the ground that accumulated saving is the result of past decisions or effects, and should not exert an independent influence. For this reason it is excluded from the list of determinants in the text.

[13] Both corporate profits and individual income taxes, which are the important taxes affected by deferred payment plans, form a part of the income shares allocated to various productive resources. They are not, therefore, to be regarded here as an additional source from which employer contributions may be paid.

purchasing power of income in general through a rise of output prices relative to factor costs, in this order. To some extent efficiency has been improved.

Reduced real cash wages and salaries

Growth of employer contributions tends to reduce the real value of cash wages (and salaries) through the process by which the extra labor remuneration represented by contributions becomes imbedded in the cost-price structure. This process brings the aggregate remuneration of labor (cash wages and salaries plus employer contributions) into proper relationship with the sales price of output. Technical factors govern this relationship; that is, real wages are more or less closely related to the physical productivity of labor. To the extent that the relationship prevails employer contributions are wedged into the cost-price structure through (*a*) reductions in money wages paid in cash, (*b*) slower expansion of money wages as productivity of labor increases over time, or (*c*) increased prices of output.[14] Because of institutional and behavioral characteristics which contribute to the rigidity of the money wage rate in a downward direction, reductions of money wages in response to the growth of contributions have been rare. Though some contributions have increased prices in general, most employer payments which have reduced real cash wages appear to have slowed down the rise in money cash wages which otherwise would have occurred. Plans voluntarily adopted work out their effect in this direction, because they do not create the same cost push forces present in negotiated plans. A similar adjustment is brought about by negotiated plans where negotiated wage rates (including employer contributions) do not rise faster than labor productivity. To some extent union pressure for pension plans may advance the price level over time, but this effect is relatively small, in my opinion.[15]

Reduction in the real value of cash wages induced by the growth of employer contributions results in a higher level of real income after taxes than otherwise would have prevailed. The dominant force producing this effect is the relative reduction in taxable wage income accompanying the growth of contributions. Whatever the route by which real cash wages are reduced, the real value of tax collections from employees is always lower than it would have been without the employer contribution; employer contributions are not currently taxed to employees, and the Government loses the personal income taxes which otherwise would have been collected on the cash wages replaced.[16] Corporate tax collections are not altered in this process, for both types of wage payment are deductible from taxable profits. Some of the loss in tax collections from employees is offset when price inflation follows the introduction of employer contributions into the cost

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[14] This type of price increase is accompanied by corresponding movements in the remuneration of both labor and nonlabor resources. It is to be distinguished from increases in product prices which are not associated with upward movements in the returns to nonlabor factors. The latter is discussed in a later section of this paper.

[15] Since there seems to be no consensus among economists whether union wage pressure tends to outstrip productivity advances, the conclusion about the inflationary effects of negotiated plans is very tentative. The effects of price inflation on saving are in the same direction as the effect of negotiated plans which merely slow down money wage increases. Thus underemphasizing the inflationary effects of negotiated plans leads only to undervaluing the strength of their effect on saving.

[16] At current tax rates the prospective personal income taxes on such contributions paid out as future retirement income are much less than the taxes presently saved, since exemptions for retirement and the aged, the progressive rate schedule, and the lower level of retirement income combine to produce a very low personal tax rate.

structure. When aggressive bargaining for retirement plans leads to higher money wages (cash wages plus employer contributions) than are warranted by the value productivity of labor, a new equilibrium can be achieved at this output only if prices of products and nonlabor resources rise sufficiently to restore the real value of various factor shares to their old level. This equilibrium requires that the percentage increase in money labor costs, appearing in the form of nontaxable employer contributions, be equal to the percentage increase in property income, which is taxable. With a progressive personal income tax, income taxes on property income rise faster than the price level; real tax collections on property income increase. This offset to the loss of tax collections on wage income is relatively small, however, if only because the growth of plans does not contribute significantly to price inflation. The primary effect of the relative decline in cash wage income is an increase of real income after taxes.

Expansion of real income after taxes through the impounding of employer contributions in deferred payment plans affects total saving in different directions, depending on the reactions of participating employees to income accruing through these institutions. Government saving is diminished at any given output by the decline in tax collections, with tax rates and government use of real resources constant. The extent to which this diminution in government saving is replaced by an increase of private saving, including employer contributions, determines the net effect on saving. If consumption increases, private saving expands by less than the decline in government saving; if consumption decreases, private saving expands by more than the fall of government saving. In the absence of empirical information on this question, general observations suggest certain tentative conclusions.

Increased real income after taxes through the replacement of taxable wages for tax-exempt employer contributions is always accompanied by an "income effect" on present consumption, and may be associated with a "substitution effect." The income effect, or the influence of the higher level of real income after taxes, tends to increase present (and future) consumption; it operates like an increase of cash wage income. The substitution effect, which reflects the change in the rate at which present consumption can be exchanged for future consumption, tends to reduce present consumption (and expand future consumption). Without deferral of pay, an employee subject to a 30-percent marginal tax rate obtains $70 of present or future consumption (neglecting interest) for each $100 of income before taxes. Each $100 of employer contributions set aside for this employee permits $100 of future consumption, if the individual's future marginal tax rate is say, zero. Whether the contribution permits the employee to expand present consumption depends upon his economic status. Though employer contributions ordinarily cannot be assigned or otherwise used directly as security for loans, they can be used to finance present consumption if the employee owns assets or would have saved from cash income without the deferral. For such "savers" each $100 of employer contributions permits an equivalent amount of either present or future consumption: there is no substitution effect operating here. But if the employee would not have saved or owns no assets, the contribution cannot be used to finance present consumption. For such

"spenders" the employer contribution leaves a choice of future consumption but no present: the substitution effect does operate here.

The replacement of cash wage income by an equivalent amount of employer contributions tends to increase present consumption of savers and to reduce present consumption of spenders. For each $100 of cash income replaced, savers may obtain $100 of present or future consumption instead of $70. This is equivalent to an increase of income after taxes, which tends to increase present consumption. But each $100 of cash income replaced permits the spender to trade $70 of present consumption for $100 of future consumption, rather than $70. By definition the spender would have saved for future consumption less than $70 of cash wages without deferral, and he must save the whole $100 of employer contributions. Since $30 of the latter are reduced personal-tax collections, he has in effect saved $70 out of the reduction in his available cash wages. Thus his consumption has been reduced. The substitution effect dominates the result by increasing the relative attraction of future consumption.[17]

The net effect on consumption is uncertain, largely because it is impossible to establish with any statistical precision the relative importance of spenders and savers and to confirm the preceding a priori analysis. Nevertheless, it seems likely, in my opinion, that to the extent these plans have reduced wages and salaries their effect on balance is to reduce consumption, that is, to increase total saving. Though a substantial fraction of contributions to plans accrues to the benefit of higher paid employees who, for the most part, may be identified as savers, the bulk of contributions to plans now in existence probably accrues to lower paid employees who may be identified broadly as spenders. Since the latter group cannot easily borrow or sell assets to finance a larger present consumption, the dominant effect appears to be some increase in total saving.[18]

Lower corporate profits

Employer contributions paid from corporate profits influence the rate of total saving by transferring income from the Government and corporate stockholders to employees. Since changes in corporate profits affect retained earnings relatively more than dividends, the transfer of retained earnings to employees is the dominant route determining the final effect. Contributions which reduce corporate saving tend to reduce somewhat total saving. On the one hand Government

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[17] If employees were allowed to defer their own pay in any amount up to some limit of compensation by replacing cash wages with employer contributions, the effects on consumption would be somewhat different. Savers would take full advantage of deferral, but still increase their present (and future) consumption. Spenders would participate in some degree, but their consumption might be higher, lower, or the same. The employee's ability to choose the amount of saving to be impounded as deferred payments permits spenders to increase their consumption and still obtain tax benefits from the scheme. In such cases the income effect outweighs the substitution effect.

This type of arrangement is similar to a tax deduction against the personal tax for individual contributions to their own retirement plans. A variant frequently proposed is to allow such deductions up to a limit for contributions by the self employed to individual retirement plans. Relevant evidence is too fragmentary to support a firm conclusion about the effect on consumption of such a deduction. But if the deduction limit were set at 10 percent of income up to $75,000, as proposed in recent discussion, the bulk of deductions would be taken by savers in the higher income groups (which account for a large fraction of personal saving of the self-employed now) for whom the income effect would be dominant. The result would be an expansion of consumption, that is, a diminution of total saving, given tax rates and Government use of real resources.

[18] Though the requirements for vesting of rights to employer contributions (such as age, length of service, etc.) are more lenient for the higher than lower paid participants, this feature does not appear to weaken the above conclusion. Lenient requirements would strengthen the income effect on the higher paid employees, but strict vesting conditions would work in the reverse direction for the lower paid.

saving and corporate saving together decline by the amount of employer contributions. Diminished Government saving is equal to the fall in corporate tax collections, and the rest is retained earnings. On the other hand, the income transferred to employees as impounded contributions tends to increase consumption from other income, at least for savers. In effect the contributions do not increase the saving of employees as much as in the transfer reduces shareholder and Government saving.[19]

This decline of total saving might be partially checked if dividends rather than retained earnings bear some of the reduction in corporate profits after taxes. Reduced dividends would shrink disposable income of shareholders, and the impact on their consumption would more or less counterbalance the enlarged consumption of employees, depending on personal-income-tax rates and the marginal propensities to consume of the affected groups. In any event the apportionment of smaller net profits between dividends and corporate saving would tend to affect the latter relatively more, and the total effect would appear to be a very small reduction in total saving.

Higher prices

To some extent funds are made available for employer contributions through advances in prices of products without corresponding adjustments in the money returns paid out to nonlabor resources. This type of price increase is possible where industrial price policy is the significant determinant of prices. Its effect is to introduce a wedge between prices of output (both consumer and investment goods) and returns paid out to the factors of production. The value of this wedge constitutes the employer contributions which accrue to labor as retirement savings. The redistribution of real income toward labor occurs at the expense of property income recipients and Government, for the income of both sectors remains unchanged at the higher price level.

This redistribution ordinarily increases aggregate saving. Income redistributed from property owners to participating employees probably increases saving. The income effect of the impounded wage gain is only partial, since only savers will expand their consumption. But the income effect of the loss to property owners is complete. With about the same marginal propensity to consume for each group, the income effect alone would operate to increase saving, and any separate influence of plans in stimulating savings would work in the same direction. However, income redistribution from Government tends to reduce saving: Government saving is reduced by the full loss of Government income, but private saving is increased by less than contributions. Since the loss of Government income ordinarily forms a relatively small portion of the income redistributed, the total effect is dominated by the redistribution from property to labor, that is, saving increases.

Increased efficiency

By providing orderly retirement and replacing aged employees, deferred payment plans tend to increase the efficiency of employees.[20]

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[19] Shareholders' consumption appears to be relatively unaffected by the level of corporate saving.

[20] This is the net effect of plans. Other effects, such as the reduction in the working force through retirement and the impairment mobility of employees where vesting is incomplete, tend to reduce output. For an appraisal of the relative strength of these tendencies as they apply to executives, compare Challis A. Hall, Jr., op. cit., pp. 264–266.

Higher efficiency promotes greater output, increased productivity of labor and capital, and potential income from which employer contributions can be paid. However, increased efficiency of resources does not necessarily bring forth the higher output which is possible, for aggregate demand may be insufficient to support the higher level of aggregate supply. If this is the case, a saving investment problem is created.

In my opinion any effects of increased efficiency would lead to an increase of saving relative to investment at the higher level of output. A small part of the increased supply would generate its own demand in the form of increased consumption, but the rest must be matched by increased demand for investment if the new potential output is to be reached. It is extremely doubtful whether the demand for investment would expand by the required amount.

Employer contributions: summary

Though the effect cannot be demonstrated with statistical precision, employer contributions alone appear to increase aggregate saving. When these costs are met from reduced cash wages and salaries, higher output prices relative to cash factor costs, reduced dividends, or increased efficiency, aggregate consumption is probably lower than it would have been without deferred payment plans. To the extent that contributions have diminished retained corporate earnings, however, consumption is slightly higher. This effect on consumption cannot dominate the total effect unless a large fraction of employer costs is borne by retained earnings. But it is unlikely that the largest part of such costs has been paid for in permanently reduced undistributed profits. Employer contributions are forms of wage and salary payments which add to wage costs of employers, on the one hand, and convey real benefits to covered employees, on the other. In a relatively free and more or less competitive economic system, these cost and benefit attributes are more likely to work themselves out through the wage and product price structure rather than on profits. Thus the dominant effect is to increase total saving. Nevertheless, the change in saving is only a fraction of total employer contributions. Though the latter are private savings (especially where the growth of plans has been rapid and recent), they are not net additions to saving: reduced tax collections and diverted private savings substantially offset the apparent increase.

Interest earnings

Net earnings of accumulated reserves are an additional form of income to covered employees. What influence these earnings may have on aggregate saving at any point in time depends upon their sources and the extent to which they are considered in current consumption decisions of covered employees. To some extent the earnings of plans will be paid for by Government either as direct interest transfers on Government debt previously issued (or not retired) to finance the reduction in tax collections occasioned by employer contributions or as reduced taxes due to exemption of trust earnings from taxes. A sizable fraction of interest earnings will represent interest which would have accrued to the private economy on other forms of saving if deferred payment plans had not grown. Some interest may represent earnings on capital formation due to the growth of plans. All economic effects of these plans combine with

the dynamic process of economic change over time to determine the relative importance of these sources.

In principle the influence on employees' consumption-saving decisions of interest accruing through these plans should be similar to that of employer contributions: the effect would be to expand consumption of "savers." To the extent interest is paid for by Government, then, the net effect is to increase consumption somewhat; on interest which would have been earned anyway in some other form of saving, the net effect is to reduce consumption (since the "income effect" of the diverted funds is weakened); earnings from additional capital create a saving investment problem, which is analogous to an expanded rate of total saving in the short run, unless population growth and technological advance outrun the rate of capital formation. It is not clear what the net effect on saving would be at any point in time. Presumably the first 2 of the above 3 sources would be most important, but their effects work in opposite directions. In any event, the opposing effects and relatively small size of net interest suggest that the total effect is relatively small.

Employee contributions

Many plans limit coverage to those employees who are willing to make supplementary contributions from their own cash resources, usually in an amount proportioned to basic compensation, to cover part of the costs of deferred benefits. Employee contributions are a form of personal saving. Tax regulations require that employee contributions to qualified plans be fully vested; usually they earn interest during the period of deposit. They are not deductible from taxable income. Though interest earned on them by qualified trusts is tax free during the period of deposit, many alternative personal investments are on roughly the same basis. Thus they do not alter the real incomes received by contributors.

Nevertheless, employee contributions tend to reduce consumption somewhat. They are likely to be regarded as diverted savings by participants who would have saved relatively large amounts anyway, and by those with assets or access to credit: consumption of these groups would be relatively unchanged. But participants who would have saved relatively small sums without the contributory requirement are forced to reduce present consumption if they cannot liquidate other assets or borrow on favorable terms to make their contributions. The aggregate effect of employee contributions in reducing consumption appears to be relatively small, however.[21] A large proportion of contributions appears to be paid by the higher paid wage and salary participants in voluntary plans. This group is probably both able and willing to make their contributions, which ordinarily range from 2 to 5 percent of basic compensation, from current saving.

Payments to beneficiaries

Retirement and other deferred benefits actually paid out to employees or their beneficiaries are an additional element affecting con-

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[21] Introduction of a tax deduction under the individual tax for employee contributions to qualified plans would increase present consumption of all present contributors, since the increased income after tax is in the form of cash. But the additional tax advantage would stimulate other changes, such as the extension of the contributory principle, which might work in the opposite direction. Nevertheless, the extension of employee contributions would be easier among the higher paid wage and salary workers rather than the lower paid, and the "income effect" would be likely to dominate. Thus consumption would be higher than it would have been without the additional tax deduction.

sumption and saving for the whole economy at any point in time. The flows of funds into plans largely affect decisions of employees in the working force; outpayments from the plans mainly influence retired individuals and others no longer in the working force. The disposition of these receipts is the final act by which retired employees adjust their lifetime consumption to the lifetime income which has accrued to them through these plans, and the final effect by which the flows of funds through plans become synchronized to exert their complete effect on saving at any point in time. Though actually paid from contributions and interest currently accruing to plans, outpayments are largely subtractions from the capital fund previously accumulated for recipients. Some of these receipts are paid in taxes, since previously untaxed employer contributions and interest are now available to beneficiaries. However, a relatively small proportion goes to Government with prevailing retirement and age exemptions and tax rates. Some of the receipts are preserved as capital funds to be consumed later or passed on as bequests. But a substantial fraction is probably consumed. The net effect is to increase consumption and reduce total saving.

[illegible]

In my opinion, the combined effect of employee and employer contributions (which appear to increase saving), payments to beneficiaries (which decrease saving), and interest earnings (which seem to produce small, but uncertain, effects on saving) is to increase total saving at the present time. In the absence of compensatory fiscal policy to replace the loss of Government revenue due to these plans, my tentative estimates indicate an increase of total saving from retirement plans alone in 1954 varying from $200 million to $900 million, depending on the degree to which private saving is supplanted by retirement accumulations. This is a relatively small expansion in saving. The range is only 7 to 30 percent of additions to reserves, or an increase of only 1 to 5 percent in personal saving (cf. table 1).

Compensatory fiscal policy

Changes in Government fiscal policy to compensate for the loss of tax revenues occasioned by the growth of plans have been neglected in the preceding analysis. If tax rates or outlays on resources were altered to remove the increased deficit, the effect on saving might be very important, perhaps more significant than the growth of plans by itself. Very rough estimates by the writer indicate that the net revenue loss from retirement plans alone in 1954 was about $800 million. At the output and price level then prevailing, a reduction in Government expenditure on real resources of this amount would have expanded total saving by an equivalent amount.[22] This type of fiscal policy in conjunction with the growth of contributions would have produced an increase of saving ranging from $1,000 million to $1,700 million, or about 6 to 9 percent of 1954 personal saving.[23] The alternative course of increasing taxes would have varying effects depending on the type of tax increase employed. For example, an across the board increase in personal income-tax rates sufficient to

[22] Multiplier effects are properly disregarded here, as in other parts of the analysis, because the effect on saving refers to the attained price and output level.

[23] Derived by adding $800 million to the increase of aggregate saving from retirement plans alone.

retire the loss of tax collections due to plans would have reduced disposable income by an equivalent amount, and diminished both consumption and private saving. The gain in total saving is equal to the decline in consumption, which would have been in the neighborhood of $630 million. Thus the course of fiscal action would have brought about an increased rate of saving accompanying the growth of plans of roughly $460 million to $1,160 million, or about 4 to 8 percent of 1954 personal saving.[23] Unfortunately it is not clear whether fiscal policies would have been different in 1954 without the tax loss due to deferred payment plans.

Saving and future growth of plans

The effect of deferred payment plans on saving in any particular year cannot be extrapolated backward into the past or forward into the future. The level of tax rates, size of funds flowing through plans, types of plans, behavioral characteristics of the economy, and fiscal policies of Government jointly determine the effect on saving, and may be quite different at other times. However, present indications are that the expected continued growth of these plans will probably increase aggregate saving. Assuming future tax rates near present levels, by 1964 these plans might increase personal saving by 2 to 7 percent without compensatory fiscal action, and from 7 to 15 percent if revenue loss is offset. More precise conclusions as to the effect of deferred plans on saving are difficult, if not impossible, to formulate, largely because the nature of Government fiscal policy depends upon factors which cannot be forecast. Among the most important of these is the demand for private investment. If this is strong during the next decade, then Government fiscal policy could contribute to a noticeable increase in the rate of saving through private deferred payment plans.

[23] A change in tax rates would alter the tax savings and revenue loss from the plans themselves. This effect is disregarded in the text, but its influence on total saving is slight.

XVI. FEDERAL, STATE, AND LOCAL GOVERNMENT FISCAL RELATIONS AND THEIR SIGNIFICANCE FOR ECONOMIC STABILITY AND GROWTH

THE IMPACT OF THE FEDERAL SYSTEM ON STATE GOVERNMENT REVENUE SYSTEMS

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Excluding from consideration defense requirements with all of their related activities and expenditures, the taxes now imposed by Federal, State, and local governments are about the same, each level requiring approximately $10 billion annually. The question for consideration is whether the requirements of the Federal Government and the tax system which imposes and collects for the Federal Government (exclusive of requirements for national defense) an amount roughly equal to the total revenue requirements in each of the other governments at State or local level has significantly circumscribed the development of State government revenue systems.

Expenditures for national defense, veterans benefits, international affairs, and finance and interest on the debt incurred during previous war and defense activities will continue for many years to come and since such expenditures are vital to our survival as a free democratic nation, it is necessary at the outset to subordinate all State and local revenue requirements to those reasonable expenditures which may be required varying in amounts from time to time in the interest of national security and to consider only that portion of the total Federal revenues which are required and expended for other purposes.

The question with which we are concerned is whether the Federal revenue system as now imposed and administered encroaches upon the sources of revenue which might otherwise be available to States and localities in order for them to fulfill and discharge the ever-increasing demands of the people for functions and services at the State and local levels. That is to say: whether the Federal system of taxation overlaps State and local systems or usurps and deprives those levels of Government from sources of revenue to which they are justly entitled.

This question immediately presents for consideration the other side of the picture and that is the appropriate level of government in which various essential functions and services are to be performed. This side of the picture which is so essential for a complete evaluation of the subject will be covered by other speakers. The Federal fiscal devices, such as grants-in-aid and grants-in-lieu is a subject so vast in its scope and subject to divergent viewpoints so as to preclude any attempt to cover it in this paper.

There are, however, many areas in taxation wherein the Federal, State, and some local governments each participate and it is desir-

able that we examine these various sources to determine whether they may be successfully levied and collected at all three levels of government or whether they should be reserved, segregated and set aside for the exclusive use of one level.

Property Taxes

The property tax should be reserved as an exclusive source of revenue for local governments. The Federal Government has never participated in this field for the obvious reason that its direct taxes are apportioned according to population and hence this form of tax is impracticable for Federal use. The States have been withdrawing from this field and relinquishing it to the local governments. Although there has been a deplorable lack of uniformity in determining assessed valuations of property for ad valorem taxes for many years arising in part by reason of adjustment of valuations to conform to rates or the converse accommodation of rates to valuations, there has nevertheless been achieved during recent years notable improvements in the field of property taxation with the adoption of more uniform standards for the valuation of properties, especially railroads, utilities, and public service corporations. To be sure the States can by suitable supervisory methods set up and maintain improved standards for uniformity but all of these areas of property taxation relate to administration rather than the fundamental concept of the level of government entitled to the revenue derived therefrom.

Sales and Use Taxes

The origin, growth, and development of the retail sales and use tax by State governments is a tribute to the ingenuity, resourcefulness, and tenacity of State governments in the exploration, experimentation, and successful administration of an entirely new concept in taxation. It was conceived during the darkest days of the depression by the State of Mississippi in 1912, extended to my State of North Carolina in the following year, and carefully nurtured although expanded during the thirties until finally it has now been enacted in varying forms in 31 States and the District of Columbia. In its first full years of operation it had a combined revenue value of $9,685,000 in the States of North Carolina and Mississippi.[1] For the fiscal year ended June 30, 1954, collections from the 31 States and the District of Columbia amounted to $2,371 million.

This is a form of consumer tax that has overcome public resistance with which it was originally confronted and has now been accepted as a fair and reasonable levy based upon the purchasing power of the consumer. In 1954 it ranked as the foremost source of revenue in 17 States and as the second major source of revenue in 12 other States.[2] While it is true that there are some overlapping liabilities, complications, inconveniences, and even discriminations in interstate transactions, sales tax administration has reached an unusually high level of efficiency and compliance and is being constantly improved by administrative procedures and cooperation between the States.

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[1] Mississippi's collections for the calendar year 1933 amounted to $2,673,955. North Carolina's collections for the fiscal year ended June 30, 1934, amounted to $6,011,700.

[2] These evaluations were made by the tax administrators in those States.

The desirability of the Federal Government imposing a general sales tax has been considered and debated during recent years but it is respectfully submitted that notwithstanding some interstate difficulties this is basically and essentially a source of revenue that should be reserved to the States except perhaps if the exigencies of a wartime emergency should justify a temporary levy by the Federal Government of this form of tax. Moreover, the States should be entitled to this source of revenue on the basis of priority arising from their concept, experimentation and development of it.

Net Income Tax

The net income tax is the backbone of the Federal tax structure and comprises about 80 percent of its source of revenue. For the fiscal year 1953 Federal income taxes collected from individuals amounted to about $29,816 million which was 47.5 percent of the total Federal revenue; and corporate income taxes amounting to $21,238 million comprised 33.8 percent of the total. During the same year the States collected $969 million in income taxes from individuals which constituted 9.2 percent of total State revenues and $810 million from corporations which was 7.10 percent of the total. Thus, there is a sharp contrast both in collections and in relative revenue values of the net income tax as between the Federal and State Governments. The Federal levy, of course, was nationwide whereas the net income tax derived by States both with respect to individual and corporate income taxes was limited to the States imposing such taxes. Thirty-one States and the District of Columbia impose taxes on the net income of individuals whereas the remaining 17 States have no individual income tax whatever. Similarly, 32 States and the District of Columbia impose a tax measured by net income upon corporations whereas the other 16 States do not have this source of revenue. Fourteen of the non-income-tax States had neither individual nor corporate net income taxes. Two other States imposed net income taxes against individuals but not corporations whereas three additional States imposed taxes on corporations but not individuals. Thus, 19 States were not utilizing this source of revenue as to individuals, corporations, or both.

The income-tax States have developed a high degree of capability in administering income taxes both with respect to corporations and individuals and through the installation of mechanized procedures or the adoption of withholding statutes have attained a high degree of compliance.

This bulwark of the Federal tax structure and important source of revenue to the States can continue to be employed concurrently by both levels of government and provides for the States not now imposing such taxes an available source of revenue for their future needs.

Death and Gift Taxes

Since the beginning of colonial times the States have developed a system of taxation on transactions involving the succession of ownership to real or personal property by inheritance, bequest, or devise so that in many of the States now imposing the death taxes that form of taxation is perhaps the oldest levy with the exception of property

taxes. Over that long period of years the States had built up and successfully administered death taxes imposed in the form of estate or inheritance taxes. The imminence of World War I in 1916 made it necessary for the Federal Government to seek new sources of taxation and hence the Federal estate tax was imposed in that year. After the close of World War I this levy was retained as a source of revenue by the Federal Government until by way of compromise with the States who were insisting upon its outright repeal a provision was made whereby a credit was allowed for State death taxes up to 25 percent of the Federal estate tax. The States, however, were not satisfied with this arrangement and continued to press for outright repeal and in 1926 the Federal Government practically surrendered this source of revenue to the States by increasing the credit from 25 percent to 80 percent. The basic Federal estate tax rates were then, as they are now, relatively low so that the result of the 1926 act was for the Federal Government to give to the States almost all of the revenue from death taxes but to remain in the field as a balance wheel. In 1935 President Roosevelt suggested a tax upon inheritances "which bless neither those who bequeath nor those who receive" and Congress responded by imposing increased estate tax rates in the form of additional taxes to the basic Federal estate tax. A mere glance at the table of rates for the basic and the additional Federal estate taxes will make immediately apparent the enormous decrease in the value of the Federal estate tax credit. Since the credit applies only to the basic tax at low rates and not the additional tax with the sharp increase in each bracket of the net taxable estate the result has been to reduce the value of the 80 percent credit from 80 percent in 1926 to about 11 percent at the present time. All the States impose death taxes in one form or another except Nevada which has a constitutional prohibition against such form of taxation. Thirty-eight States impose inheritance taxes. Thirty-six States impose an estate tax against the 80 percent Federal estate tax credit although at least four of those States do not levy a separate inheritance or estate tax. At least 8 States impose a tax upon the estate broader in base than the mere 80 percent Federal tax credit.

The gift tax is a protective companion of death taxes and therefore policy and administrative considerations are applicable to both. It is imposed by the Federal Government and by 12 States. Its principal value is the protection it affords against the avoidance of death taxes but nevertheless it has some substantial revenue value.

For the fiscal year 1953 combined collections from inheritance, estate, and gift taxes by Federal, State, and local governments amounted to $1,107 million. Of that amount the Federal Government received 79.6 percent amounting to $881 million. The States received 20.1 percent amounting to $222 million and the local governments received the balance amounting to about $4 million. As a revenue producer these taxes comprised about 1.4 percent of Federal collections and about 2.1 percent of State collections. Thus, it can be seen that the proportionate revenue value to the Federal Government is relatively small but if the States were given this source exclusively and could maintain something comparable to the Federal estate tax rates, basic and additional, the total revenue value to the States would be equivalent to more than $800 million which by comparison is about one-third of the aggregate collections from the general sales tax. While

it is doubtful that many of the States would find it economical or politically wise to impose death taxes at the high prevailing Federal estate tax rates, nevertheless if this source of revenue were completely segregated and set aside for the States it would afford them a highly valuable source and without any serious deprivation to the National Government. If there was not a complete segregation much could be accomplished by restoring the full 80 percent credit applicable to the Federal estate tax basic and additional.

Automotive Taxes

As our highway systems began to expand and develop about three decades ago modern highway engineering and construction supplanted the outmoded and inadequate State and county roads and motor transportation entered upon a new era. Paralleling the development of a modern highway system was the modern engineering, designing, and production of motor vehicles. The suppliers of motor vehicle fuels likewise contributed their part by adopting modern methods of producing, refining, and marketing petroleum products.

Motor fuels taxes

The financing of this vast highway system made necessary the imposition of an excise tax on gasoline measured by the unit of the gallon and commencing with the State of Oregon each State began to impose a rate commensurate with its needs for highway construction, maintenance, and repair. These rates have gradually increased through the years. In the depression days of 1932 the Federal Government first introduced its tax on gasoline as an emergency measure but has levied it continually since that time. There is, of course, a national interest in providing a good interstate highway system but the States have shown a leading responsibility in the construction, repair, and maintenance of modern highways and an appreciation for interstate cooperation in highway development.

A resolution was adopted by the conference of governors at Houston, Tex., in 1952, memorializing Congress to repeal the Federal tax on motor fuels in order that the States might reimpose it at the State level. This tax is one that lends itself to the principle of segregation of Federal and State sources of revenue. While it is recognized that certain States, because of the wide disproportionate mileage of Federal highways which traverse them, would require and should receive Federal assistance, it is nevertheless the preponderant opinion of the States that if the present Federal tax on motor fuels should be relinquished to them they could handle their respective highway problems without the present related highway grants made annually by the Federal Government. With a provision for safeguards for those few States where Federal aid, due to special circumstances, is essential for the maintenance of an adequate highway system, a desirable step in the direction of decentralization of governmental functions could be accomplished by segregation of revenues in this field. The Federal Government should relinquish this form of taxation completely to the States as promptly as the transfer of functions can be accomplished.

Motor vehicle registration

The registration of motor vehicles and issuance of licenses as well as title registration and drivers licensing are all essentially regulatory

measures for identification, protection of highway traffic and highway safety. But motor vehicle licenses combined with gross receipts taxes on commercial vehicles, special fuels taxes and ton mileage taxes have become an important part of the highway revenues in the States. Reciprocal arrangements have been entered into by the various States with the result that interstate automobile travel presents no problem. While it is true that the enormous growth of the trucking industry engaged in interstate commerce truck traffic has presented the question of reasonable compensation to the various States whose highways are used by interstate commerce trucks. Many of the States have worked out equitable plans for taxing the use of their highways by commercial vehicles and considerable additional progress is being made in that direction. There appears to be no doubt but that the remaining problems of truck reciprocity can be solved by the several States without Federal intervention and that license fees for registration of all motor vehicles, private and commercial, should be retained exclusively by the States for the present.

For the fiscal year 1953 total collections from motor fuels amounted to $2,925 million of which the States received $2,019 million or 69 percent. The remaining 31 percent amounting to $906 million was derived by the Federal Government. During the same year there was returned to the States by way of Federal grants for highway construction $510,073,000. Taxes imposed and collected for the use of the highways should be devoted exclusively to the construction, repair, maintenance, improvement, and policing the highway system and should not be diverted for any other governmental use, State or Federal.

Tobacco Taxes

The Federal Government was the pioneer in the taxation of tobacco products, extending back many years prior to the time of the present widespread popularity of the cigarette. But the Federal levy is on the manufacture and importation of tobacco. At the present time excise taxes on tobacco products of various kinds are well established sources of States' revenue and are now imposed by 41 States and the District of Columbia. These taxes as presently imposed apparently originated in the State of Iowa in 1921. In 1923 Georgia, South Carolina, South Dakota, and Utah imposed similar taxes. The Arkansas tobacco tax was levied in 1924 followed by similar taxes in the States of North Dakota and Tennessee in 1925. Louisiana enacted its tobacco tax in 1926 followed by Alabama and Kansas in 1927. In 1930 Mississippi enacted its tobacco tax and the following year Ohio and Texas imposed their levies. The tobacco taxes in Arizona and Oklahoma were imposed during the depression days of 1933. In 1935 the States of Connecticut, Pennsylvania, and Washington enacted their levies followed by Kentucky in 1936 and Vermont in 1937. By 1939 the revenue value of this levy spread rapidly for during that year the States of Massachusetts, New Hampshire, New York, Rhode Island and Wisconsin imposed such a tax. There was no further extension of this levy by any State until 1941 when Illinois and Maine enacted the tax followed by Florida and New Mexico in 1943.

Idaho joined the group of tobacco tax States in 1945 and 1947 the levy was extended widely for during that year Indiana, Michigan, Minnesota, Montana, Nebraska, Nevada, and West Virginia entered the field. New Jersey followed suit in 1948 and in 1949 Delaware and the District of Columbia made similar levies. The State of Wyoming is the latest addition to the tobacco tax family of States, its tax having been imposed in 1951. While it is true that the Federal tax on tobacco is imposed at the manufacturer's or importer's level and the excise taxes imposed by the States are all at the consumer level, nevertheless it must be recognized that the total taxes on the tobacco product are paid by the individual consumer. Some of the States have experienced difficulties of enforcement arising by reason of the unlawful importation of tobacco products into their jurisdictions but through the mutual cooperation of the tobacco tax administrators, strengthened by the so-called Jenkins Act enacted by Congress, a high level of compliance and minimum evasion has now been accomplished.

For the fiscal year 1953 total tax collections on tobacco products amounted to $2,124 million of which the Federal Government received $1,655 million or 77.9 percent. The other 22.1 percent amounting to $469 million was received by 41 States and the District of Columbia. A small portion of this revenue was received by municipalities, many of which are located in States which do not impose a tobacco tax at a State level.

Notwithstanding the early entrance of the Federal Government into this field of taxation, it is now a well-developed and highly valuable source of revenue to the States and has not appreciably affected the tobacco industry and is generally accepted by the consumer. Both levels of government should continue the use of this form of levy as at present on a concurrent basis.

Alcoholic Beverage Taxes

The Federal, State, and local governments all levy highly diversified forms of excise taxes and license fees on all kinds of alcoholic beverages. A notable feature in this field of taxation is the wide variation in the number, type, and amount of these levies in the several States with the inevitable overlapping. The heavy taxation of alcoholic beverages perhaps originated for the purpose of strict regulation and rigid control over the manufacture and sale but the revenue value is of great importance to all levels of government. This is a source of revenue which is not well adapted to segregation not only because neither level of government can well afford to surrender this source exclusively to the others but also because the retention of the licensing and sale of alcoholic beverages by the State and local governments provides a strong arm and formidable weapon in the enforcement program for strict regulation. Aside from the illicit manufacture of alcoholic beverages for which the Federal Government has its own enforcement agency in the ATU, the principal source of revenue derived by the Federal Government is at the manufacturer's level where their agents and inspectors are in position to effectively enforce collection at the source. Hence, there is little need for licensing the sale and distribution of alcoholic beverages by the Federal Government from

which source it derives very little revenue. This is a function which should be reserved to the States and localities whose enforcement agencies are close to the sale and distribution of the products and who could attain more efficient and effectual enforcement if the licensing could be reserved exclusively to the States and localities. This is an area wherein regulation and control could be greatly improved by the States provided the additional revenue were made available to them. Excise taxes on alcoholic beverages should be continued by both levels of government as at present. Revenue receipts from alcoholic beverages in 1953 amounted to $3,326 million, of which the Federal Government received $2,781 million or 83.6 percent, leaving the balance of $545 million or 16.4 percent to the States, a portion of which was derived by the local governments.

Federal Unemployment Compensation Tax

Each of the 48 States imposes an unemployment compensation tax against employers on their taxable payrolls to provide for unemployment insurance of their employees. The rates in the different States vary according to their experience in the payment of unemployment compensation insurance. The taxes so collected are paid over to the Federal Government which has general supervision over unemployment compensation throughout the Nation.

The Federal Unemployment Tax Act as amended August 5, 1954, provides for a 3 percent tax each year on the taxable payrolls of the same employers but also provides for a credit for State unemployment taxes paid by the employer up to 90 percent so that the net Federal unemployment tax on the employer is three-tenths of 1 percent annually on his payroll.

The proceeds of the Federal unemployment tax are earmarked for the following purposes:

(1) Grants to the States of amounts found necessary by the Secretary of Labor for the proper and efficient administration of the State unemployment compensation law.

(2) Appropriations to the Department of Labor to cover the expenses of administration of the Federal Bureau of Employment Security and to the Treasury Department to meet the cost of collecting the unemployment tax.

(3) Establishment of a Federal loan fund in the amount of $200 million from which repayable advances could be made to the State employment funds which might be dangerously low.

(4) Provision for the amount of any annual excess of Federal unemployment tax collections over expenditures after the aforesaid loan fund has been accumulated, which excess is to be transferred to the unemployment funds of each State and proportioned according to the taxable payrolls. This excess may also be used, subject to certain restrictions, to pay administrative costs not financed by Federal grants.

Prior to the Reed amendment the excess in receipts by the Federal Government of unemployment compensation tax over expenditures was retained in the general fund of the Federal Government but the Reed amendment has served to keep within the employment security program the taxes collected from employers for that purpose.

The States are in position to collect this tax efficiently and disburse it for its intended purpose. The cost of administration should be

borne by the States but that can be accomplished by increasing the 90 percent credit to a full 100 percent credit or perhaps slightly less so as to provide assistance to certain States whose administration would exceed the additional credit for their taxes. This would afford a continuation of the Federal supervision of unemployment insurance laws without interference with State administration. The States are not now suffering from the present arrangement since the enactment of the Reed amendment but it is the considered opinion in many quarters that the complete handling of unemployment taxes should be by the individual States.

Conclusion

The writer has not undertaken any appreciable research for source material in preparation of this paper but has relied in part upon the wealth of material which has been accumulated from exhaustive studies covering each phase of taxation at various levels of government herein commented upon. On the other hand, I have used some of the available compiled data and in particular the report of the Commission on Intergovernmental Relations and the accompanying reports of the various study committees published in connection therewith; also the report of the committee on intergovernmental fiscal relations of the National Tax Association, of which I am a member. I have undertaken to relate those reports and other data to my own viewpoint as a State tax administrator, particularly the practical aspects relating to available sources of revenue with which our legislative bodies are frequently concerned and the administrative aspects of enforcement and compliance. The opinions herein expressed are my own and do not necessarily reflect the conclusions or policies of any of the branches of State government of which I am a part.

INTERGOVERNMENTAL FISCAL DEVICES FOR ECONOMIC STABILIZATION

James A. Maxwell,[1] Clark University

I. State Devices

Economic stabilization is a responsibility which falls upon the Federal Government and not upon the State and local governments. But State and local governments have a stake in achievement of economic stability because without it performance of their functions is impaired. On the one hand, depression forces a slash in basic services and a refusal to meet genuine welfare needs. On the other hand, boom also erodes efficiency. Revenues tend to lag behind price rises, and this brings a lag of salaries and wages of personnel, which impairs morale and hinders recruitment.

State and local governments should, therefore, do what they can to effectuate economic stabilization. A positive contribution by them via adjustment of their expenditures, revenues, borrowing would augment and reinforce a Federal program. State and local spending

[1] Much of this material was prepared for the New York Temporary Commission on the Fiscal Affairs of State Government, of which Frederick L. Bird was chairman. The commission reported in February 1955. I acknowledge also a great debt for the ideas to the chairman.

and taxing as an aggregate is now about 43 percent of Federal and would become larger if world tensions diminished. For some functions of government their spending exceeds Federal spending. For example ,their spending for public construction is two-thirds of total spending on it, and this type of spending is of special importance for economic stabilization.

Unless State and local governments can help in economic stabilization, the Federal job is obviously going to be more difficult. If, in depression, State and local spending and borrowing decreases, if their tax rates rise, and if, in boom, the opposite occurs, then the net effect will be an aggravation of cyclical swings. Sometimes in the past this has happened. In 1933, for example, State and local spending on public works was one-third of its amount in 1929. Expansion of Federal spending on public works, 1929–32, was negated by the State-local shrinkage.

Such a sequence of events is not inevitable; State and local governments can, in their financing, contribute to stabilization. The specifications for successful accomplishment of a program of economic stabilization may be outlined. In favorable economic conditions State tax rates should be increased, or at least maintained, in order to achieve surpluses. These surpluses should be used to create reserves which can be drawn on in recession, and to finance (pay as you go) capital requirements which cannot be postponed without detriment to the economy of the State. If this is done, the credit of the State will be strengthened and its borrowing power will be conserved for use in recession. The State government must also shape its relationships with local governments so as to foster a program of economic stabilization. Distribution of State funds to the local governments should not be abundant in good years and niggardly in poor years. On the contrary, the flow should be countercyclical. State regulation of local finances similarly should avoid contributing to cyclical instability.

If the above policies are followed in a period of high employment and rising income, the State government will be able, in unfavorable economic conditions, to pursue a counterdeflationary program. Without raising tax rates or levying new taxes, it can maintain existing services, increase capital construction, and enlarge its aid to local governments.

The above specifications cannot at present be met by most State governments. The most obvious obstacles to an ideal countercyclical program are the numerous constitutional and statutory restrictions upon taxing, spending, and borrowing. The recent report of the Commission on Intergovernmental Relations (the Kestnbaum Commission) declares that—

> these self-imposed constitutional limitations make it difficult for many States to perform all the services their citizens require and, consequently, have frequently been the underlying cause of State and municipal pleas for Federal assistance.

There is, it said:

> a very real and pressing need for the States to improve their constitutions.[1]

These restrictions are unfortunately especially effective in limiting countercyclical finance. In most States deficit finance is made difficult or impossible by obstacles to borrowing, and by tax rate and debt

[1] The Commission on Intergovernmental Relations, A Report to the President for Transmittal to the Congress, June 1955, pp. 37–38.

limitations. Partly as a result the revenue systems of State and local governments have been designed with little built-in flexibility.

Many State and local officials have become aware that the goal of financial stability for their governments should not be divorced from the overall goal of economic stability. The tax assessor who does not raise valuations in a period of boom, or lower them in depression, has the business cycle in mind. He is afraid that higher valuations in boom will boost government spending, that lower valuations in depressions will have the opposite effect. He takes it upon himself to protect the government against the behavior of elected officials. The advocates of pay as you go have a similar practical philosophy, and so also do those who push hard for a rigid program of debt retirement. These officials have grasped half a theory; they understand what are proper financial policies under prosperous conditions. But they fail to perceive that, under different conditions, different policies are indicated. It is simply not correct that accumulation of debt is always bad and debt reduction always good. Other financial practices also reveal an implicit theory of fiscal policy. Tax reserves, open or concealed, are of the same genus. The error is that, quite often, the conditions under which increase or decrease of debt or reserves is appropriate are not analyzed.

These schemes have the faults of misemphasis, rigidity, incompleteness. They set goals which, at certain times, cannot be achieved; they are illogical since they refuse to link conclusions concerning economic policy to relevant premises. But some of these schemes can be adapted to the goal of stabilization even if it is assumed that the present structure of State and local finance will not soon be significantly altered. What might be done will be discussed below under four headings: (1) "Tax Reserves," (2) "Capital Construction," (3) "Debt Management," (4) "Distribution of State Funds to Localities."

Tax reserves for current services

A scheme of this sort is actually being used by the State of New York and by New York City. The logic of tax reserves is simple: Since economic fluctuations are an inherent and inescapable feature of our society, and since they bring a corresponding fluctuation in annual revenues, part of the revenue of the more abundant years should be salted away to be drawn upon in years which are less abundant. This tactic will serve the double purpose of providing a cushion against recession and a restraint upon the growth of expenditure in boom.

It is, perhaps, natural to reason that a tax reserve should be tied to particular taxes. If, for example, the individual income tax is variable in yield, why not set up a reserve to even out the annual amount which is made available? And so with other variable taxes. This approach is, however, incomplete in its logic; it is, besides, unnecessarily complicated, since the yield of each tax is affected by factors peculiar to it. The purpose of a reserve is to protect a government against both the decreased aggregate revenue and the larger aggregate expenditure which depression will bring. In short, the amount of the reserve should be related to the amount of prospective deficits (and surpluses).

Suppose as a simple and artificial case, that a government, looking 6 years ahead, could expect a sequence of 3 years of surpluses followed by 3 years of matched deficits as follows:

	Surplus		*Deficit*
Year 1	$5 million.	Year 4	$5 million.
Year 2	$10 million.	Year 5	$10 million.
Year 3	$5 million.	Year 6	$5 million.

The appropriate reserve would be $20 million. In the actual world no such orderly sequence occurs, and, as a result, a reserve scheme must be framed by making reasonable, if imprecise, guesses.

Let it be assumed that the revenue-expenditure system of a State government (New York) is such that the budget is in balance in a "normal" year, and that normalcy is indicated adequately by the level of income payments. Figures of income payments do have considerable merit as an overall criterion of economic conditions, and they are, besides, reasonably current. National figures of quarterly income payments are almost current; State by State figures are annual and are available 7 months after the close of the year, but rough estimates by quarters are available earlier. A norm figure of income payments could be projected by assuming a rate of growth. Suppose this to be 3 percent. If, then, the 1954 figure of income payments is $33.0 billion, and if 1954 is a normal year, the projection would be as follows:

"Normal" income payments, New York

	Million		*Million*
1954	$33,000	1956	$35,010
1955	33,990	1957	36,060

Keeping in mind that the budget is presumed to be in balance in a normal year, what would be the amounts of the surpluses and deficits when actual income payments are above and below normal? For the State government revenues should vary proportionately to income payments.[3] If, then, normal revenue receipts in 1956 were estimated at $1,200 million, a recession which brought a fall of 15 percent in income payments (from $35,010 million to $29,759 million) would bring a fall in revenue receipts of $180 million. But this would not be the amount of the deficit because expenditures would rise—let us suppose by $45 million. The deficit would, therefore, be $225 million. Deficits could obviously be estimated to correspond with a fall in income payments of less than 15 percent, and for every year. (See table below.) Similarly surpluses could be calculated for every year by supposing income payments to be above normal by 1 to 15 percent.

These calculations leave undetermined the appropriate amount of the reserve. This should bear a relationship to the sequence of prosperous and depressed years. Since research cannot determine what this sequence will be, an arbitrary determination must be made. Possibly the reserve should be enough to cover deficits of maximum amount for 2 years. The illustrative calculation above indicates that, for the near future, this would mean a reserve of $450 million.

Once established, the mechanics of the scheme would not be difficult. When the budget for a year, say 1956, was being prepared,

[3] The revenues of most State governments have less built-in flexibility because of greater dependence on commodity taxes.

suppose that prospective income payments were 15 percent below the normal of $35 billion. The relevant deficit of $225 million would then be budgeted to be withdrawn from the reserve fund. Suppose, conversely, that when the budget for 1956 was being prepared prospective income payments were 15 percent above the normal. The relevant surplus of $225 million would be budgeted as a payment to the reserve.

It is very obvious that the several estimates required by the scheme rest upon assumptions that events may falsify. These estimates are neither forecasts nor blueprints, but merely formal attempts to plan ahead for contingencies which, in the large, will occur even though, in detail, they are incalculable.

The scheme, as outlined, is automatic in operation, and any automatic scheme, operating by formula, may be criticized as inflexible in relation to the diverse situations which may arise. The scheme could, of course, be made to operate at the discretion of the executive or legislature. In this case the risk would be run that political executives and legislatures may, in prosperous years, rank tax reduction or larger spending ahead of accumulation of reserves.

Range of prospective income payments with relevant surpluses and deficits, 1956

Percent		Millions of dollars	
		Income payments	Surplus or deficit
Above normal	15	40,251	+225
	14	39,901	+210
	13	39,551	+195
	12	39,201	+180
	11	38,851	+165
	10	38,501	+150
	9	38,151	+135
	8	37,801	+120
	7	37,451	+105
	6	37,100	+90
	5	36,751	+75
	4	36,400	+60
	3	36,050	+45
	2	35,700	+30
	1	35,350	+15
Normal	0	35,000	0
Below normal	1	34,650	−15
	2	34,300	−30
	3	33,950	−45
	4	33,600	−60
	5	33,249	−75
	6	32,899	−90
	7	32,549	−105
	8	32,199	−120
	9	31,849	−135
	10	31,499	−150
	11	31,149	−165
	12	30,799	−180
	13	30,449	−195
	14	30,099	−210
	15	29,749	−225

The exposition leaves aside problems which would arise in putting the scheme into effect. If, at the outset, a sequence of above-normal years should occur, the exposition above can stand. But if, per contra, the beginning was marked by a sequence of below-normal years, the scheme would be inoperative for lack of reserve. Various in-between situations can readily be envisaged.

In the event that immediate operation of the scheme was felt to be important, a reserve might be borrowed. Provision for retirement of this debt from surpluses would be specified.

The reserve scheme examined above appears, in principle, to be desirable for local governments as well as for a State government. The need to protect their current services against shrinkage in recession and unwise expansion in prosperity is very obvious. Since their revenues are less variable than those of the State government, the appropriate amount of the reserve would be relatively less high.

Should a scheme be imposed upon local governments by State law? Should the reserves be placed in the hands of the State government? Affirmative answers will be given by persons who think that prompt provision of an effective scheme of economic and financial stabilization is of great importance. An effective scheme is to the interest of local governments, and the significance of State compulsion is chiefly to secure prompt and reasonably uniform action. State custody of the reserves ought to be accompanied by State payment of interest at an attractive rate.

Capital construction

Public construction may be for projects which are, or are not, self-supporting. The appropriate method of finance, apart from the objective of economic stabilization, is not the same for each type. The assumptions are made here (without supporting argument), that self-supporting projects, strictly defined, should as a general rule be financed by borrowing, whereas non self-supporting projects should be financed pay as you go.

Introduction of the objective of economic stabilization into the argument requires modification of these simple generalizations. This objective will be promoted when projects, whether self-financing or not, are held back in prosperity and launched in recession. It will be promoted also if, in recession, the method of finance even of nonself-financing projects is by borrowing.

Complete acceptance of these generalizations leaves unsolved a host of technical questions concerning their application. The most important are: (1) What indicators are to designate a prosperous year, a recession year, so that the appropriate method of finance will be known? (2) How determine what projects and what amount of capital outlay should not be postponed even in a prosperous year?

(1) Possibly the best indicator would be the level of private construction. When it is high, the level of public construction should be kept low, and conversely. Minor increases and decreases in the level of private construction should be disregarded. Acceleration (deceleration) of the amount of public construction, and a shift in the method of finance, would be warranted only by a change of 15 to 20 percent in a year in the amount of private construction. Possibly the rules which permit a shift to an expansive policy should be less austere than those for the opposite shift.

(2) The problem of deciding upon the relative postponability of projects can be solved only by development of extensive and accurate advance planning. A program should be prepared for 5 years ahead, revised annually. This program should not consist of loosely framed estimates; on the contrary, each part should be able to meet the scrutiny of the Director of the Budget, with discard of those parts which

fail to pass appraisal. Piecemeal presentation of projects by departments should not be tolerated. Systematic preparation of a long-range program would bring advantages beyond those of finance. It would give assurance that all possible alternatives are studied, and that the elaborate sequence of steps between preliminary planning and actual construction is orderly in execution. Beyond a doubt some unforeseeable needs for capital facilities would develop outside the long-range program; these would be handled ad hoc. But the criteria which would justify such a circumstance should be strict.

Successful application of such a program would have a double leverage in terms of economic stabilization. Variation in the amount of capital spending according to economic conditions is stabilizing; variation in the method of finance reinforces this effect. Even if the amount of such spending did not change when a year of recession occurred, a shift to borrowing would be expansionary. Such a shift would have another virtue. Relieving the general fund from provision of this expenditure would permit maintenance of general fund expenditures for other purposes. Provision of the ordinary services of Government is thereby protected in some measure against dislocation in recession.

A hypothetical case will illustrate the application of the scheme. Suppose the State government of New York for the next decade planned $2 billion of capital spending for improvements. Suppose 4 of the years turned out to be slack, i. e., the level of private construction fell off by 15 to 20 percent from normal, while 6 were prosperous. A constant yearly rate of spending of $200 million, with finance in prosperous years from the general fund and in slack years from borrowing, would allow general-fund revenues to fall by $200 million in a slack year without any reduction in spending for other purposes and with a balanced budget. At the end of the decade debt would have grown by $800 million. If, however, annual variation of spending is arranged so that capital outlays are $150 million in prosperous years and $275 million in slack years, the protection for general-fund spending would be reduced and debt at the end of the decade would be larger by $1,100 million.

What advance authority to borrow should be provided? The pattern just outlined would indicate that maintenance at all times of prior authority of $275 million would be adequate.

Financing local improvements, pay as you go, in prosperous years when private construction is at a high level is also desirable. It is unlikely to be achieved without State compulsion coupled with inducements. An appropriate inducement might be State grants for planning and for construction. The State government might pay one-half of the cost of planning local improvements. The aim would be to build up a shelf or reserve of projects for which detailed plans and specifications had been prepared. It might offer also grants-in-aid for construction of improvements. The rate of such grants would be low—perhaps zero—when the level of private construction was high, and at the rate of 25 percent (more or less) when the level of private construction fell below some specified figure. Some agency would have to be given responsibility for administering the grants, including decisions concerning timing and method of finance.

Debt management

The two rules now widely accepted in financing capital facilities by borrowing are that the bonds should (*a*) not run for a period longer than the probable life of the facility, (*b*) be retired by equal annual installments. These rules represent real progress over earlier practices which allowed issuance of debt the term of which exceeded the term of the facility, and which allowed reissuance of debt upon maturity. But modification of these rules in order to provide some flexibility over the business cycle would seem advantageous.

In prosperous years serial bonds might be issued for terms considerably shorter than the life of the capital facility.[4] This would at once place a heavier annual charge upon the budget, and, so long as prosperity continued, would be desirable. In the event of recession, however, this would not be desirable. If the serial bonds issued in prosperity had a call feature which permitted refunding into an issue of longer term (although in no case longer than the probable life of the facility), the defect would be remedied.

In recession years, conversely, serial bonds might be issued for the maximum allowable period. This would impose relatively low fixed charges on the budget, a desirable contingency in the circumstances. These bonds, issued in recession, would have a call feature permitting speedup of their retirement in subsequent years of prosperity.

Distribution of State funds

State governments annually make large distributions to local governments, chiefly as grants or from the proceeds of State-collected taxes. In 1952 $5,014 million of local revenues (26.1 percent) were from these sources. Of this amount 84 percent went to public welfare, education, and highways.

State sharing of volatile revenues is a hazard to local fiscal stability. By providing local units with large yields in good years, these shared revenues induce expansion of spending. When, in recession, the yields decline, the local units are forced either to cut back expenditure or to find new revenues from which to maintain it. State grants, the amount of which waxes and wanes in direct correlation with economic conditions, have the same faults.

Distribution of State funds should, so far as possible, aim to protect local governments against cyclical forces. In recession, when an expansion of welfare expenditure at the local level is desirable and inevitable, the State should enlarge the amount, and probably the share, of the cost which it will finance. Conversely, in prosperity, as need for welfare expenditure declines, the State should reduce its financial participation. State aid for highways should have a similar pattern over the cycle. Aid for education, on the other hand, should not be variable over the cycle because need for it is not cycle sensitive. The objective of State educational grants is to compensate for economic inequalities among the local units to the end that a desirable minimum level of provision is achieved in each unit.

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[4] In the pages above it is argued that, in prosperous years, non-self-financing projects should be financed from current taxes. Obviously changeover to such a policy would always be gradual. The technique explained here is an intermediate one which would facilitate a changeover.

II. Federal Devices

The chief financial contact of the Federal Government with the governments of the States is via grants which, currently, amount to approximately $3 billion a year. Of this, 49 percent goes to public assistance and 19 percent to highways. Except in the emergency of the depression after 1929, Federal grants have not taken account of the business cycle. A number of students, however, have suggested that account should be taken. Some State-local functions in receipt of Federal grants have a cyclical pattern in that need for them is greater in depression and less in prosperity. It is, besides, obvious that the financial ability of State and local governments to handle functions varies cyclically.

This line of thought received some notice in the recent Report of the Commission on Intergovernmental Relations (the Kestnbaum Commission), and even more in reports of its study committees. The grants most relevant here are those for (*a*) public assistance and (*b*) public construction, notably highways.

Public assistance

Federal grants for public assistance amounted to $1,330 million in fiscal 1953, of which 68 percent was for old-age assistance. One large category of public assistance, general assistance or direct relief, receives no Federal grants. This category is markedly subject to cylical influences: the number of recipients rises sharply in depression and declines sharply in prosperity. The opinion is widely prevalent that, in event of a sustained depression, the State and local governments could not cope with the burden of general assistance and that Federal intervention would come.[5]

Another opinion held quite widely is that Federal grants for public assistance are divided into too many pieces. The majority of a study committee on Federal Aid to Welfare, reporting to the Commission on Intergovernmental Relations, favored a change from the present system to a block grant for all public assistance, including general assistance. While the present grants are open-end, the new block grant would be closed, i. e., the yearly amount per State would be allocated by a formula.

A summary description of such a grant would be as follows: The need for public-assistance funds in a State might be measured by such criteria as population and per capita income; the fiscal capacity of a State to support public assistance might be measured by per capita income. If, for example, the Congress decided that, for a given year, the public-assistance needs of each State were $17.34 per capita, and that the State-local share should be 0.53 percent of income payments to individuals, then the difference between the two would be the

[5] Report of the Commission on Intergovernmental Relations, p. 271. The Advisory Committee Report on Local Government which was made to the Commission on Intergovernmental Relations stated that · "The National Government, in cooperation with State and local officials, should immediately develop a policy for taking care of general assistance if and when widespread unemployment ever again becomes an issue. If this is not done then the National Government and the States as well, will again be faced [sic] without plans to meet a great human catastrophe."

amount of the allotment for a State. A great many variants are possible.[6]

The point to stress here is that a scheme of this sort, both because of inclusion of general assistance and because of the formula, would be flexible in response to varying cyclical needs. The Federal share would rise in recession and shrink in prosperity, and this would be a significant advantage. A closed grant of this sort would, however, face two technical difficulties concerning timing. One is that the Federal appropriation process is lengthy and inflexible. As a result, prompt adjustment of the yearly allotment would not be easy. A second technical difficulty is that of framing and keeping current a measure of need of the individual States (reflecting especially the potential number of recipients). Other problems of a political nature should be mentioned. A block grant for all public assistance would, indirectly, bring general relief into the Federal grant program, even though Congress has refused to add it as a separate category. Again, a countercyclical scheme requires that Federal grants be reduced in prosperity, and yet such a move would encounter resistance. These political problems are not appraised here, but the conclusion is offered that, on economic grounds, the proposed scheme has important advantages.

Public construction

Federal grants are provided for construction of highways, schools hospitals, airports, with the important slice going to highways. The grants provide an amount equal to approximately 10 percent of total State and local expenditure for new public construction. In the 1930's through PWA and WPA, practically all State-local construction was in receipt of grants.

Federal grants at present are not framed on a countercyclical basis. In the event of depression the Congress might, however, add supplementary grants for the existing programs, discontinuing such grants when economic conditions improved. It might also offer grants for public works not now receiving grants, again dropping them with economic recovery.

A more formalized scheme (applicable either to existing grants or to a broader coverage) which gives explicit recognition to economic stabilization is as follows: The total Federal allocation per year would vary inversely with economic conditions, and, for this purpose, the best guide would appear to be the level of private construction. When the level was high, the total of the Federal grants should be smaller; when low, it should be higher. Not only the total amount of the grants, but also the percentage of the cost of each project eligible for grants, might be varied yearly so as to reflect cyclical conditions. When the level of private construction was high, the percentage of the cost of approved projects should be low; when the level was low, the grant percentage would be higher.[7]

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[6] Some of them are described in Federal Aid to Welfare, a study committee report submitted to the Commission on Intergovernmental Relations, June 1955. See also Maxwell, Federal Grants and the Business Cycle. (National Bureau of Economic Research, 1952), pp. 59–71.

[7] A scheme of this sort is spelled out in Maxwell, op. cit., pp. 104–112.

One other countercyclical feature of this scheme may be mentioned. Increase of State-local spending for public construction in recession would have less expansive effects if provided from taxes than from borrowing. The Federal Government might wish to make borrowing in depression attractive to State and local governments in order to secure the maximum expansionary effect and to get around statutory restrictions. Federal loans of this sort would, of course, stop when the level of private construction rose to some specified figure.[8]

Besides construction grants, a good deal of opinion has been offered in favor of Federal planning grants to encourage State and local governments to prepare, in prosperity, a shelf of projects that might be started in the event of depression. While the precedent for repayable advances already exists, outright grants would be more effective.

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[8] The Advisory Committee on Local Government (report, p. 4) recommended to the Commission on Intergovernmental Relations that: "The National Government should be prepared to purchase legally authorized and economically sound issues of local government bonds which cannot be sold immediately in the public market at reasonable rates. This procedure would lessen the pressure for direct Federal financing of local public works and, when properly administered, would result eventually in no ultimate cost to the National Government."

XVII. THE IMPACT OF FEDERAL ESTATE AND GIFT TAXATION

THE RISE AND DECLINE OF THE ESTATE TAX

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Death taxes are ancient taxes. They were known to the Egyptians, as well as the Romans and Greeks.[1] Even the complaints against them have a venerable pedigree. Pliny the Younger provides as good an example as any. He is among the earliest critics who have left us summaries of their complaints. Pliny eloquently argued that a tax on the shares of direct heirs "was an 'unnatural' tax, augmenting the grief and sorrow of the bereaved."[2] Almost 2,000 years later the same argument was still being heard. For in 1898 Senator Allen forcefully inquired whether it was right "to stand with the widow and the children at the graveside of a dead father to collect a tax." And then he sympathetically referred to the widow "in weeds" and the children "in tears."[3]

In criticism, too, the fashions change. Now the complaints are more sensitive to the laws of economics than to the distress of the survivors. Instead of picturesque allusions to weeds and tears there are grave observations on such formidable subjects as savings, investments, and incentives. Many voices are heard, and all speak with assurance and authority. The words may vary, but the message seems always the same. We are solemnly informed, with a suitable air of gloom and despair, that our economic system is doomed unless the estate tax is entirely repealed or severely curtailed. We are dramatically reminded, so that we are properly alarmed, that Karl Marx was inclined to favor an estate tax.[4] Here, also, the principle of guilt by association is complacently applied. This approach is less poignant than Pliny's but probably more effective. Professor Seligman was unduly optimistic when he wrote, "The inheritance tax today scarcely needs defense."[5]

It is easy to assume, as too many do, that if there is so much smoke, there must surely be a fire. Whether all this consternation is justified I leave to others to say. I shall try to be modestly helpful in a less emotional area. The critics of the estate tax usually build on the premise that it functions with relentless and monotonous efficiency. It is the grim guillotine of wealth. I shall, therefore, examine the

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[1] See West, The Inheritance Tax, p. 11 (2d edition, 1908); Shultz, The Taxation of Inheritance p. 3 (1926); Gibbon, The Decline and Fall of the Roman Empire, pp. 142, 144 (Modern Library edition).

[2] Shultz, The Taxation of Inheritance p. 6 (1926).

[3] 31 Congressional Record 5081 (1898). Cf. 42 Congressional Globe p. 4708 (1870); and see Smith, The Wealth of Nations, 810 (Modern Library edition, 1937).

[4] For one of many interesting examples of this sort of reasoning see Dresser, The Case for the Income Tax Amendment: A Reply to Dean Griswold, 39 A. B. A. J. 25 (1953). Cf. Eisenstein, Book Review, 9 Reading Guide, p. 37 (1954).

[5] Seligman, Essays in Taxation, p. 133 (seventh edition, 1911).

accuracy of this assumption. Is the premise as firm as the dismay which it seems to inspire? Obviously, in order to decide how well the estate tax is doing, we must first decide what it is supposed to do. And so my inquiry divides at once into two questions. First, what are the objectives which have been assigned to the estate tax? Second, how well does the tax achieve its ends? The answers which emerge should shed some relevant light on the fearful prophesies which the tax periodically provokes. Perhaps they may also suggest a change in our way of thinking about the tax.

I. A Fragment of History

If we guide ourselves by prevailing notions, the estate tax is animated by a single purpose—the confiscation of excessive accumulations of wealth. Congressman Kean recently echoed these notions when he approved the tax "entirely on the basis of the social benefit in preventing the piling up of too big estates."[6] Evidently the estate tax is not regarded as a levy designed to produce revenue.[7] This view of the tax easily implies certain conclusions. As long as the tax prevents estates from "piling up" too high, it presumably does all that can be expected of it. While the tax produces a modest revenue, the revenue is inevitably incidental to its assault upon aggregates of wealth. The tax can hardly appropriate property without gathering some revenue in the process. But its performance is not to be judged by the size of its fiscal haul. Though its yield may be small, it may still be effective.

This understanding of the tax usually satisfies those who applaud it and those who deplore it. The first group can always argue that it is immaterial whether the tax produces much revenue because revenue is not the purpose of the tax. The crux of the matter is that the tax breaks down hereditary estates, and this vital task is sufficient unto itself. On the other hand, the second group is able to argue that the relatively small yield reinforces its conviction that the tax is a pernicious levy. Not only does the tax level wealth, but this evil is not even excusable on the ground of revenue. Both schools are equally loyal to the same error of which neither is aware. It may come as a surprise, but death taxes in the United States were devised to produce revenue. Indeed, I suspect that a good deal of the emphasis on the social objective of the tax, as distinguished from its fiscal objective, is skillfully contrived to keep its yield as low as possible. The reasoning is simple. Why collect more revenue through the estate tax if the tax is not really expected to raise revenue in the first place?

Though skeptics say that history teaches us nothing, at the very least it may be informative here. Death taxes, no less than other taxes, derived from a desire to obtain revenue. What was true abroad was equally true here. The first Federal death tax appeared shortly after the Constitution was adopted. In 1797, amid deteriorating relations with France, Congress levied a stamp duty on legacies and intestate

[6] Hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., p. 125 (1950). A year later Congressman Kean was of the same opinion. The estate tax, he said, "was not chiefly for the production of revenue, but rather for a social benefit, in order not to allow these great piles of capital to grow and grow." Hearings before the Committee on Ways and Means on revenue revision of 1951, 82d Cong., 1st sess., p. 68 (1951).

[7] Cf. Wedgwood, The Economics of Inheritance, p. 12 (Pelican edition, 1939).

shares of personalty.[8] The rates were mild. They were 25 cents on shares over $50 and not over $100; 50 cents on shares over $100 and not over $500; and $1 for every additional $500. Shares passing to the surviving spouse and descendants were exempt. When the crisis passed, the tax disappeared.[9] It had been imposed solely for revenue, and revenue was no longer urgent.[10]

Federal death duties reappeared during the Civil War. In 1862 Congress imposed a legacy tax on personalty and a stamp tax on probates of wills and letters of administration.[11] In 1864 the legacy tax was increased and a succession tax on realty was added. Both levies ranged from 1 to 6 percent on the basis of relationship.[12] Again Congress was wholly inspired by the revenue required for military exigencies. If any other motive was about, it was successfully concealed. Secretary of the Treasury Chase proposed a death tax as a means of financing the war.[13] In Congress the tax was lauded as "a large source of revenue" that would "be most conveniently collected."[14] After the war the death duties were discarded.[15] Though they had not evoked any "widespread objection," they succumbed to the pleasing assumption that taxes must be reduced whenever a war ends.[16]

Within two decades the scene changed. By the close of th[e cen]tury a death tax movement had emerged in response to the st[ress]es and strains of the period.[17] The movement was tenacious [and i]t seemed ominous. It irrevocably identified death duties with the social control of hereditary wealth. "The seething spirit of the times," writes Myers, "was equally concerned with striking hard and deep at plutocracy's wealth as well as its political power." A Federal death tax assumed messianic proportions in the minds of those who wished to strike hard and deep. "Steep taxes would tend to shatter great fortunes. They would decrease the number of social drones. Heirs would have less funds to indulge in lavish expenditures." And a death tax "could not be shifted so as to become a tax on the laboring or consuming public."[18]

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[8] Act of July 6, 1797, ch. 11, sec. 1, 1 Stat. 527 made effective on July 1, 1798, by act of December 15, 1797, ch. 1, sec. 1, 1 Stat. 536. In 1796 the Ways and Means Committee had recommended a 2 percent duty on all testamentary dispositions and intestate successions, except those to parents, spouses, and descendants 5 American State Papers, p. 409 (1832). Two years earlier a special committee had proposed a tax on probates of wills and letters of administration, and a tax on receipts for legacies and distributive shares of personalty, subject to exemptions for wives and descendants. Ibid., at 277

[9] Act of April 6, 1802, ch. 17, 2 Stat. 148.

[10] The War of 1812 did not produce a death tax. But in early 1815 Secretary of the Treasury Dallas suggested an inheritance tax as a possible source of revenue. 6 American State Papers, p. 887 (1832).

[11] Act of July 1, 1862, ch. 119, secs 94, 111 112, 12 Stat 432, 475, 483, 485 487. The legacy tax applied if the entire personal estate exceeded $1,000; the share of husband or wife was exempt; and the rates on a taxable share varied from 0.75 to 5 percent, according to the taker's relationship. The stamp tax progressed from 50 cents to $20 for estates up to $150,000--with $10 more due for every additional $50,000 or fractional part of this amount.

[12] Act of June 30, 1864, ch. 173, secs. 124-150, 13 Stat. 223, 285 291 (1864). In 1865 Congress retroactively exempted the widow's share from succession duty. Act of March 3, 1865, ch 78, sec. 1, 13 Stat. 469, 481. In 1866 it exempted a minor child's legacy to the extent of $1,000. Act of July 13, 1866, ch. 184, sec. 9, 14 Stat. 98, 140.

[13] 32 Congressional Globe Appendix, p. 25 (1862).

[14] Ibid., at 232 See also 34 Congressional Globe, p 1718, 1880 (1864).

[15] The legacy and succession duties were repealed in 1870. Act of July 14, 1870 ch 255, sec 3, 16 Stat. 256. The stamp duty was removed in 1872. Act of June 6, 1872, ch 315, sec. 36, 17 Stat. 256.

[16] See Smith, The United States Federal Internal Tax History From 1861 to 1871, pp. 105 106 (1914).

[17] See Shultz, The Taxation of Inheritance, pp. 102, 135 (1926); Ratner, American Taxation, p. 235 (1942); Paul, Taxation in the United States, pp. 65 86 (1954).

[18] Myers, The Ending of Hereditary American Fortunes, pp. 222 223 (1939).

The propaganda for a death tax soon acquired the invaluable virtue of respectability. In 1889 Andrew Carnegie became a traitor to his class by joining the movement. At the time of his treason Carnegie was worth about $30 million, though he "was not one of the richest Americans."[19] "Why," he asked, "should men leave great fortunes to their children? If this is done from affection, is it not misguided affection? Observation teaches that, generally speaking, it is not well for the children that they should be so burdened." The wealthy who are wise, he declared, should hesitate to provide more than "moderate sources of income" for wife and daughters, and "very moderate allowances indeed, if any, for the sons." The "thoughtful man" would just as soon leave to his son "a curse as the almighty dollar." For "the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would."[20] In the light of his startling analysis Carnegie welcomed the "growing disposition to tax more and more heavily large estates left at death." It was "a cheering indication of the growth of a salutary change in public opinion." "Of all forms of taxation," he wrote, a progressive death duty "seems the wisest." He found it "difficult to set bounds to the share of a rich man's estate" which the Government should appropriate. But he was sure that the tax should be graduated; that it should exempt "moderate sums" to dependents; that it should rise "rapidly as the amounts swell"; and that "of the millionaire's hoard" at least 50 percent should be taken.[21]

Yet Congress remained steadfast. Despite the continuing pressure it refused to level hereditary wealth. Though it taxed inheritances in 1894[22] and 1898,[23] its objective was simply the collection of revenue. The tax of 1898, like the prior ventures of 1797 and the Civil War, was prompted by military spending. As in those cases, when the emergency was gone, the tax passed away.[24] The persistent demand for a death tax produced only one concrete result. A Federal toll on inheritance was now a tolerable method of taxing the wealthy for the support of the Government. But a tax which seeks revenue from the well to do is no more peculiarly regulatory than a tax on the not so well to do.

The taxes of 1894 and 1898 were at best a feeble recognition of what has come to be known as "ability to pay." The rate of 1894 was a flat 2 percent; while the rate of 1898 barely moved, in the case of close kin and normal beneficiaries, from 0.75 percent to 2.25 percent.[25]

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[19] Carnegie, The Gospel of Wealth, xxii (1933).

[20] Ibid., at 8, 9, 49, 50.

[21] Ibid., at 9, 10. In 1892 Carnegie declared, "Every dollar of taxes required might be obtained in this manner, without interfering in the least with the forces which tend to the development of the country through the production of wealth." West, The Inheritance Tax, 186 (second edition, 1908).

[22] Act of August 15, 1894, ch. 349, sec. 27, 28 Stat. 553 (1894). This statute was the famous act of 1894, which imposed an income tax, not an inheritance tax. However, income was defined as including "money and the value of all personal property acquired by gift or inheritance." When the Supreme Court invalidated the income tax in *Pollock v. Farmers' Loan & Trust Co.*, 157 U. S. 429 (1895), rehearing, 158 U. S. 601 (1895), this definition was buried in the general debris. As to the merits of an income tax on inheritance, compare Seligman, The Income Tax, p. 513 (1911), and Essays in Taxation 129 (seventh edition, 1911), with Simons, Personal Income Taxation 125 (1938).

[23] Act of June 13, 1898, ch. 448, secs. 29-30, 30 Stat. 448, 464-466, amended on March 2, 1901, ch. 806, sec. 11, 31 Stat. 938, 948.

[24] Act of April 12, 1902, ch. 500, secs. 7, 11, 32 Stat. 96.

[25] Estates under $10,000 were exempt and legacies to spouses were tax free.

These rates scarcely reflected a determined desire to lay low large aggregates of wealth.[26] Neither tax had any soaring ambition beyond revenue. Representative Underwood accurately summarized the situation when he declared –

> The inheritance tax is levied on a class of wealth, a class of property, and a class of citizens that do not otherwise pay their fair share of the burdens of the Government.[27]

Soon the situation became worse. The death-tax movement penetrated into the White House. In the spring of 1906 Theodore Roosevelt made a proposal which others found appalling.[28] He recommended "the adoption of some such scheme as that of a progressive tax on all fortunes, beyond a certain amount, either given in life or devised or bequeathed upon death to any individual—a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual." The tax would "be aimed merely at the inheritance or transmission in their entirety of those fortunes swollen beyond all healthy limits."[29] A few days after the proposal was made, the President appraised it as an essay in "courageous radicalism."[30] The "very large fortunes," he said, "are needless and useless, for they make no one really happy and increase no one's usefulness, and furthermore they do infinite harm and they contain the threat of far greater harm."[31]

Later the President returned to the same disquieting theme. At the end of 1906 he declared that a death duty would improve the distribution of the tax burden, and then suggested that the levy should do more than produce revenue. "The tax," he stated, "should increase very heavily with the increase of the amount left to any one individual after a certain point has been reached." The President emphasized that "it is most desirable to encourage thrift and ambition, and a potent source of thrift and ambition is the desire on the part of the breadwinner to leave his children well off. But," he added, "this object can be attained by making the tax very small on moderate amounts of property left: because the prime object should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate." He discreetly refused to say "how far" the tax should, in effect, limit the transmission of "the enormous fortunes in question."[32]

In 1907 the President saw things more clearly and hence he was more analytical. He focused upon the essential conflict between in-

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[26] There were those who regarded such rates as dangerous efforts to control accumulations. To Senator Elkins, for example, the 1898 act meant "that a man shall not accumulate more than a certain sum during his life. It is simply a tax against the accumulation of wealth." He detected grave consequences which are still being feared. "The tax," he said, "favors spending as you go, on the theory the Government will take it away when you die. What will be the incentive to accumulation if you can tax inheritances? * * * We are leaving the ancient landmarks, breaking down ancient traditions * * *." 31 Congressional Record, p. 5082 (1898). Four years earlier Senator Platt had stated the same conclusion less elaborately. "The death duties are very odious," he said. 26 Congressional Record, p. 6821 (1894). On the other hand, Senator Chilton hailed the 1898 tax as "the welcome introduction of a high principle in Federal taxation." 31 Congressional Record, p. 5092 (1898).

[27] 35 Congressional Record, p. 1830 (1902).

[28] See Paul, Taxation in the United States, p. 88 (1954).

[29] 18 Works of Theodore Roosevelt 578 (Memorial edition, 1925).

[30] "I am no more to be frightened out of a courageous radicalism," he wrote, "by the creatures who yell that it is socialism, than to be frightened out of a proper conservatism by the equally senseless yell that it represents reaction." 5 The Letters of Theodore Roosevelt, p. 212 (Morison edition, 1952).

[31] Ibid.

[32] 17 Works of Theodore Roosevelt, pp. 432–434 (Memorial edition, 1925).

heritance of wealth and equality of opportunity. "A heavy progressive tax upon a very large fortune," he declared, "is in no way such a tax upon thrift or industry as a like would be on a small fortune. No advantage comes either to the country as a whole or to the individuals inheriting the money by permitting the transmission in their entirety of the enormous fortunes which would be affected by such a tax; and as an incident to its function of revenue raising, such a tax would help to preserve a measurable equality of opportunity for the people of the generations growing to manhood." After denying "the slightest sympathy" with Socialist theory, the President concluded:

> Our aim is to recognize what Lincoln pointed out: The fact that there are some respects in which men are obviously not equal; but also to insist that there should be an equality of self-respect and of mutual respect, an equality of rights before the law, and at least an approximate equality in the conditions under which each man obtains the chance to show the stuff that is in him when compared to his fellows.[33]

By this time the movement for an inheritance tax to regulate hereditary wealth had made appreciable headway. In 1912 the Progressive Party boldly announced:

> We believe in a graduated inheritance tax as a national means of equalizing the holders of property.[34]

Even many conservatives had become more kindly disposed toward ideas previously denounced as socialistic and populistic. In that era, as in our own, it was not unusual to answer a disturbing proposal by calling it a derogatory name. Congress, however, refused to be seduced. In 1909 and again in 1913 it disapproved of death taxes.[35]

In 3 years the picture changed as war approached. Once more military appropriations induced Congress to impose a death duty, and once more the congressional motif was the collection of required revenue, not the control of hereditary wealth. As the Blakeys have noted, in the "Democratic textbook of 1916" death taxation was "the largest untapped field of revenue in this country."[36] The Ways and Means Committee soon echoed this view in the face of mounting expenditures.

"No civilized nation," the committee reported, "collects so large a part of its revenues through consumption taxes as does the United States, and it is conceded by all that such taxes bear most heavily upon those least able to pay them." The revenue system would "be more evenly and equitably balanced " if "a larger portion of our necessary revenues" were "collected from the incomes and inheritances of those deriving the most benefit and protection from the Government." Hence the committee proposed a progressive estate tax which it grouped with the income tax as an attractive source of revenue. The committee pointedly observed that in England the income tax yielded about 37 percent and the death duties about 21 percent of total collections. "With less than one-half the population and wealth of the United States, the revenues from income and inheritances, including

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[33] 17 Ibid., at pp. 504-505. In 1908 the President seemed to feel that a Federal death tax should be levied only "in the case of large inheritances." See 6 The Letters of Theodore Roosevelt, p. 1013 (Morison edition, 1952).

[34] Myers, The Ending of Hereditary American Fortunes, p. 223 (1939).

[35] See Blakey, The Federal Income Tax, p. 25 et seq., p. 112, note 39 (1940); Ratner, American Taxation, pp. 271, 274, 286 (1942).

[36] Blakey, The Federal Income Tax, p. 113 (1940). Cf. Ratner, American Taxation, pp. 354, 357 (1942).

'death duties,' in Great Britain were more than four times the revenue derived from these sources by the United States." The committee anticipated that the Federal estate tax would be much more productive than the State inheritance taxes, which had never been "a source of large revenue." [37] Apparently in terms of revenue the estate tax was conceived amid high hopes and pleasant expectations.

The 1916 act allowed an exemption of $50,000, and fixed rates which ranged from 1 percent on the first $50,000 of taxable assets to 10 percent on any amount over $5 million.[38] Within 6 months the rates were increased by 50 percent [39] because of "extraordinary appropriations for the Army and Navy and fortifications." On this occasion the estate tax was coupled with the excess-profits tax as a source of revenue.[40] In another 7 months the rates rose once more when Congress imposed an additional war estate tax.[41] The rates now climbed from 2 percent on the first $50,000 of taxable assets to 25 percent on sums over $10 million. But again they were not too stable.

The 1918 act revised the rates within a scale of progression starting from 1 percent on the first $50,000.[42] In effect, the rates on amounts not exceeding $1.5 million were reduced; the rates on amounts not exceeding $450,000 were halved and so restored to the level of the 1916 act; and the rates on amounts exceeding $1.5 million were left undisturbed.[43] The revised rates were reenacted in 1921.[44]

At this point I should pause to generalize. Although the estate-tax rates pushed upward for a fleeting period, they made no discernible attempt to level inherited wealth. The tax was initially imposed in response to the need for revenue, and the rates increased as the need increased. The purpose of Congress did not embrace the destruction of large fortunes. Under the 1921 act the effective rate on an estate of $10 million, before allowance of the exemption, was only 16.7 percent. Of course, many who urged higher rates were very anxious

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[37] See H. Rept. 922, 64th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 23. In 1913, 42 States imposed inheritance taxes. The total receipts from these taxes were about $28 million as compared with $132 million in Great Britain. Ibid., at p. 25.

[38] 1916 act, secs. 201, 203 (a) (2). The Ways and Means Committee originally proposed rates moving from 1 percent on the first $50,000 to 5 percent on any excess over $450,000. H. Rept. 922, 1st sess., C. B. 1939-1, pt. 2, p. 25. The Senate Finance Committee proposed the rates finally adopted. S. Rept. 793, 64th Cong., 1st sess., ibid., at p. 29; conference report No. 1200, 64th Cong., 1st sess., ibid., at p. 38.

[39] Act of March 3, 1917, sec. 300.

[40] H. Rept. 1366, 64th Cong., 2d sess., C. B. 1939-1, pt. 2, pp. 44-46.

[41] Act of October 3, 1917, sec. 900. The Ways and Means Committee initially recommended, as a top rate of additional tax, 15 percent on amounts over $15 million. The total maximum rate would then have been 30 percent. For purposes of the additional tax it also reduced the exemption to $25,000 and imposed a tax of 1 percent on any amount between $25,000 and $50,000. H. Rept. 45, 65th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 54. The Finance Committee tried to remove the increases altogether but then yielded. S. Rept. 103, 65th Cong., 1st sess., ibid., at p. 65; conference report 172, 65th Cong., 1st sess., ibid., at p. 83.

[42] 1918 act, sec. 401.

[43] These rates were the fruits of compromise. The Ways and Means Committee fixed rates rising from 3 percent on the first $50,000 to 40 percent on amounts over $10 million. H. Rept. 767, 65th Cong., 2d sess., C. B. 1939-1, pt. 2, p. 103. The Finance Committee then eliminated the estate tax and substituted an inheritance tax measured by the individual shares of the beneficiaries. S. Rept. 617, 65th Cong., 3d sess., ibid., at p. 127. In conference the estate tax was restored at lower rates than those approved by the Ways and Means Committee. Conference report 1037, 65th Cong., 3d sess., ibid., at p. 151. Many members of the Finance Committee were less than enthusiastic over any death tax. But they considered such a tax "important for fiscal reasons," especially because of "the probable loss in revenue following the prohibition of alcoholic liquors." Blakey, The Federal Income Tax, p. 175 (1940).

[44] 1921 act, sec. 401. Before this act was passed, the Senate voted increased rates ranging from 30 percent to 50 percent on amounts over $15 million. The top rate applied to any excess in net estates over $100 million. The Senate receded in conference. See conference report 486, 67th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 229; Ratner, American Taxation, p. 411 (1942).

to regulate wealth and the power which it confers.[45] But what they sought and what they got were not the same. The rates speak pretty clearly for themselves. They were not devoted to any objective other than the production of revenue. Those who are unalterably opposed to the leveling of wealth would cheerfully welcome a top rate of 25 percent on net estates over $10 million.[46]

We are now on the threshold of the Mellon era in estate taxation. Secretary of the Treasury Mellon was firmly persuaded that the estate tax would eventually subvert the American economy.[47] He argued that a top rate of 25 percent on estates over $10 million was "very heavy," and should at least be lowered for the "good of the country." [48] As things were going, it might be "only 2 or 3 generations until private ownership of property would cease to exist." [49] The Secretary vigorously denied that there was any "social necessity for breaking up large fortunes in this country." And so he set about to remove or reduce the estate tax before disaster overtook us. Very likely he would have succeeded but for the remarkable resistance of a few stubborn Congressmen.[50] Though the tax was finally saved, the rates were thoroughly cut.

At first the Secretary was not very successful. In 1924 Congress raised the estate tax rates and imposed a gift tax. It also granted a credit for State death taxes, not exceeding 25 percent of the Federal tax, to mollify those who condemned it as an exertion of power reserved to the States.[51] The new rates increased the burden on all taxable estates over $100,000, and reached a maximum of 40 percent on amounts over $10 million, as compared with 25 percent under the 1921 act. For example, an estate[52] of $1 million paid a tax of $17,500 under the 1921 act, or an effective rate somewhat below 5 percent; and a tax of $70,000 under the 1924 act, or an effective rate of 7 percent. Again, under the 1921 act the tax on an estate of $5 million was $632,500—an effective rate of about 13 percent; under the 1924 act the tax on the same estate was $947,500—an effective rate of about 19 percent. In the case of an estate of $10 million the 1921 act appropriated $1,670,-500—an effective rate of about 17 percent; and the 1924 act, $2,543,-500—an effective rate of about 25 percent.[53] A displeased President signed the 1924 act, while objecting to its "high estate tax rates." [54] The Under Secretary of the Treasury felt compelled to make a grave prediction. "We shall have more golf players," he said, "and fewer

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[45] See Paul, Taxation in the United States, pp. 108, 119–120 (1954). Herbert Hoover was among them. After World War I he wanted "to thaw out frozen and inactive capital and the inherited control of the tools of production by increased inheritance taxes." 2 The Memoirs of Herbert Hoover, p. 29 (1952).

[46] Secretary of the Treasury Mills lends me able support here. The Secretary was rigidly set against an estate tax for leveling purposes, but he was finally reconciled to an estate tax for revenue purposes. As he informed the Finance Committee in 1932, if "you are imposing a tax with the idea of getting considerable revenue," then "probably 25 percent is as high as you want to go." Paul, Taxation in the United States, pp. 157–158 (1954).

[47] See Mellon, Taxation: The People's Business, pp. 111 et seq. (1924).

[48] Ibid., at p. 112.

[49] Ibid., at p. 119.

[50] This recalcitrant group consisted of Representatives Green and Ramseyer of Iowa, Frear of Wisconsin, and Garner of Texas.

[51] 1924 act, secs. 301, 319–324. The Senate Finance Committee had rejected all these changes and restored the rates of the 1921 act. S. Rept. 398, 68th Cong., 1st sess., C. B. 1939–1, pt. 2, pp. 270, 289–290. Then the Senate had substituted an inheritance tax for the estate tax, and changed the gift-tax rates and exemptions. See Blakey, The Federal Income Tax, p. 244 (1940); Ratner, American Taxation, p. 415 (1942). Ultimately the Senate yielded. Conference Report 844, 68th Cong., 1st sess., C. B. 1939–1, pt. 2, p. 308.

[52] The "estate" is the net estate before deduction of the exemption.

[53] The calculations under the 1924 act include the credit for State death taxes.

[54] Blakey, The Federal Income Tax, pp. 246, 251 (1940).

Henry Fords and Thomas Edisons." "Are we not fooling ourselves," he said, "when we think we can defeat economic laws?" And then he promptly answered that retribution was certain. "We are now selling our seed grain and will have nothing to sow when next spring comes."[55]

In 1926 Secretary Mellon emulated Robert Bruce. He tried again and did much better.[56] At the very outset the Ways and Means Committee reduced the rates to a maximum of 20 percent. The existing rates "in the upper brackets" were condemned as "excessive." At the same time the available State credit was raised to 80 percent of the Federal tax. The revenue from the estate tax was expected to become a mere $50 million as the States took advantage of the larger credit.[57] The Finance Committee considered these revisions inadequate and proposed a complete repeal of the tax. If the tax was to be abolished, the committee further reasoned, it was "inequitable to apply the high rates of the 1921 law merely to those estates where the decedent happened to die while the 1924 law was in operation." Therefore, the committee retroactively repealed the 1924 rates, so that the rates of the 1921 act would apply to all decedents dying after the enactment of that act.[58] At the end the Finance Committee retreated but imposed a price. It agreed to the much lower rates and much higher credit.[59] In exchange, the exemption was doubled,[60] the 1924 rates were retroactively removed,[61] and the gift tax was repealed.[62] The retroactive dispensation bestowed refunds of about $250 million on seven estates, among others.[63] This tidy sum exceeded twice the total estate and gift tax revenue for fiscal year 1925, and was about 10 percent of the total internal revenue receipts for that year.[64]

Under the 1926 act the estate tax was less than under the 1918 act, and the larger credit for State taxes left little of what remained. Moreover, the estate tax no longer enjoyed even the poor protection of a frail gift tax. However, the administration was still dissatisfied, and so it was disinclined to give up. In 1927 and 1928 Secretary Mellon continued to urge the elimination of the estate tax. Congress failed to respond to his advice. The 1928 act left the rates and the exemption unchanged.[65]

In 1931 a strange thing happened. Secretary Mellon revised his views on the estate tax as the great depression intensified the need for revenue. Torn between a dislike for deficits and a dislike for the tax, he recommended an increase in rates.[66] The sentiment in Congress also changed.[67] The exemption was reduced from $100,000 to $50,000, and the rates were more than doubled. Under the new schedule the rates started at 1 percent on the first $10,000 above the exemption and

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[55] Winston, State and Federal Relations in Inheritance Taxation, Proceedings of the National Tax Association, pp. 249-251 (1925).

[56] See Blakey, The Federal Income Tax, p. 251 et seq. (1940).

[57] H. Rept. 1, 69th Cong., 1st sess., C. B. 1939-1, pt. 2, pp. 317, 324-325, 332.

[58] S. Rept. 52, 69th Cong., 1st sess., ibid., at pp. 338-339.

[59] 1926 act, sec. 301.

[60] 1926 act, sec. 303 (a) (4). The exemption was raised from $50 000 to $100,000.

[61] 1926 act, sec. 322. See Conference Report 356, 69th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 370.

[62] 1926 act, sec. 1200 (a).

[63] See Ratner, American Taxation pp. 428 429 (1942).

[64] See Surrey and Warren, Federal Income Taxation—Cases and Materials, p. 22 (1954 edition).

[65] See Blakey, The Federal Income Tax, p. 278 et seq. (1940); Ratner, American Taxation, pp. 431-433 (1942).

[66] See Ratner, American Taxation, p. 445 (1942).

[67] See Green, The Theory and Practice of Modern Taxation, p. 168 (1933).

rose to 45 percent on any excess over $10 million. The credit for State taxes was not allowed against the increase in Federal tax.[68] A new and better gift tax was also imposed.[69]

I have come to the end of the Mellon era. Those years were a bleak period for the estate tax. It barely survived the efforts to repeal it. The prevailing philosophy ordained that any Federal estate tax, whether high or low, was a grave threat to our economic welfare. A top rate of 20 percent on huge estates was barely tolerated. Between 1926 and 1928 the estate tax receipts declined from $116 million to $60 million. In 1933 they fell below $30 million.[70] But for present purposes another development was more important. When the estate tax was finally revived at the end of this dismal period, the controlling motivation was a desire to obtain revenue and not a desire to break down estates. Among those who made tax policy the levy was still a fiscal measure. The Ways and Means Committee carefully explained that the estate tax increase was "an emergency measure," and expressed "the hope" that in 2 years "the financial condition of the country" would warrant a reduction.[71]

With the Roosevelt administration the estate tax entered a new phase. The leveling of hereditary fortunes was formally approved as one of its objectives.[72] This altered attitude first bore fruit in the Senate.[73] Under the 1932 act the rates on net estates over $1 million rose from 19 percent to 45 percent. In 1934 the Finance Committee proposed a new schedule for those estates ranging from 20 percent to 50 percent.[74] The committee stated that the increases would not only add revenue, but also "tend to prevent undue accumulation of wealth. This objective is more properly reached by estate tax than by income-tax increases."[75] Through the efforts of Senator LaFollette the Senate moved beyond the committee and increased the burden on all net estates over $70,000.[76] The maximum rate was fixed at 60 percent for estates over $10 million.[77]

In 1935 the accent on leveling became bolder. On June 19 of that year the President recommended, in addition to the estate tax, "an inheritance, succession, and legacy tax in respect to all very large amounts received by any one legatee or beneficiary."[78] His message briefly and simply justified progressive death taxes as a means of regulating the wealth of the few for the benefit of the many. "The

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[68] 1932 act, secs. 401, 402. See S. Rept. 665, 72d Cong., 1st sess., C. B. 1939—41, pt. 2, pp. 504, 523-524. Cf. H. Rept. 708, 72d Cong., 1st sess., ibid., at pp. 460, 462, 476.

[69] 1932 act, secs. 501-532.

[70] See Warren and Surrey, Federal Estate and Gift Taxation—Cases and Materials, p. 9 (1952 edition).

[71] H. Rept. No. 708, 72d Cong., 1st sess., C. B. 1939 41, pt. 2, p. 463. But cf. Paul, Taxation in the United States, pp. 152, 156 (1954).

[72] Before assuming the Presidency Herbert Hoover had also praised death taxation as a leveler of hereditary wealth. See note 45, supra. Toward the end of his term he articulated the same theme. He declared that "the estate tax, in moderation, is one of the most economically and socially desirable, or even necessary, of all taxes." And he regarded the estate tax as similar in function to the abolition of primogeniture—as a means of striking against "the evils of inherited economic power." 3 The Memoirs of Herbert Hoover, pp. 135-136 (1952).

[73] Representative Pettengill had vainly argued for the same view in the House. See Paul, Taxation in the United States, p. 178 (1954).

[74] S. Rept. 558, 73d Cong., 2d sess., C. B. 1939-1, pt. 2, pp. 586, 591.

[75] Ibid., at 591.

[76] See Blakey, The Federal Income Tax 360 (1940). The Senate reduced the exemption to $40 000, but this change was eventually eliminated. Conference Report 1385, 73d Cong., 2d sess., C. B. 1939-1, pt. 2, p. 635.

[77] 1934 act, sec. 405 (a).

[78] See H. Rept. 1681, 74th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 643. In order "to prevent, so far as possible, evasions of this tax," the President also proposed "the imposition of gift taxes suited to this end." Ibid.

transmission from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and sentiments of the American people." "The desire to provide security for one's self and one's family is natural and wholesome," he declared, "but it is adequately served by a reasonable inheritance. Great accumulations of wealth cannot be justified on the basis of personal and family security. In the last analysis such accumulations amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others." In short, "inherited economic power is as inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our Government."[79]

Congress did not pursue the route proposed by the President. Instead it simply increased the rates of the estate tax.[80] The rates, as reconstructed, began at 2 percent on the first bracket of $10,000 and ended at 70 percent on the last bracket above $50 million. The exemption was pared from $50,000 to $40,000.[81]

After the 1935 act the emphasis on leveling died away. There were only two more changes in rates, and neither was stimulated by the philosophy of the President. Once again Congress was exclusively concerned with revenue for military purposes. In 1940 it imposed a temporary defense tax consisting of a 10-percent increase in the estate tax.[82] In 1941 what was temporary became permanent. The defense tax was integrated with the estate tax, and the rate progression was variously accelerated.[83] The rate structure now rose from 3 percent on the first $5,000 of net estates to 77 percent on any residue over $10 million. With the enactment of the 1941 act the development of the rates came to a dead end.[84] The Treasury's efforts to increase the tax—in 1942, 1943, 1950, and 1951—were uniformly disapproved.[85] Even military budgets were no longer helpful.[86]

What illumination do we derive from this hasty glance at history?[87]

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[79] Ibid. For the political context of the message, see Blakey, The Federal Income Tax, p. 366 et seq. (1940).

[80] The Ways and Means Committee tried to be more cooperative. It provided for an inheritance tax and a correlative gift tax. H. Rept. 1681, 74th Cong., 1st sess. C. B. 1939-1, pt. 2, pp. 645, 648-651. The Finance Committee replaced these with the increased rates and reduced exemption which were finally enacted. S. Rept. 1240, 74th Cong., 1st sess., C. B. 1939-1, pt. 2, pp. 655-657; Conference Report 1885, 74th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 663. See further Blakey, The Federal Income Tax, p. 373 et seq. (1940).

[81] 1935 act, sec. 201 (a) (b).

[82] 1940 act, sec. 201.

[83] 1941 act, sec. 401 (a) (b). See H. Rept. 1040, 77th Cong., 1st sess., pp. 2, 3, 27, 51 (1941); S. Rept. 673, pt. 1, 77th Cong., 1st sess., pp. 2, 3, 16, 42 (1941); Conference Report 1203, 77th Cong., 1st sess., p. 13 (1941).

[84] See Internal Revenue Code of 1954, sec. 2001.

[85] See hearings before the Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d sess., pp. 6, 15 (1942); hearings before the Committee on Ways and Means on Revenue Revision of 1943, 78th Cong., 1st sess., pp. 7, 57 (1943); hearings before the Committee on Finance on H. R. 3687, 78th Cong., 1st sess., pp. 46, 94 (1943); hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d sess., pp. 5, 22 (1950); hearings before the Committee on Ways and Means on Revenue Revision of 1951, 82d Cong., 1st sess., pp. 4, 14, 68 (1951).

[86] I am not suggesting that estate tax rates should periodically change as budget needs shift. I am simply saying that even heavy spending in a period of crisis does not persuade Congress to establish a stronger rate structure.

[87] My résumé is necessarily less than complete. I have failed to mention, for example, the repeated efforts to abolish the estate tax on the ground that death taxes fall within the fiscal province of the States. The credit for State taxes was the device skillfully used to withstand these assaults. See Green, The Theory and Practice of Modern Taxation, p. 167 (1933); Blakey, The Federal Income Tax, p. 257 (1940); Ratner, American Taxation, p. 428 (1942); Groves, Retention of Estate and Gift Taxes by the Federal Government, 38 California Law Review, p. 28 (1950).

The answer seems rather clear. In the quarter century between 1916 and 1941 the estate tax passed through several stages. For our purposes they may be counted as four. The first stage ended with the 1921 act. It was a period of rising rates followed by a relapse among the smaller estates. The governing objective was plainly revenue. The second stage was the Mellon era. It began with the 1924 act and closed with the 1932 act. In that unfortunate period the tax was almost destroyed and then revitalized as a source of revenue. The third stage started with the 1934 act and was continued by the 1935 act. Under these 2 acts the progression sharpened as the rates climbed from 45 percent to 70 percent. The dramatic emphasis was on leveling, but the continuing need for revenue in the face of deficits was also effective. The fourth stage was marked by the 1940 and 1941 acts. The larger burdens which they imposed derived entirely from the quest for revenue.

At best, then, the social objective of the estate tax was prominent only in 1934 and 1935. Yet even in those years the deliberate destruction of "great accumulations of wealth" was more verbal than actual. The 1934 and 1935 acts treated the larger fortunes more gingerly than the smaller ones. Under the 1932 act the rate of progression had been 1 percent per bracket for net estates not exceeding $50,000, and 2 percent for all brackets beyond that amount. The 1934 act raised the rates for net estates over $70,000. If leveling was its purpose, it went about its work in peculiar fashion. For net estates between $70,000 and $4.5 million the new rate of progression per bracket was almost invariably 3 percent.[*] For net estates above that range the revised rate per bracket was 2 percent. As the hereditary fortune became larger the progressive impact became softer. The behavior of the 1935 act was similarly strange if leveling was the grand design. It increased the tax on all estates—the moderate kind as well as the immoderate variety. For net estates between $100,000 and $7 million the rate of progression was 3 percent per bracket. But for net estates between $7 million and $50 million the rate of progression was 2 percent—the same rate that prevailed in the smallest brackets up to $100,000. In accordance with this policy of diminishing progression the rate of increase was only 1 percent in the final bracket covering any residue over $50 million.

The same point may be made a little differently. Under both the 1934 and 1935 acts, as under the 1932 act, the brackets became wider as the net estate increased. In other words, the progression was most rapid in the very low brackets and most leisurely in the very high brackets. The 1934 act established 26 brackets. Below $200,000 there were 8 brackets. Of these, each of the first 5 covered $10,000; the sixth, $20,000; the seventh, $30,000; and the eighth, $100,000. Between $200,000 and $1 million the span of each bracket was $200,000; between $1 million and $5 million the span was $500,000; and between $5 million and $10 million the span was $1 million. The last bracket covered any excess over $10 million. The pattern of the 1935 act was barely different. It added 2 brackets above $10 million with still wider spans of $10 million and $30 million.

[*] Of the 14 brackets extending from $70,000 to $4.5 million, there were only 3 exceptions. In the $50,000 to $70,000 and the $70,000 to $100,000 brackets the rate of progression was 2 percent. In the $200,000 to $400,000 bracket the rate was 4 percent.

Neither the 1934 act nor the 1935 act disturbs my conclusion that the estate tax has been primarily imposed for revenue. I am not unaware that the tax has also helped to redistribute wealth, but any progressive levy on income or wealth will have this effect. Nor do I forget that the desire to control accumulations significantly contributed to the development of the tax. Undoubtedly that objective infiltrated into its rate structure. The fact remains that the growth of the tax responded more to the stimulus of revenue than to eloquent exhortations for the dismantling of estates.

II. A Dim View of the Present

I have rapidly traced the career of the estate tax in the light of the two objectives with which it is associated. I now approach the next question. How ably does the tax pursue the aims which have been assigned to it? Does it do its job well or is there ample room for improvement? I turn first to its performance as a source of revenue and then to its achievement as a leveler of wealth.

A. *The fiscal objective*

In 1933 death taxes were authoritatively praised for their capacity to produce revenue. To quote a comprehensive report prepared for the Joint Committee on Internal Revenue Taxation, "A well balanced death duty is one of the best forms of taxation and is a good revenue producer."[89] The friends of the estate tax seem to agree that it has not lived up to this laudatory observation. President Truman declared that the tax is vitally impaired by "serious weaknesses."[90] According to Senator Humphrey, the tax is in "a pitiful state."[91] Certainly the statistics are not very cheerful.[92] They seem to say that as a revenue producer the tax has fallen on evil days.

The estate and gift taxes together account for only about 1.5 percent of the revenue.[93] The situation used to be different. From 1935 through 1940 the two taxes produced more than 6 percent of the revenue. In 1936 their combined yield exceeded 10 percent.[94] Even in the years 1928-33, when the estate tax receded to its lowest point since 1917, it generally contributed over 2 percent of the total.[95] The current

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[89] Federal and State Death Taxes, reports to the Joint Committee on Internal Revenue Taxation, p. 170 (1933).

[90] See hearings before the Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d sess., p. 5 (1950). See also hearings before the Committee on Ways and Means on Revenue Revision of 1951, 82d Cong., 1st sess., p. 4 (1951), in which President Truman referred to "the broad loopholes" in the estate tax.

[91] Humphrey, Tax Loopholes, p. 11 (Public Affairs Institute, 1952).

[92] See data in Warren and Surrey, Federal Estate and Gift Taxation—Cases and Materials, p. 9 (1952 edition); Surrey and Warren, Federal Income Taxation—Cases and Materials, p. 22 (1951 edition); Review of the 1956 Budget, Executive Office of the President, Bureau of the Budget, August 25, 1955, p. 29.

[93] The collection figures for particular years relate to fiscal years.

[94] The annual percentages of the 2 taxes for the period 1935–40 were 6.49, 10.84, 6.59, 7.39, 6.99, and 6.76. The 10.84 percent for 1936 was due to a temporary eruption of gifts in 1935 to avoid the gift tax increases of that year, effective January 1, 1936. In 1935 total net taxable gifts were about $1.2 billion—almost as high as the entire estate-tax base in that year. Hence in 1936 the gift tax produced 4.58 percent of the total revenue. See Warren and Surrey, Federal Estate and Gift Taxation—Cases and Materials, p. 9 (1952 edition); Pechman, Matched Estate and Gift Tax Returns, 3 National Tax Journal, pp. 153, 163 (1950).

[95] In 1928 the yield of the estate tax was a little over $60 million. After a slight rise in 1929 and 1930, it went steadily downhill to less than $30 million in 1933. Yet in only 2 of those years—1931 and 1933—did the estate tax account for less than 2 percent of the revenue. Furthermore, until June 6, 1932, there was no gift tax to bolster the estate tax. In 1933 the estate and gift taxes togeher accounted for more than 2 percent of total contributions (ibid).

percentage of revenue derived from the estate and gift taxes is about as small as the percentage produced by the estate tax alone in 1918. Hence a professor of law has come to a gloomy conclusion. The reason for studying the estate and gift taxes, he says, is not their significance in the fiscal scheme of things, but their "power to stimulate and challenge the student."[96] If the taxes are fiscally unimportant, at least they sharpen the legal wits.

The picture is not entirely black. Though the relative yield of the transfer taxes has drastically decreased, their absolute yield has, on the whole, increased.[97] During the thirties their highest return was $378 million.[98] Between 1940 and 1955 their yield has risen from $360 million to $936 million. While they have never produced $1 billion a year, they would already have exceeded that figure but for the adoption of estate and gift splitting in 1948.[99] After splitting was approved the revenue fell off, and only in 1953 did the collections again approach the yield of 1948. The estimated receipts for 1956 are $975 million.

Moreover, when we make percentage comparisons in terms of total revenue, it is wise to be careful lest the analysis become foolish.[1] The poor relative showing of the transfer taxes has little to do with their own inadequacies as revenue producers. As I have just indicated, their yield has more than doubled since their best year in the thirties. The explanation lies elsewhere. The estate and gift taxes have dwindled in overall fiscal importance because of the phenomenal growth of the individual and corporate income taxes.

This point is sufficiently illustrated by the individual income tax.[2] In 1934 that tax produced $420 million and the transfer taxes $113 million—a ratio of 3.7 to 1. In 1936 the ratio became smaller—less than 2 to 1—as the respective yields were $674 million and $379 million. The individual income tax and the transfer taxes were then pretty much in the same class as sources of revenue. Before Pearl Harbor the individual income tax moved further ahead of the transfer taxes. But as late as 1941 the revenue from the former was still only about 3½ times the revenue of the latter. After 1941 the disparity dramatically changed. The estate tax remained a class tax; the income tax became a mass tax. And so in fiscal 1955 the income tax produced about $29 billion and the estate and gift taxes $936 million, making a ratio of more than 30 to 1. The transfer taxes are simply no longer in the same league with the individual income tax. The corporate taxes have also left them far behind.[3]

Hence, it makes little sense to compare the yield of the estate tax with the yield of the income taxes. The estate tax must always suffer by the comparison, and the suffering is always undeserved. We should no more expect chickens to behave like ducks than the estate tax to perform like an income tax. By its very nature the estate tax is highly selective in its incidence. It is a tax reserved for the prosperous. There are less taxpayers who are well-to-do than those who are not,

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[96] Bittker, Estate and Gift Taxation—Cases and Materials, p. v (1951).
[97] See sources cited in note 92, supra.
[98] This amount was produced in 1938.
[99] 1948 act, secs. 361, 372.
[1] Cf. hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., pp. 22, 36 (1950).
[2] See data cited in note 92, supra.
[3] In 1955 the yield of the corporate taxes was $18.3 billion.

and a death tax seeks out only those who are. The income tax reaches more than 40 percent of all individuals over 14 years of age.[4] The estate tax reaches only about 1 percent of all adult decedents.[5] Even if it embraced many more decedents, it would still lag hopelessly behind. But if the two taxes must be compared, the appraisal should be in terms of the same exclusive clientele. On this basis the appropriate rod of comparison is the revenue obtained by the progressive element of the income tax[6] from those who later qualify as decedents under the estate tax. For this purpose we may reasonably consider only those taxpayers whose income is beyond the $20,000 bracket.[7] From this group the progressive element of the income tax derives about $2.2 billion.[8] Of this sum, the amount attributable to income from property, as distinguished from personal services, is probably not very much above $1 billion. In sum, the estate-tax revenue is fairly close to the income tax revenue which the progressive rates secure from the same group of taxpayers.

Yet after we fully discount percentage comparisons, it is still true that the estate tax does poorly revenuewise. In 1951, for example, the total net value[9] of estates reported on taxable returns was about $4 billion and the total tax computed on this total was $577 million, or a mere 11 percent.[10] Obviously, the tax could easily be much more productive.[11] If it fails to live up to its capacities, the fault is with Congress. For the tax has become the pariah of our internal revenue system. As a rule, it is ignored; when it is not ignored, it would do better if it were. And so its inadequacies methodically increase from one act to another. An excessive exemption is combined with inadequate rates, and these are joined by significant loopholes.

The estate tax exemption has fared much better than the income-tax exemptions. While it is entirely proper to reduce the latter, it is considered almost profane to touch the former. At present the estate-tax exemption is $60,000, or $20,000 more than it was before World War II.[12] After 40 years of estate taxation it is $10,000 higher than it was in the beginning.[13] These contrasts, however, hardly tell the whole story. The difference is not only one of $10,000 or $20,000, as the case may be. There is still another and better exemption which I

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[4] See hearings before the Committee on Ways and Means on revenue revision of 1950 81st Cong., 2d sess., pp. 22, 36 (1950). In 1939 the tax affected only 4 percent of all persons over 14. Ibid

[5] See ibid. at pp. 22, 36, 76

[6] The progressive element includes all graduated rates above the starting rate of 20 percent

[7] Insofar as married couples are concerned, this restricted group includes only those couples whose combined taxable income is over $40,000.

[8] See National Association of Manufacturers, A Tax Program for Economic Growth, p. 55 (1955). The total yield from the progressive element of the income tax is about $4.7 billion. Ibid.

[9] The net value is gross value less all deductions other than the exemption and the marital deduction. It does not include community property which passes to the surviving spouse as coowner.

[10] This figure is derived from a tabulation of returns filed in 1951. See Statistics of Income for 1950, pt. 1, pp. 235 236. This percentage is a drop from 1945 In that year the aggregate net value of estates shown on taxable returns was $2.7 billion and the aggregate estate tax reported was $531 million, or about 20 percent. See hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., p. 76 (1950) It is estimated that the estate tax touches about 10 percent of the total value of property transferred each year at death. Ibid

[11] Great Britain obtains about 4.5 percent of its internal revenue from death taxes. Groves Retention of Estate and Gift Taxes by the Federal Government, 38 California Law Review, pp. 28, 31 (1950).

[12] Internal Revenue Code of 1954, sec. 2052. Between 1935 and 1942 the exemption stood at $40,000. There was also a special exemption of $40,000 for life insurance payable to specific beneficiaries. In 1942 Congress abolished the insurance exemption and increased the general exemption to $60,000. 1942 act, secs. 404 (a), 414.

[13] 1916 act, sec. 203 (a) (2).

shall shortly examine. It is known as the marital deduction; it is granted to a decedent who is survived by his spouse; and it may be as much as half of his net assets.[14] When this additional exemption fully applies, no estate tax is due until the net assets exceed $120,000. And even when the net assets exceed $120,000, half of the net assets is still tax free, apart from the specific arithmetical exemption of $60,000. Whether the exemption be regarded as $60,000, $120,000, or some larger figure equal to half of the net assets plus $60,000, it is now regarded as inviolate.

A defective rate structure cooperates with a generous exemption. The rates extend through 25 brackets—from 3 percent on the first $5,000 to 77 percent on any excess over $10 million.[15] Though they are quite formidable, they are not really as fierce as they look.

In the first 7 brackets, which embrace only $60,000, the progression is rapid. It leaps from 3 percent to 25 percent.[16] Then it tapers off as the brackets broaden. The eighth bracket covers $40,000 at 28 percent, and the ninth bracket $150,000 at 30 percent. In other words, the progression is 25 percent for the first $100,000 and only 2 percent higher for the next $150,000. The progression now proceeds to slow down still more. There are 5 brackets between $250,000 and $1.5 million; the width of each bracket is $250,000; and the increase per bracket is 2 or 3 percent. Next come 5 brackets between $1.5 million and $4 million; the width of each bracket is $500,000; and the increase per bracket is 3 or 4 percent. Then there are 4 brackets between $4 million and $8 million; the width of each bracket is $1 million; and the increase per bracket is 3 or 4 percent. The last 2 brackets consist of 1 between $8 million and $10 million, subject to an increase of 3 percent; and another for any excess over $10 million, subject to an increase of 1 percent.

From the standpoint of revenue these rates are scarcely impeccable. They start with an impressive burst of speed and suddenly begin to tire. The net result is that they are sharply progressive at the wrong place. The rapid rise at the outset is much ado about very little. Taxable estates not exceeding $100,000 account for about 75 percent of all taxable returns. But they yield only about 10 percent of total estate tax revenue.[17] In this area quick progression is a meaningless flurry of activity. The revenue from these small estates turns largely on the size of the exemption and the initial rate. Progression can be productive only among the other 25 percent of taxable estates which yield 90 percent of the revenue.[18] Yet it is precisely there that progression conspicuously deteriorates.

So far I have made believe that the rates are more potent than they are. Needless to say, a tax is not entirely known by the rates which Congress may enact. The amount which is paid depends on the base of the tax as well as the rates of the tax. If there are troublesome doubts on this score, percentage depletion should remove them. In the

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[14] Internal Revenue Code of 1954, sec. 2056.

[15] Internal Revenue Code of 1954, sec. 2001.

[16] The first 7 brackets consist of 2 with a spread of $5,000 each and 5 with a spread of $10,000 each.

[17] These figures are derived from tables in Statistics of Income for 1950, pt. 1, pp. 235–236. The tables show the distribution of taxable estates before deduction of the exemption. The figures which I cite represent taxable estates after the exemption is taken off.

[18] As the Treasury has emphasized, "The bulk of the estate-tax revenue comes from a limited number of large estates." Hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., p. 76 (1950).

case of the estate tax the rates are also often illusory. The tax was born with two infirmities which continue to be incurable and in recent years it has acquired a few more ailments. All these inadequacies sufficiently qualify as loopholes.

Of the two native inadequacies, one involves the perennial problem of gifts. The easiest way to avoid a tax at death is to make a gift during life. Therefore, the estate-tax base has always included various kinds of inter vivos gifts which are convenient substitutes for a will.[19] These precautions are helpful but inadequate, for the estate tax can still be avoided by gifts. The income tax also stimulates generosity before death. It is no secret that gifts may reduce that tax as well, if the donees are in lower brackets as they usually are.[20] The desire to avoid income tax may be more effective than the desire to avoid estate tax because the savings are more immediate.[21] In enacting the gift tax Congress purported to kill 2 birds with 1 stone. I quote some of the relevant observations of the Ways and Means Committee and the Finance Committee. The gift tax serves as "a protection to both estate and income taxes." Its function is to "assist in the collection of the income and estate taxes, and prevent their avoidance through the splitting up of estates during the lifetime of the taxpayer." The formula for computing the gift tax is designed "to impose a tax which measurably approaches the estate tax which would have been payable on the donor's death had the gifts not been made and the property given had constituted his estate at his death." [22]

These are brave words, but here, too, the words speak louder than the deeds. Whatever merits the gift tax may have as a guardian of the income tax, it is not a redoubtable defender of the estate tax. It does not prevent "avoidance through the splitting up of estates"; nor does it "measurably" approach the estate tax that would have been paid if the gift had not been made. At best, the gift tax is a cut-rate transfer tax in lieu of the estate tax. It is a bargain made available to those who are willing to give before they die.

There are several familiar reasons why the gift tax functions this way. At the risk of repeating what has often been said, I shall briefly enumerate them. To begin with, the gift tax is computed separate and apart from the estate tax.[23] As a result, gifts are removed from the higher estate-tax brackets to the lower gift-tax brackets. Second, the gift tax has its own exemption, as well as annual exclusions. For a single person the exemption is $30,000 [24] and the annual exclusion is $3,000 per donee.[25] For a married person the exemption and exclu-

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[19] Generally speaking, these gifts are transfers in contemplation of death, transfers intended to take effect in possession or enjoyment at or after death, and transfers reserving certain rights or powers in the donor. For the present provisions, see Internal Revenue Code of 1954, secs. 2035 2040.

[20] At times the income tax creates a conflict of interest. The donor may hesitate to make a gift because his beneficiaries will lose a stepped-up basis for the property—its value on the date of death or on the alternate valuation date. See Internal Revenue Code of 1954, sec. 1014. In the same connection, the splitting of income between husband and wife has removed any income-tax incentive for gifts from one to the other.

[21] According to a recent comprehensive study, however, "the potential savings in estate taxes" are "much more important than the savings in income taxes as a stimulus to the making of gifts." Butters, Thompson, and Bollinger, Effects of Taxation—Investments by Individuals, p. 46 (1953).

[22] H. Rept. 708, 72d Cong., 1st sess., C. B. 1939-1, pt. 2, pp. 462, 477; S. Rept. 665, 72d Cong., 1st sess., ibid. at pp. 504, 525.

[23] Internal Revenue Code of 1954, sec. 2502. Where both taxes reach the same transfer, a credit for the gift tax is allowed against the estate tax. Ibid., sec. 2012.

[24] Ibid., sec. 2521.

[25] Ibid., sec. 2503.

sions are twice as much.[26] Third, the gift tax rates are only three-fourths of the estate tax rates.[27] Finally, the amount paid as gift tax is not included in the gift tax base, while the amount paid as estate tax is contained in the estate tax base.

The upshot of all these factors is that wealthy individuals are enabled to shift from higher estate taxes to lower gift taxes. The total tax paid depends not only on the amount transferred, but on the manner of its disposition. The dual system of transfer taxes is peculiarly profitable to the larger estates. If an owner of $10 million transfers $2 million by gift, the saving in transfer taxes can be as much as about $1.4 million.[28] However, benefits are also enjoyed by the smaller estates. Not so long ago the Treasury supplied a modest example. An individual has an estate of $300,000. If he bequeaths one half to his wife and one half to his 3 children, the estate tax is $17,500. But if he gives $180,000 to his wife and children over 5 years, and leaves $120,000 at death, no tax at all is due.[29] President Truman correctly observed that existing law "affords excessive opportunities for tax reduction by splitting between the gift and estate taxes the total amount of wealth transferred by an individual." [30]

I have said that the gift tax is a cut rate tax. But like other bargains, it does not always attract the customers. A Treasury analysis discloses that for decedents as a whole total gifts before death are relatively small as compared with total transfers at death. On the other hand, it also appears that "the greater the wealth the larger the part that is transferred inter vivos." Those who are supposed to be taxed the heaviest are enabled to avoid the most. Of the decedents studied, those who had between $500,000 and $1 million disposed of less than 10 percent of their aggregate property during life. But those who had more than $3 million disposed of more than 25 percent by gift.[31] While the wealthy are not fully sensitive to the savings bestowed by the gift tax, there is undoubtedly a leak in estate-tax revenue. And it is a nice question whether two individuals possessed of the same wealth should pay diverse transfer taxes because one is more tax conscious than the other or better able to make gifts before death.

The second initial inadequacy of the estate tax focuses on the skipping of tax through life estates. Again I am only referring to what is commonly known among tax lawyers. A little arithmetic will il-

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[26] Ibid., sec. 2518.

[27] Compare ibid., sec. 2001, with ibid., sec. 2502.

[28] In this example, I am assuming that there is no estate or gift splitting, and that the donor applies against the transfer of $2 million his gift-tax exemption of $30,000 but no exclusion. If the gift is not made, the estate tax is somewhat over $6 million. But if the gift is made, the gift tax is slightly over $550,000 and the estate tax a little over $4 million, or a total of about $4.6 million.

[29] See hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., pp. 6, 23 (1950). The second half of the example evidently assumes that over the 5-year period each child annually receives $6,000 and the wife $18,000. Each gift to each child is tax free because it falls within the annual exclusion. Of each $18,000 given to the wife, $9,000 is tax free under the marital deduction, and another $3,000 is tax free under the annual exclusion. The residue of $6,000 per year, or $30,000 over the 5 years, is covered by the gift-tax exemption. The $120,000 left at death is free from estate tax because of the exemption of $60,000 and a marital deduction of $60,000.

[30] Ibid., at p. 6.

[31] See ibid., at pp. 75, 77–82, 85. The transfers by gift include the amounts paid as gift tax, which are also removed from the estate tax base. See further the excellent discussion in Pechman, Analysis of Matched Estate and Gift Tax Returns, 3 National Tax Journal, p. 158 (1950). Pechman points out that in order to "minimize gift and estate taxes, individuals with total wealth of $5 million or more should have transferred at least 70 percent of their property during life." Ibid., at p. 159.

illustrate the problem. Assume that A has $3 million, as well as a son B and a grandson C. A bequeaths his estate outright to B, and B similarly bequeaths his estate outright to C. For the sake of simplicity I also assume that neither B nor C accumulates any additional wealth.[32] At A's death the estate tax is $1,231,400, leaving a balance of $1,768,600. At B's death the tax is $622,070, leaving a balance of $1,146,530. At C's death the tax is $359,446.70, leaving a balance of $787,083.30. However, the result is quite different if A bequeaths his $3 million in trust, if B and C are given successor life estates, and if the principal is ultimately payable to C's issue. At A's death the tax is still $1,231,400, but no tax is due when B and C die. The residue at C's death is then $1,768,600, or more than twice as much as the sum left if A, B, and C resort to outright bequests.[33]

Once more a Treasury survey is illuminating.[34] It indicates that decedents who leave net estates exceeding $500,000 place about 45 percent of their total transferred property in trust. Though there is "no consistent pattern of variation by size of *gross* transfers," those with larger accumulations put relatively more in trust than those with smaller accumulations. The transfers in trust range from one third to one half of gross transfers. To make matters worse, about 30 percent of the total transferred property is settled for two generations or more, and so the estate tax is skipped twice or more. The larger the amount of wealth transferred, the longer the average duration of the trusts. Decedents who transfer gross amounts between $500,000 and $1 million put less than 15 percent of their wealth into trusts for two generations or more. Decedents who transfer gross amounts exceeding $3 million put over 40 percent of their wealth into such trusts. It is "the wealthiest taxpayers" who "make the most effective use of the tax advantages of transferring property in trust."[35] These findings reinforce President Hoover's conclusion on the same subject. As he expressed it, "fortunes have become so large, and lawyers so cunning that they can freeze them into trusts extending over more than three generations."[36]

I do not detect any persuasive reason why this condition should be allowed to continue. Nor do I understand why the creation of long term trusts should be particularly encouraged. From the standpoint of the economy cogent arguments can be made that outright transfers should be taxed more leniently than transfers in trust. Private trusts are not conspicuous sources of risk capital.[37] At the very least, however, outright transfers should not be treated worse.

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[32] I am also assuming that none of the hypothetical estates is reduced by a marital deduction. If a marital deduction is taken somewhere along the line, it does not alter the essential point of the example. See also note 34, infra.

[33] Cf. H. Rept. No. 327, 82d Cong., 1st sess., p. 7 (1951).

[34] See hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., pp. 75–79 (1950).

[35] The Treasury's survey covered returns filed in 1945. It seems to remain valid except as it has been affected by the later adoption of the marital deduction. Simple life estates for surviving spouses do not qualify for that deduction (Internal Revenue Code of 1954, sec. 2056 (b) (1)), and hence less of those estates are created to the extent that other types of dispositions are used to obtain the deduction. But this is small comfort to the revenue. The surviving spouse can still set up life estates for the successors in interest, and the marital deduction gives them an additional tax saving which they would not otherwise enjoy.

[36] Vol. 3, The Memoirs of Herbert Hoover, p. 136 (1952).

[37] Cf. Friedrich, The Economics of Inheritance, in Social Meaning of Legal Concepts (No. 1), p. 32 (Cahn edition, 1948).

From the original infirmities of the estate tax I briefly turn to those which have been added. Here I reach what Professor Simons called "the Realpolitik of taxation." [38] The tax bar prefers to call the same thing a "technical amendment." It does not agree with Shakespeare that a rose by any other name always smells as sweet. The policy of "the Realpolitik" or "technical amendment" may seem devious but it is never obscure. The lesson which it conveys is very simple. The best way to handle progressive taxes is to leave the rates alone and redefine the base through "technical amendments." This formula for success is much more impressive than the method used by Secretary Mellon. The Secretary stubbornly persisted in making frontal attacks on the rate structure. He failed to realize that in tax law it is often wiser to be subtle than bold. Besides, "technical amendments" have other solid virtues which should not be overlooked. The tax reduction is more selective and the revenue loss is less disturbing. And, not to be overlooked, appearances are better maintained that way. The table of rates continues to look as effective as ever, and almost everybody continues to speak highly of ability to pay.

The estate tax has been no more able to escape "technical amendments" than the income tax.[39] Its base is meticulously defined and efficiently eroded. And so, while the rates have not been touched since 1941, the burden has nevertheless diminished. In recent years the principal "technical amendments" have dealt with the marital deduction, gifts in contemplation of death, and the proceeds of life insurance.[40]

The marital deduction is an exemption which is felicitously called something else. It excludes from a decedent's taxable estate his bequests and other transfers to his surviving spouse.[41] If the decedent is married and fully uses the deduction, half of his entire net assets, as well as the $60,000 of exemption, passes tax free. It makes no difference how substantial the estate may be. The larger the estate, the larger the deduction. Without resorting to the language of arithmetic, the marital deduction provides, in effect, an alternative rate schedule. It enables the decedent to divide his estate in two, so that each share is separately taxed. The share which is without the deduction is taxed at the decedent's death. The share which is within the deduction is later taxed at the spouse's death.[42] Regardless of what the rates may suggest, the top rate of 77 percent applies to taxable estates exceeding $20 million rather than $10 million.

I do not mean to imply that a marital deduction is inherently wrong in principle. Even Andrew Carnegie felt that a widow should be allowed a "moderate" source of income after her husband was gone. My criticism is directed rather to the principle as now applied. It is not impossible to have a marital deduction which leaves the rate progression undisturbed. To illustrate, upon the surviving spouse's

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[38] Simons, Federal Tax Reform, p. 16 (1950). See also Simons, Personal Income Taxation, pp. 218–219 (1938).

[39] See Randolph E. Paul's paper entitled "Erosion of the Income-Tax Base and Rate Structure."

[40] For present purposes I put aside the amendments provoked by the Supreme Court's decisions on reserved life estates and retained reverters in *Commissioner v. Estate of Church* (335 U. S. 632 (1949)), and *Estate of Spiegel v. Commissioner* (335 U. S. 701 (1949)).

[41] Internal Revenue Code of 1954, sec. 2056.

[42] If the surviving spouse makes gifts before death, as is often the case, the tax saving is still greater because of the gaping discrepancy between the estate tax and the gift tax.

death the amount previously allowed as a marital deduction could be taxed at rates determined by adding that amount to the first decedent's taxable estate. The tax on that amount would then be merely deferred, not also reduced.[43] I fail to see why the size of the estate which finally passes to the children and other descendants should be more or less, depending on whether a marital deduction was previously taken. The marital deduction should benefit only the marital partner.[44]

It is not easy to measure the revenue loss for which the deduction should be blamed. The calculation turns on how married decedents would have disposed of their property in the absence of the deduction.[45] Here we can at best indulge in educated guesses. For example, one husband may bequeath all his property outright to his wife. He might well have done the same though the marital deduction had never been enacted. Another husband may leave half of his property outright to his wife and half for her in trust. If there had been no deduction, he might have preferred to place all his property in trust for her benefit. The tax reduction in the first case is not the same as in the second case.[46]

While it is difficult to measure the revenue loss, it is at least possible to make a conservative evaluation.[47] A cautious appraisal is better than none. I have, therefore, approached the problem in the manner of Holmes' famous "bad man."[48] I have assumed that the prospective decedent very carefully calculates the best tax consequences available to him and makes his choice accordingly. I have eliminated any tax which the Treasury might collect, in the absence of the marital deduction, because of his negligence or indifference. If there were no marital deduction, our hypothetical decedent would place all his property in trust for his wife in order to skip a further tax at her death. In view of the marital deduction, he leaves her one-half outright and one-half in trust. As a result, the half left in trust is taxable at his death,[49] while the half owned outright is taxable at her death.

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[43] A provision to this effect would have to be refined to deal with a number of problems, such as inter vivos gifts by the surviving spouse and community property. Since it is well nigh impossible to do very much about community property, perhaps the only ultimate solution, if any comes, is a separate and higher rate schedule for marital deduction property and community property when the second spouse dies.

[44] There seem to be more decedent-husbands than decedent-wives. Of 753 returns filed in 1945 for larger estates, 343 or 46 percent represented husbands who died first, and only 56 or 8 percent represented wives who died first. These figures do not include spouses living apart. Among the other decedents, 105 or 14 percent were widowers; 153 or 20 percent were widows; and 79 or 11 percent were single. See hearings before the Committe on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., p. 76 (1950).

[45] Apparently more than 52 percent of the wealthier decedents die married. See footnote 44, supra.

[46] Assume that each of these husbands leaves a net estate of $1 million before exemption; that the tax due at his death is paid entirely out of principal; that, apart from this diminution of the estate, it remains the same until the wife dies; and that the wife has no other property. In the first case, without the marital deduction, the tax is $303,500 at his death and $193,475 at her death, or a total of $496,975; with the marital deduction, the tax is $126,500 at his death and $256,695 at her death, or a total of $383,195. In the second case, without the marital deduction, the tax is $303,500 at his death and nothing at her death, or a total of $303,500; with the marital deduction, the tax is $126,500 at his death and $126,500 at her death, or a total of $253,000. These computations are not reduced by the State credit.

[47] In 1948 the Treasury estimated the estate and gift tax loss at $250 million. See hearings before the Committee on Finance on H. R. 4790, 80th Cong., 2d sess., p. 24 (1948). In 1950 it appraised the loss as about $300 million, or one-third of the revenue from both taxes. Hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., pp. 5, 126, 130 (1950). These estimates, I gather, are too large because they do not take into account the tax later payable when the property is transferred by the surviving spouse.

[48] Holmes, Collected Legal Papers, pp. 170-171 (1920).

[49] I am assuming that the tax on the half in trust is payable out of the trust.

On the assumptions which I have just made—which necessarily understate the revenue effects of the deduction[50]—the reduction in effective rate varies between 14 and 100 percent for estates ranging from $100,000 to $10 million.[51] The following table indicates the extent of the revenue loss at various levels:[52]

Taxable estate before exemption	Effective rate without marital deduction	Effective rate with martial deduction	Percentage of reduction
	Percent	*Percent*	
$100,000	4.8		100
$150,000	11.7	1.4	88
$200,000	15.8	4.8	70
$250,000	18.1	8.6	53
$300,000	19.7	11.7	41
$400,000	21.9	15.8	28
$500,000	23.3	18.1	22
$750,000	25.6	21.4	16
$1,000,000	27.0	23.3	14
$2,000,000	31.3	27.0	14
$5,000,000	40.8	33.2	19
$7,500,000	46.1	37.4	19
$10,000,000	49.8	40.8	18

The reductions shown by the table are instructive in several respects. First, the estate tax is pretty much eliminated in the bottom brackets. Though the progression is very rapid there, it hurriedly leads nowhere. Second, the marital deduction drastically erodes the progressive rate structure. As the last column indicates, the tax cut is more substantial where the progression would otherwise be more telling. The reduction in effective rate is 53 percent for an estate of $250,000, and 14 percent for an estate of $2 million. Third, the benefits do not respond to any intelligent principle of rate reduction. Why, for example, should the effective rate on an estate of $10 million be reduced by 18 percent, while the effective rate on an estate of $750,000 is reduced by 16 percent? Why should the percentage reductions for estates of $1 million and $2 million be the same? Why should the tax on an estate of $5 million be reduced almost to the same extent as the tax on an estate one-tenth its size? In fact, for estates within the sweeping range of $750,000 to $10 million the percentage of reduction varies only between 14 and 19 percent. If lawyers requested this kind of reduction by a candid revision of the rates, they would be greeted with appropriate displeasure. They have obtained precisely the same result by a "technical amendment."

The next "technical amendment" involves gifts made in contemplation of death. The Federal estate tax has always embraced gifts of this kind.[53] As the Supreme Court has stated, "The dominant purpose is to reach substitutes for testamentary dispositions and thus to pre-

[50] The understatement is particularly true of the smaller estates, since trusts and life estates are used more by owners of the larger estates.

[51] I am referring here to taxable estates before the deduction of the $60,000 exemption.

[52] This table is constructed from the table appearing in hearings of the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., p. 25 (1950). The effective rate in the third column represents the sum of the tax paid on half of the property at the husband's death and the tax paid on half at the wife's death, divided by the estate left at the husband's death. The table reflects Federal tax liabilities after allowance of the maximum credit for State taxes.

[53] The present provision appears in Internal Revenue Code of 1954, sec. 2035. For the development of the concept of "contemplation of death," see Federal and State Death Taxes, Reports to the Joint Committee on Internal Revenue Taxation, pp. 55, 109 (1933); Bradford, Evolution of the Meaning of the Words "Gifts Made in Contemplation of Death" in Inheritance Tax Legislation, 9 Virginia Law Review, pp. 267, 269 (1923).

vent the evasion of the estate tax."[54] A gift is deemed in contemplation of death—

> where for any reason the decedent becomes concerned about what will happen to his property at his death and as a result takes action to control or in some manner affect its devolution.[55]

A decedent-to-be has the requisite concern, for example, if he makes a gift to avoid the estate tax.[56] In 1950, Congress provided that gifts in contemplation of death are not subject to estate tax if made more than 3 years before death.[57]

Under the present dispensation avoidance is exceedingly easy. A donor may make any number of gifts in contemplation of death, and no estate tax is due as long as he survives 3 years. It makes no difference that the gifts derive solely from a desire to avoid the tax. Admittedly, the contemplation-of-death statute has not been a model provision. Any statute which makes motive the touchstone of taxability breeds administrative difficulties. But a feeble statute is no substitute for a troublesome one—especially if the basic design is to prevent tax avoidance. Even the tax committees which approved the 3-year rule made a significant confession. "Undoubtedly," they declared, "many gifts have escaped the estate tax because of the difficulty which the Government encounters in reconstructing the motives of the deceased."[58] This "difficulty" was resolved by making avoidance less difficult.[59]

The third prominent "technical amendment" takes care of insurance on the decedent's life. Under the 1939 code, as revised in 1942, insurance payable to specific beneficiaries was taxable if the decedent either paid the premiums or had any incident of ownership at death.[60] This twofold rule disposed of a problem which was about as old as the estate tax. Originally the provisions of the tax omitted to mention life insurance. Before long the Ways and Means Committee made an unpleasant discovery. It learned that "wealthy persons" were "resorting" to the purchase of insurance as a "method of defeating the estate tax." Insurance agents had "openly urged persons of wealth to take out additional insurance" because it would not be taxable.[61] The amendment of 1942 sought to make sure that this problem was adequately solved. It wisely recognized that, regardless of tax motivation in a particular case, life insurance is "testamentary" in nature.[62] For the essential function of insurance is to serve as a will.

In its heroic tax revision of 1954 Congress methodically undid its solution of 1942. It abolished the premium payment test. Insurance is no longer taxable, though carried by the decedent, if he surrenders all incidents of ownership before death.[63] Hence insurance proceeds

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[54] *United States* v. *Wells*, 283 U. S. 102, 116–117 (1931).
[55] *Allen* v. *Trust Co. of Georgia*, 326 U. S. 630, 635 (1946).
[56] Ibid., cf. *Farmers' Loan & Trust Co.* v. *Bowers*, 98 F. 2d 794 (2d Cir. 1938), certiorari decided 306 U. S. 648 (1939); *First Trust & Deposit Co.* v. *Shaughnessy*, 134 F. 2d 940 (2d Cir. 1943), certiorari denied 320 U. S. 744 (1943).
[57] 1950 act, sec. 501 (a). This amendment is now incorporated in Internal Revenue Code of 1954, sec. 2035 (b).
[58] H. Rept. 2319, 81st Cong., 2d sess., p. 62 (1950); S. Rept. 2375, 81st Cong., 2d sess., p. 57 (1950). See also hearings before the Committee on Ways and Means on revenue revision of 1950, 81st Cong., 2d sess., pp. 74, 162 (1950).
[59] See H. Doc. 523, 80th Cong., 2d sess., p. 58 (1947).
[60] Internal Revenue Code of 1939, sec. 811 (g), as amended by 1942 act, sec. 404. Depending on the circumstances, insurance was also taxable if it was transferred before death and if the transfer was in contemplation of death, intended to take effect in possession or enjoyment after death, or subject to certain powers or interests in the decedent. See Paul, Federal Estate and Gift Taxation, sec. 10.39 (supplement 1946).
[61] H. Rept. 767, 65th Cong., 2d sess., C. B. 1939–1, pt. 2, p. 102.
[62] H. Rept. 2333, 77th Cong., 2d sess., p. 57 (1942).
[63] Internal Revenue Code of 1954, sec. 2042.

should virtually disappear from the estate tax base. As a practical matter, the tax has returned to the situation of 1918. It is not too rash to assume that insurance agents are busily giving the same advice now that they zealously gave then. If this assumption is for some reason erroneous, I must reluctantly conclude that they are strangely derelict in the performance of their duties.

The avoidance which is now authorized may be illustrated by a small example. A 40-year-old individual has a wife and 3 children. He buys $900,000 of insurance for them by paying annual premiums of $6,000 per beneficiary. He retains none of the incidents of ownership. Each premium is a nontaxable gift because it falls within the annual exclusion or the marital deduction.[64] At the insured's death the entire $900,000 is received taxfree.[65] I can add little to what Congressman Eberharter has said. As he has observed, "wealthy individuals" may again "—as they once did—pass on large portions of their wealth through the form of life insurance without paying an estate tax."[66]

B. The social objective

I have yet to consider the operation of the estate tax in terms of its social objective—the leveling of hereditary wealth. Here the critical question is not how much the tax should produce, but how much the heirs should keep. A good deal of my prior analysis equally applies here. To the extent that the tax fails to corral available revenue it increases the shares which pass to the heirs. But the two questions are nevertheless separate and distinct. The permissible size of inherited wealth is an issue to be resolved on its own in the light of social policy. While one answer may collaterally yield more revenue than another, the wisdom of the answer has little to do with revenue.

Having made this distinction, I am still not out of the woods. It is generally agreed that the estate tax should, in the language of the Finance Committee, "prevent undue accumulation of wealth."[67] An undue accumulation, it seems, is an accumulation that is considered excessive for social reasons. Or, to state the obvious, a premeditated policy of leveling presupposes that if an estate left at death is too large, it should be made less large. But how large is too large? And how can we tell whether an estate which is overly ample has been adequately reduced? If we are to make an intelligent appraisal, we must have a discriminating standard which guides our appraisal. A word like "undue" may be convenient, but it is rarely instructive.

In order to find some standard I return to the two Presidents who helped make the social objective of the tax politically palatable. Little would be gained by looking elsewhere. Insofar as Congress is concerned, they have articulated the only criteria which have been at all meaningful.

The first Roosevelt was less than meticulous. He distinguished between "a small fortune" and "a very large fortune"—which he also called enormous and swollen. And he advocated a heavy progressive

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[64] Internal Revenue Code of 1954, secs. 2503, 2513, 2523; Revenue Ruling 55-408, IRB 1955 26, p. 32.

[65] See 94 Congressional Record 7906 (1948).

[66] Ibid. at 7907. The 1954 code has added a cognate loophole. Benefits payable under a tax-exempt pension plan, attributable to the employer's contributions, are not subject to estate tax. Internal Revenue Code of 1954, sec. 2039 (c). For some mysterious reason these benefits are considered more worthy of immunity than other property which passes at death. See H. Rept. 1337, 83d Cong., 2d sess., p. 90 (1954); S. Rept. 1622, 83d Cong., 2d sess., p. 471 (1954).

[67] See discussion at note 74, supra.

tax on all fortunes beyond a certain amount so that only a certain amount would pass to any one individual.[68] But he failed to indicate when an estate is sufficiently swollen so that it should be leveled, and when an estate is sufficiently leveled so that it ceases to be swollen. At what point does a fortune cease to be small? Is an estate of $2 million small or large? Or is any fortune small if it is not quite enormous? Even if everyone agreed on the size of a small fortune, an obtrusive ambiguity would remain. For the crucial words "a certain amount" are too laconic to be informative. This phrase can be read as proposing an ultimate and absolute ceiling on inheritance. On the other hand, it may have inartistically expressed a more customary notion—that heirs of large fortunes should receive diminishing portions as the progressive rates move upward.

The second Roosevelt was more helpful, though he, also, was not unambiguous. He contrasted "fortunes" and "accumulations" which are great and vast with a reasonable inheritance which adequately serves to provide security for one's self and one's family.[69] In his view a reasonable inheritance along these lines was enough. Of course, a reasonable inheritance does not carry the same arithmetical connotations to everybody. The most reasonable minds will quarrel over what is reasonable. Yet despite its ambiguity the concept employed by the President supplies a useful framework for analysis. It expresses an economic standard which has a familiar content, no matter how vague it may be at the outer edges. All large concepts are inevitably ambiguous. Nevertheless we use them since we cannot do without them.

Now that we have the standard, let us apply it. On two occasions—in 1934 and in 1935—the rates were supposedly rearranged to level estates as well as raise revenue. In 1934, as I have already noted,[70] the Finance Committee constructed a new rate structure, reaching a maximum of 50 percent on net estates over $10 million. Apparently the committee thought that the progressive rates below 50 percent would sufficiently appropriate any "undue" accumulation below $10 million, and that the top rate would effectively remove any "undue" residue above that amount. More specifically, under the committee's rates an estate of $10 million, including the exemption, would have borne a tax of about $3.4 million, or less than 35 percent of the fortune left at death. Congress proceeded further. It increased the rates to a maximum of 60 percent, so that the tax on an estate of $10 million became about $4.1 million. In 1935 the committee raised its sights. It persuaded Congress to appropriate about 50 percent of an estate of $10 million, and about 65 percent of an estate of $50 million.[71]

Effective rates of this kind do not transform "large fortunes" into "a reasonable inheritance." They are undoubtedly substantial and they obviously cut deep. But they still leave about $5 million in an estate of $10 million, and more than $17 million in an estate of $50 million. Though Congress raised the rates twice after 1935,[72] the increases are insignificant in the present context. Neither of them

[68] See the discussion beginning at note 28, supra.
[69] See the quotation at note 78, supra.
[70] See discussion at note 74, supra.
[71] See discussion at note 80, supra.
[72] See discussion at note 82, supra.

derived from any animus against the transmission of hereditary wealth. In any event, they do not particularly change the picture. If a full marital deduction is taken, an estate of $10 million now bears an effective rate of about 19 percent. On the same assumption an estate of $50 million bears an effective rate of about 70 percent.[73] In either case the residue that lingers on—$8.1 million in one case and $14.7 million in the other—seems more than a "reasonable" provision for the "security" of one's family. Indeed, I should confess that I am guilty of exaggeration. The tax burdens as I have computed them are a good deal imaginary. They do not take into account the tax avoidance that goes on via the loopholes in the base. Taxes are substantially reduced or entirely skipped. The proud possessor of $10 million is not prone to await the impact of the tax in helpless fashion.

However, if all the loopholes were closed, the rate structure would still be seriously defective. A policy of leveling is rooted in the tacit premise that if an estate exceeds a certain amount—whatever that amount may be—the excess should be taken away. It logically follows that as the excess becomes larger, the progression should become sharper. The rate structure of the estate tax is wholly at odds with a policy of leveling. As the size of an estate increases, the rate of progression decreases.[74] The rates do precisely what they should not do.

Under a genuine policy of leveling it is not enough that the rates progress the right way. Congress must also decide upon the appropriate size of a reasonable inheritance which adequately maintains the decedent's family. Beyond that point the rates should be very high if the remainder of the estate is to be seriously leveled. The problem, then, is, when does an estate become more than reasonable? Herbert Hoover thoughtfully suggests that "moderate inheritances under, say, $100,000" are a reasonable "provision for dependents." "Several millions of dollars," he feels, "is economic power and too often it falls into the hands of persons of little intention to use that power for public benefit either in expansion of enterprise and employment or for public services. It is the breeding ground of playboys and playgirls of morally obnoxious and degenerating character."[75] While Hoover's views probe an absorbing question, Congress has preferred to leave it unresolved.[76]

III. A Final Appraisal

It would be pleasant to end on a note of modest optimism. Unfortunately, I am considerably restrained by my own analysis. The estate tax, I believe, is in a period of decline. Unlike its predicament in the Mellon era, the present problem is not so much sudden death as chronic illness. If the past is a guide to the future, the tax

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[73] These computations are before reduction for the State credit. They are made on the basis of the facts outlined in the discussion at note 48 supra, and presuppose that only half of the estate is taxed at the death of each spouse. In short, the calculated burden is the sum of the two taxes on the separate halves.

[74] See discussion at note 114, supra.

[75] 3 The Memoirs of Herbert Hoover, p. 136 (1952). Through Hoover regards an individual inheritance of $100,000 as sufficient, he seems reluctant to impose heavy rates immediately beyond that amount. He also thinks that a death tax on individual shares is better than a death tax on the estate as a whole. Ibid.

[76] Though the English estate tax is often viewed as an effective leveler of wealth, the results are not so impressive as they are reputed to be. In the period 1911–13, 1 percent of the population held 65 percent of privately owned property. In the period 1946–47, 1 percent still held 50 percent. See Tawney, Equality, p. 275 (1951 edition).

should continue to ail for some time. Very few seem to be concerned about its condition, and I see little help on the horizon. Until 1952 the tax had a friend in the Treasury. That friend is now gone, too.

The tax fares poorly when the economy is in high gear. What was true in the twenties has been true in the forties and fifties. Congressman Green has proved to be an accurate prophet. In "more prosperous times," he wrote in 1933, a renewed war on the tax should be expected. "No purpose is more persistent in the minds of most of those who have large estates than increasing them and keeping them perpetually in the family. There are many exceptions, but this is the general rule."[77] The tax has been popular in Congress only during war or depression. But even these crises no longer seem to suffice. Throughout our participation in World War II and the Korean hostilities Congress refrained from raising the rates or reducing the exemption. And since deficit financing has become more respectable, the tax may well be ignored in any future depression.

Yet, apart from its limited base, it is hard to devise a better tax than a death tax.[78] Estates represent ability to pay. And as they are mere windfalls to the beneficiaries, they should be taxed more heavily than any other kind of acquisition.[79] To quote an appraisal of Civil War days, "there is no property upon which a tax can better be laid than upon inheritances."[80] The argument will, of course, be made that it is foolish to seek more revenue from the estate tax, since the additional yield will be relatively small. While this point is often made, it is always irrelevant. One may just as cogently contend that various income-tax loopholes should be ignored because they benefit only a few and hence the revenue loss is minor. The question is not whether the estate tax will produce much more or little more when compared with other taxes. The question is whether estates constitute available sources of revenue which are insufficiently tapped. Congress should seek its revenue wherever it may appropriately find it.

The argument is too facile for another reason. Even if Congress is uninterested in obtaining more revenue, it should still enlarge the yield of the estate tax. The additional revenue would compensate for tax reductions which Congress might like to make elsewhere. For example, there is much talk these days of relief for the upper income-tax brackets. If we assume that this relief is desirable, the estate and gift taxes are available as an offset against the resulting revenue loss. By raising rates and lowering exemptions Congress could derive another $500 million from these taxes. Aside from replacing relinquished revenue, this increase would improve the political feasibility of relief for high incomes.

The income tax brings to light another role for the estate tax. It is no secret that the income-tax base is riddled with loopholes which I need not catalog. More and more taxpayers are relieved of the taxes which the progressive rates suggest that they owe. Apart from special dispensations for select groups, the corporate entity is a general sanctuary from the impact of progression. It permits the accumu-

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[77] Green, The Theory and Practice of Modern Taxation, p. 171 (1933).
[78] Cf. Twentieth Century Fund, Facing the Tax Problem, pp. 415, 501 (1937).
[79] Cf. *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941, 942 (Ct. Cls. 1952).
[80] 32 Congressional Globe 1534 (1862). Cf. ibid. at Appendix 232. See also Smith, The United States Federal Internal Tax History From 1861-71, p. 107 (1941).

lation of earnings after a top rate of 52 percent in lieu of 91 percent. In brief, there are discriminations between personal service income and investment income; between certain personal service income and other personal service income; between certain investment income and other investment income; and between individual income and corporate income. By the grace of Congress various taxpayers are not bearing the burden which their fellow taxpayers are expected to endure with equanimity and fortitude. In these circumstances perhaps the only practical solution is a vigorously effective estate tax. Congress' undue generosity would cease at death, and the estate tax would serve as a delayed income tax.[81] Death taxes have often been justified as compensatory levies on those who escape their share of the fiscal burden during life.[82] Though this view is not without its defects, it still contains a hard core of truth. If the income tax fails to do its job, only the estate tax can assure an eventual day of reckoning.

Finally, the estate tax should be made a true leveler of wealth beyond "a reasonable inheritance" for the "security" of the decedent's family. I need not rehearse the old and familiar arguments which sustain this conclusion.[83] It seems sufficient to say that an economic system which prides itself on equality of opportunity should level "unreasonable" estates without compunction.[84] Wedgwood has observed that there are three sources of economic inequality: unequal ability, unequal luck, and unequal inheritance.[85] Unequal luck seems bad enough without unequal inheritance.[86] The mere incident of birth is not a significant contribution to society.

Obviously a system of private enterprise presupposes disparities in wealth; and inequality of property among parents engenders inequality of opportunity among children. To that extent we are committed to less than full equivalence of opportunity. But it does not follow that inequality justifies much more inequality. In other words, large differences in wealth do not inevitably imply the same large differences in inherited wealth. For that matter, inheritance of any kind is neither a necessary nor inherent attribute of private property.[87] It is not impossible to have individual ownership with-

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[81] Bastable maintained that "the death duties" are "a capitalized income tax levied only on accumulated wealth, and sparing those comparatively temporary parts of income that result from personal exertion." Bastable, Public Finance, p. 594 (third edition revised and enlarged, 1922). See also ibid. at p. 608. Cf. Pigou, The Economics of Welfare, p. 718 (1920); Shirras and Rostas, The Burden of British Taxation, p. 77 (1943); Stamp, The Fundamental Principles of Taxation, p. 163 (new and revised edition, 1936).

[82] See Seligman, Progressive Taxation in Theory and Practice, p. 214 (1894); Seligman, Essays in Taxation, p. 131 (seventh edition, 1911); Shultz, The Taxation of Inheritance, p. 193 (1926); Federal and State death taxes, reports to the Joint Committee on Internal Revenue Taxation, p. 100 (1933). This argument played an important part in the development of death taxes in this country. See West, The Inheritance Tax, p. 204 (second edition, 1908).

[83] Many of them are stated with admirable brevity and clarity in Franklin D. Roosevelt's message of 1935. See H. Rept. 1681, 74th Cong., 1st sess., C. B. 1939-1, pt. 2, p. 643.

[84] Secretary Mellon argued differently. He thought that an estate tax frustrated equality of opportunity. See Mellon, Taxation: The People's Business, p. 123 (1924).

[85] Wedgwood, The Economics of Inheritance, p. 81 (Pelican edition, 1939).

[86] See Friedrich, The Economics of Inheritance, in Social Meaning of Legal Concepts (No. 1), p. 35 (Cahn edition, 1948). In 1930 Julius Rosenwald estimated that 95 percent of the large fortunes were due to luck. See Myers, The Ending of Hereditary American Fortunes, p. 236, note 8 (1939).

[87] See Seligman, Progressive Taxation in Theory and Practice, p. 214 (1894); Seligman, Essays in Taxation, p. 122 (seventh edition, 1911); West, The Inheritance Tax, p. 223 (second edition, 1908); Cohen, Law and the Social Order, p. 29 (1933). John Stuart Mill sought to distinguish between intestate succession and testate succession. He reasoned that "the right of bequest, or gift after death, forms part of the idea of private property," while "the right of inheritance, as distinguished from bequest, does not." 1 Mill, Principles of Political Economy, book 2, ch. 2, sec. 3 (fifth edition, 1894). But insofar as immediate heirs are concerned, this distinction was insignificant in Mill's scheme of thought.

out devolution by will or intestacy. However, I am not in the least inclined to argue for the abolition of inheritance. My position is a good deal milder. In my view, inheritance exhausts its useful purpose once it provides for the comfort of the surviving spouse and prepares the offspring to live by their own exertions.

Many years ago John Stuart Mill made a proposal which we would do well to borrow and revise. The estate tax should fix a limit on "what anyone may acquire by the mere favor of others without any exercise of his faculties." If "he desires any further accession of fortune, he shall work for it."[88] Or in Theodore Roosevelt's exuberant language, he should "show the stuff that is in him when compared with his fellows."[89] When inheritance does much more, it gravely and inexcusably augments inequality of opportunity. It then becomes hereditary economic power, which is no more tenable than hereditary political power.[90] As Roger Babson so succinctly put it, "I do not see why the control of ten or twenty thousand men should descend by inheritance through the death of some manufacturer, any more than the control of a city or a State should pass on to the son of a mayor or a governor."[91]

Professor Berle has recently reminded us of Jefferson's "picture of the ideal United States." It was "a country in which none was very rich; none very poor; all were producers, all owners and consumers."[92] Within its limitations the estate tax has much to contribute toward the consummation of Jefferson's vision.

PROPERTY DISPOSITION UNDER THE FEDERAL ESTATE AND GIFT TAXES

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INTRODUCTION

The purpose of this paper is to describe the types of property dispositions individuals make today largely because of the present Federal estate and gift tax laws. No attempt is made herein to determine whether such property dispositions are good or bad for the economy of the country or whether they are desirable or undesirable for the human beings who are the beneficiaries thereof.

What is the test for determining what property dispositions are made largely because of the Federal estate and gift tax laws? Certainly the test is not whether the sole motivation for the making of the disposition is to avoid Federal estate or gift taxes. Under such a test very few, if any, present day property dispositions would qualify because normally there are other influential factors that play a significant part in molding the final form of the disposition. The other factors may be Federal income-tax considerations, State tax laws, in-

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[88] 1 Mill, Principles of Political Economy, book 2, ch. 2, sec. 4 (fifth edition, 1894). Mill would have controlled the size of bequests by a direct limitation.

[89] See quotation at note 33, supra.

[90] See Nathanson, the Ethics of Inheritance, in Social Meaning of Legal Concepts (No. 1), p. 89 (Cahn edition, 1948); Cohen, Law and the Social Order, p. 31 (1933).

[91] Myers, The Ending of Hereditary American Fortunes, p. 255 (1939).

[92] Berle, The 20th Century Capitalist Revolution, pp. 29-30 (1954).

dividual characteristics of the beneficiaries involved, the nature of the assets subject to disposition, etc.

If the selection of a particular form of property disposition eliminates or minimizes Federal estate or gift tax costs, it is believed fair to conclude that the property disposition involved is one made largely because of the present Federal estate and gift tax laws. Thus our search is for the types of property dispositions that meet this test and which reasonably might be made in normal family situations.

Logically the next step would be to ascertain to what extent individuals take advantage of such property arrangements. No scientific investigation has been made to determine how widely the property dispositions later described are used.[1] Any statements made herein as to the extent of use are nothing more than guesses of the author based on his own personal experience in the preparation of estate plans and based on his discussion of the matter with lawyers and others in various parts of the country.

The analyses which follows has three phases. They are as follows.

First phase.—Property dispositions where the property owner desires to retain complete control of the subject matter involved until he dies but wants to reduce to the minimum the Federal estate taxes payable on his death.

Second phase.—Property dispositions where the property owner wants to eliminate from his gross estate for Federal estate tax purposes certain assets even at the expense of loss of control over such assets.

Third phase.—Property dispositions where the property owner's objective is to avoid the impact of estate and gift taxes on the transferred property on the death of or on a transfer by a beneficiary.

First Phase—Retention of Complete Control Until Death

If the property owner desires to retain complete control over his assets until he dies, he will not encounter any gift tax problem because by hypothesis he will not make any gifts during his lifetime. As far as estate taxes on his death are concerned, they can be reduced by his property dispositions taking effect on his death only to the extent such dispositions either keep the value of the property disposed of from going into his gross estate or make such value deductible from his gross estate.

Exclusion from gross estate

Section 2039 (c) of the 1954 code provides that there shall be excluded from the gross estate of a decedent the death benefit payable under a qualified pension plan to the extent such benefit is not attributable to payments made to the plan by the deceased employee. If the plan is entirely noncontributory, the entire death benefit is excluded from the deceased employee's gross estate. The section, however, is not applicable if the death benefit is payable to the deceased employee's executor. Thus the manner of disposition of this asset has a direct bearing on the estate tax which may be imposed on the employee's death.

[1] For an attempt to determine what proportions of wealth owned by individuals are transferred during life by matching estate- and gift-tax returns, see Joseph A. Pechman, Analysis of Matched Estate and Gift Tax Returns, National Tax Journal, vol. III, p. 153.

If it is determined that the liquid funds of the employee death benefit are needed to meet various death obligations of the employee, such benefit should be made payable to the trustees of an inter vivos trust established by the employee and such trust should contain a provision authorizing the trustees to pay various death obligations of the employee. In this way, the employee death benefits will be kept out of the *gross* estate of the employee (assuming the death benefits are payable under a qualified noncontributory pension plan) because the same are not payable to his executor but they will be available to meet death obligations for all practical purposes to the same extent as if they had been payable to his executor.

A donee of a power of appointment has control over the devolution of the appointive assets within the limits established by the donor of the power in the instrument creating power. Section 2041 of the 1954 code defines the circumstances under which the value of the appointive assets will be includible in the *gross* estate of the donee of the power. In two instances, the action taken by the donee of the power will cause the value of the appointive assets to be includible in his *gross* estate whereas if such action had not been taken such assets would have been excluded.

The first instance is whether the donee's power is a *general* one and was created on or before October 1, 1942, and the donee exercises the power. His action in exercising such power causes the value of the appointive assets to be includible in his *gross* estate. If he allows the property to pass to the takers in default of appointment, though in effect it is he who determines that they take by not exercising the power, the value of the appointive assets will be excluded from his *gross* estate. Thus, it is only under very special circumstances that the donee of such power should exercise the same.

The second instance is where the donee has an exempt power of appointment but exercises the same by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such power, for a period ascertainable without regard to the date of the creation of the first power. Section 2041 (a) (3) provides that such action on the part of the donee of the power will cause the value of the appointive assets to be included in his *gross* estate. This provision was inserted in the Internal Revenue Code to take care of the situation in Delaware where the validity of interests created by the exercise of a power of appointment, whether the power of appointment is general or special, is judged for purposes of the rule against perpetuities from the date the power is exercised rather than from the date the power is created. However, residents of States other than Delaware must be careful or the exempt character of a power being exercised may be destroyed under this section of the code. For example, if the donee of a special power of appointment exercises the same by giving the appointee a life interest in the appointive assets with a general power to appoint the same by deed or by will, he will destroy the exempt character of his power because he will have created another power of appointment which can be validly exercised to create interests the validity of which will be judged from the date the second power is exercised rather than from the date of the crea-

tion of the first power. This situation is within the language of section 2041 (a) (3) but does not present the danger that led to the enactment of that section because the value of the appointive assets will be includible in the gross estate of the donee of the second power whether he exercises the same or not. Section 2041 (a) (3) was enacted to prevent the creation of an indefinite succession of new powers with respect to appointive assets that would keep the appointive assets out of the gross estate of each successive donee.

Deduction from gross estate

Property dispositions that will reduce the impact of estate taxes on the transferor's estate because the value of the transferred property is deductible from (not excluded from) his gross estate in determining the taxable estate will be either estate tax marital deduction gifts or charitable gifts. The marital deduction, of course, will be available only if the transferee is the transferor's spouse and survives the transferor.

An estate tax marital deduction gift may take the form of an outright transfer, a transfer of a legal life interest in the spouse with a general power of appointment, a transfer in trust with the income payable for life to the spouse and a general power of appointment, or a transfer of a life interest (legal or equitable) to the spouse with remainder to her estate (other forms of transfer may also meet the tests laid down by section 2056 of the 1954 code). The probabilities are that the estate tax marital deduction is causing a substantial amount of wealth to be placed in the so called power of appointment trusts which give the surviving spouse the power to control the devolution of the property on her death, whereas if the marital deduction did not exist such control would not be given.

If a person has control over the disposition of assets not includible in his gross estate (such as certain employee death benefits or certain appointive assets), it is unwise from a tax standpoint to give such assets to his surviving spouse in a form that will cause them to be added to the gross estate of such spouse. The transfer of such assets to the surviving spouse will never qualify for the estate tax marital deduction because such deduction is available only with respect to property included in the deceased spouse's gross estate.

The net cost of making charitable gifts depends on the top estate-tax bracket of the transferor's estate. Many charitable gifts which are made undoubtedly would not be made if no estate-tax charitable deduction existed.

If a person plans to establish an inter vivos charitable trust so that the full amount of the income realized from property placed in the trust will be free from any income tax, it may be desirable estate taxwise for him to set up such a trust so that it will remove the income from the trust property from his gross income for income-tax purposes, but not remove the value of the trust property from his gross estate for estate-tax purposes. By keeping the value of the trust property in his gross estate, the value will be deductible as a charitable gift, but he will increase the maximum allowable marital deduction available on his death and thereby decrease his estate-tax bill. He can keep the value of the trust property in his gross estate and at the same time remove the income from the trust property from his gross

income by making himself one of the trustees and providing that the trustees can terminate the trust at any time by paying out the corpus and accumulated income to such charities as may be selected by the trustees. The reservation of such a power of termination in the trustees will not cause the income to be taxable to the settlor of the trust because the income is irrevocably devoted to charitable purposes, but it would seem that such power of termination gives the settlor in conjunction with another the type of power referred to in section 2038 of the 1954 code so that the property over which such power exists is includible in the settlor's gross estate. In other words, section 2038 seems to apply whenever there is a power to terminate a trust even though on termination the trust property must be paid over to a charity.

Second Phase—The Elimination of Control Prior to Death

If a property owner does not take advantage of the Federal gift tax specific exemption (sec. 2521 of the 1954 code) and the annual gift tax exclusion as to gifts of present interests (sec. 2503 (b) of the 1954 code), he is passing up an opportunity to make his property available to others without any tax cost. Even after he has used up his gift-tax specific exemption so that future gifts in excess of the annual gift tax exclusion will be taxable, it may be less costly taxwise to turn over property to his intended beneficiaries because the gift tax imposed will be at the bottom of the gift tax rates, whereas if the property is retained and passed on on death, it will be taxed at the top estate tax rates.

When a property owner undertakes to make inter vivos transfers for the purpose of eliminating from his own gross estate for Federal estate-tax purposes the value of the property transferred, he also desires to eliminate from his own gross income for income-tax purposes the income from the transferred property. The mere fact that he has accomplished one of these objectives does not assure the accomplishment of the other because the income-tax rules and the estate tax rules are not correlated. If he accomplishes both of his objectives, his loss of control over the transferred property is complete from a legal standpoint. Whether his loss of control is complete from a practical standpoint depends upon the willingness of the transferee to abide by the wishes of the transferor in regard to the transferred property.

A husband normally does not regard the transfer of property from himself to his wife, though legally all control over the transferred property is given up, as effecting any economic change in his position. Due to the gift tax marital deduction, a substantial amount of property can be transferred from the husband to his wife tax free. For example, if the husband has not used up any of his specific exemption, he can give outright to his wife $60,000 and in addition make annual gifts to her in the amount of $6,000 without any gift tax being payable on such transfers. The equalization of the respective estates of a husband and wife, particularly if the same can be accomplished without the payment of any gift tax, may save estate taxes because only one-half of the total estate will be taxed on the death of each one no matter in which order they die whereas if the equalization through inter vivos gifts is not made, the splitting of the estates for estate-tax purposes is only possible if the husband dies first.

If the transfer of the property is to be made to a person other than the transferor's spouse, normally the transfer will be made only when the transferor is completely satisfied that the assets which will remain under his control after the transfer will be adequate to take care of his own foreseeable needs. In other words, the loss of legal control in such cases retards hasty action because of the realization that future developments might make the transferor dependent upon the transferee, which is an undesirable family development where the transferee is other than the transferor's wife. Thus transfers to persons other than the transferor's wife occur primarily in large estates whereas transfers to the transferor's wife may take place in large or small estates.

The factor which encourages in appropriate cases transfers to a member of a family other than the transferor's wife is the income-tax advantage which may result by spreading the family income over several tax entities. This factor is not significant normally where the transfer is to the transferor's wife in view of the fact that husband and wife can file joint returns and pay a tax which equals twice the tax which would be assessed on one-half of their total income.

Section 2503 (c) of the 1954 code has cleared the way for the establishment of a trust for a minor with no interest under the trust being deemed a future interest so that the annual gift-tax exclusion is available with respect to contributions thereto. In order for a trust to qualify as a section 2503 (c) trust, the trustee must have the power to expend all the income and principal for the benefit of the minor during his minority. Consequently, the creator of the trust for the minor cannot himself be a trustee thereof without having a power to terminate the trust and when the settlor of a trust as trustee has the power alone or in conjunction with another to terminate it, the value of the trust property will be includible in his gross estate for Federal estate-tax purposes under section 2038 of the 1954 code.[2]

Not infrequently a property owner may desire to make inter vivos transfers that will not necessarily result in the intended beneficiaries gaining control over any of the property transferred. Such a result is obtained when the transfer is made in trust with discretion in the trustee in regard to the payment of income and principal to the described beneficiaries. Such a transfer does not create any present interest under the trust so that the annual gift-tax exclusion is not available with respect to contributions to the trust but the specific gift-tax exemption may be applied against the property placed in such a trust. As long as the settlor himself does not have the power in regard to the income or corpus, either alone or in conjunction with another, such a transfer in trust may remove the value of the trust property from his gross estate for estate-tax purposes. The income from the trust property, however, may be includible in the settlor's gross income, even though he does not have the power alone or in conjunction with another to control the payment of income and corpus, because the income-tax rules (sec. 674 of the 1954 code) are not identical with the estate-tax rules. To remove the income of the trust property from the settlor's gross income in the type of trust under consideration, not more than one-half of the trustees can be in the

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[2] See *Lober et al.* v. *U. S.*, 346 U. S. 335, 78 Sup. Ct., p. 98 (1953).

category of what are called subordinate trustees. Thus the trust will be one that not only legally eliminates the settlor's control but will be one that very likely deprives him of practical control because of the presence of the independent nonsubordinate trustee.

The elimination in the 1954 code of the premium payment test as a basis of including in the gross estate of an insured the proceeds of a policy on his life (sec. 2042) has made available for transfer inter vivos the ownership of life-insurance policies when the objective is to eliminate from one's gross estate the value of some of his presently owned assets. The selection of this asset for inter vivos transfer is often urged because the face amount of the policy is being removed from the transferor's gross estate for estate-tax purposes whereas the value of the transferred property for gift-tax purposes will be substantially below its face amount. Factors working against the selection of this asset for inter vivos transfer, however, are the possible need for liquid assets to meet the various death expenses of the insured and the problems created in handling this asset in the estate of the transferee if he dies before the insured.

Third Phase—Beneficiary Freed From Tax

When the property owner desires to dispose of his property so as to eliminate or minimize the impact of estate and gift taxation on the property in the hands of the transferees, he has the choice of a long-range fixed and rigid plan or a long-range flexible plan. By either type of long-range plan, he can keep the property from being subject to an estate or gift tax as it passes from beneficiary to beneficiary for from 80 to 100 years in any State in which the common-law rule against perpetuities is in effect.

The 80- to 100-year period is based on the likelihood that such period of time will normally elapse before the end of a trust that is to endure for 21 years after the death of the survivor of selected lives. If several of the selected lives are infants at the time the period of the rule against perpetuities begins to run, it will be quite likely that 80 to 100 years will elapse before 21 years after death of the survivor of such selected infants.

Long-range fixed and rigid plan

By a long-range fixed and rigid plan is meant one that is fixed from the beginning not only as to beneficiaries but also as to the amount of income or corpus that each beneficiary is to receive throughout the duration of the property arrangement. Under such a plan if the right of each beneficiary to receive his designated share is contingent on such beneficiary living to the date of distribution with a succession of alternative beneficiaries so that under all conceivable circumstances the dispositive instrument spells out what is to be done with the property, no beneficiary will have any interest that will be subject to estate taxes as a result of his death before the termination of the plan.

If a beneficiary is free to alienate his interest under a fixed and rigid plan he may make a gift thereof that will subject him to a gift tax. In many States, however, the alienability of his interest can be effectively curtailed by a so-called spendthrift clause.

The long-range fixed and rigid plan is normally an unwise one to adopt because of the likelihood that as the years go by a change in the

financial or physical condition of the selected beneficiaries, or fluctuations in the worth of designated dollar payments, will make such plan completely out of tune with the times. Consequently, the better course of action usually is to insert in the plan flexibility to meet changing conditions to the extent that can be done without adverse tax consequences.

Long-range flexible plan

Flexibility in a plan may be obtained by giving to the trustee discretionary powers as to income or corpus or both (a discretionary trust) or by giving to the beneficiaries powers of appointment. The maximum flexibility is produced by including in the plan both discretionary powers in the trustee and powers of appointment in the beneficiaries. Adverse tax consequences result from the inclusion of flexibility if the holder of a power is treated as the owner for estate and gift-tax purposes of the assets over which the power exists.[3]

Whether the discretionary powers in a trustee or the power of appointment in a beneficiary is under consideration, such power holder (assuming he is not also the creator of the power) will not be deemed the owners of the assets over which a power exists for estate or gift-tax purposes if he cannot benefit himself, his creditors, his estate, or creditors of his estate by the exercise of the power (secs. 2041 and 2514 of the 1954 code).

It should be noted, however, that even though the power holder cannot be benefited by the exercise of a power such exercise may deprive him of the possibility of benefiting from the nonexercise of the power. For example, suppose that a trust is established under which A, as trustee, is given discretion to pay corpus to B the income beneficiary and on B's death, the then remaining corpus is to be paid to A if he is then living and otherwise to someone else. A cannot benefit himself by the exercise of his power to pay out corpus but he may benefit from a nonexercise of the power. In such case, if A exercises the power and thereby gives up his contingent remainder to the extent of the corpus paid out he is making a gift for gift-tax purposes of such contingent interest but on his death before B his contingent interest is eliminated because of his failure to meet the stipulated requirement of survival and no intetrest under the trust is includible in his gross estate for estate-tax purposes. Because of the gift-tax result mentioned, however, care should be taken to make certain that the power holder cannot benefit from either the exercise or nonexercise of the power if no adverse estate or gift-tax result is to be present as a result of the creation of the power.[4]

Even though the power holder may benefit himself by the exercise of the power no adverse estate or gift-tax consequences are present if the power falls into any one of the following categories:

1. The exercise of the power is limited by an ascertainable standard relating to the health, education, support, or maintenance of the power holder (secs. 2041 (b) (1) (A) and 2514 (c) (1)).

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[3] Adverse tax consequences also would be present if such holder was treated as the owner of such assets for income-tax purposes, but the income-tax phase of the problem is beyond the scope of this paper.

[4] Another example of a situation where the power holder loses financially by the exercise of a power is one where the trust instrument directs the trustee to pay income to A for life and to pay the corpus to A's children from time to time during A's lifetime as A may specify in an instrument in writing delivered to the trustee.

2. The power holder can exercise the power only in conjunction with the creator of the power (secs. 3041 (b) (1) (C) (i) and 2514 (c) (3) (A)).

3. The power holder can exercise the power only in conjunction with a person having a substantial interest in the property subject to the power which is adversely affected by the exercise of the power.

Only category No. 1 above is significant when the objective is to introduce flexibility into a long range plan. Category No. 2 is ruled out because of the adverse tax consequences so far as the creator of the power is concerned and category No. 3 does not accomplish the objective due to the unlikelihood that the one having the adverse interest will consent to an exercise of the power.

In one instance the power holder may benefit himself by the exercise of the power and there is only a slight adverse estate-tax consequence occasioned thereby. If the power holder cannot withdraw during any calendar year in excess of $5,000 or 5 percent of the aggregate value of the assets subject to the power, whichever is greater in amount, he will be deemed to have a general power of appointment for estate-tax purposes only over the limited amount subject to withdrawal in the year of his death. This restricted adverse estate-tax result grows out of the language in section 2041 (b) (2) which points out that the lapse of such a power will not be deemed an exercise thereof for estate-tax purposes and the language of section 1514 (e) which recognizes that such lapse will not be an exercise of the power for gift-tax purposes. If the power of withdrawal exceeds the greater of the amounts mentioned above, each year in which the power lapses will be deemed an exercise for both estate- and gift-tax purposes to the extent that the property which could have been withdrawn by the exercise of the lapsed power exceeds in value the greater of the above-mentioned amounts. In light of the above, it is easy to understand why many long-range plans provide for a limited right of withdrawal ($5,000 or language which meets the 5-percent test) in a beneficiary to provide flexibility.

ECONOMIC EFFECTS OF ESTATE AND GIFT TAXATION

C. Lowell Harriss, Columbia University

After 20 years of Federal estate taxes at high (and generally stable) rates what do we know about the economic effects? The amount we can say with confidence, that is accurate, is rather small. True, some tendencies are reasonably clear, but there is little basis for measuring them. Consequently, it is difficult to judge the significance of a trend that undoubtedly exists. In other cases even trends are not marked clearly.

Difficulty of Determining Economic Effects

Some of the economic effects are indirect, hidden, and generally mixed with others. They result because persons potentially subject to the tax act to reduce or eliminate their tax liability. Such actions probably have greater results (per dollar of revenue or per estate) than the comparable results for other taxes.

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Death and gift taxes are to a large extent under the deliberate control of the property owner. They are almost completely divorced from ordinary market transactions. The actions needed to reduce most other types of tax involve the two-sidedness of a sale, an employment agreement, or other business matter. Saving a sales tax will generally require foregoing a purchase (or sale) which is desirable in itself. Rarely is it wise to give up income (in the broad sense of growth of economic power plus consumption and including desired leisure as a form of consumption) to save tax, for rates are not over 100 percent. But death tax is hardly an incident of a transaction desirable on other grounds. Yet action to reduce death tax may involve relatively little sacrifice of what is desired for other reasons. The same may apply as regards gift tax, for (excepting charitable gifts and others of incidental amounts) the reason for making the gift is not always (or ordinarily) some strong, compelling search for a nontax objective. Hence normal economic considerations do not exert as strong a check on estate (or gift) tax avoidance as on the avoidance of some other taxes. So we expect owners of estates to try to escape death taxes—as they certainly do. The actions they take do not always leave traces clear enough to permit satisfactory analysis of the economic results, even if data potentially available were compiled.[1]

Another difficulty of studying this problem is that the magnitudes are small compared with those bearing on the economy as a whole. Death and gift taxes loom large in the economic calculation of wealthy families, but the $1.2 billion or so a year they bring government treasuries cannot compare with income, property, sales, or even payroll taxes. Nor does this amount seem large in relation to annual savings or other of the more important magnitudes that apply to the whole economy. Something that is relatively small may tip a balance and have effects quite out of proportion to its own size—if it does, in fact, weigh at the margin. Yet it is not always clear what is bringing a disproportionately large result because it is operating at the margin. This is true of death and gift taxes; they are small in relation to the total economy but possibly large enough to have substantial influence at some points.

Reduction of Large Fortunes

One undeniable effect is the reduction of large fortunes. Despite the opportunities for escaping tax—and they are numerous—large holdings of private wealth have been taxed and depleted substantially. In 1951, for example, 11 gross estates of $10 million and over contained $183 million gross ($111 million net) and paid tax of $69 million. The average net amount left for distribution to heirs was under $4 million. The 34 estates of from $5 million to $10 million with $236 million gross ($150 million net) paid tax of $74 million—leaving a net average of less than $2 million. These figures are reasonably typical of the years since the marital deduction became effective. Even smaller fortunes—large to most of us but less than the princely holdings of

[1] The Treasury and a few State agencies assemble and publish useful statistics on death and gift taxes, but facts that are far from complete. In view of the preoccupation of economists with other matters and the lack of general interest in death and gift taxes, the use of more resources to compile data on these levies might be hard to justify. Yet it would not be impossible to get somewhat more information (even without revising tax returns) if Congress or the Executive felt that the need were sufficient.

the very wealthy—are being depleted. Perhaps 90 percent of the $1.2 billion combined Federal and State death and gift tax each year comes from families with wealth over perhaps $400,000.[2] A full generation of such taxation will dwarf the result to date. Beyond any question death taxes are cutting down private fortunes, and in general the biggest ones most, though the inequality with which taxes fall on family accumulations of essentially the same size may well seem distressing. Large estates remain, of course. But they are fewer, and they average less, than if there had been no estate and gift taxes.

What are the economic effects of the reduction of large personal holdings of wealth? With only half a generation, 20 years—and these years of tremendous change in other respects—of truly high death taxes we cannot expect to see much of the long-run result. Nor, as the decades roll by, can we compare what comes to exist with what would otherwise have existed. In an important sense the country will never know the effects of the tax. In broad terms, however, one result is that the tendency of economic inequality to cumulate, to feed on itself, has been cut; fortunes once started grow more slowly than if the estate and gift taxes were markedly lower.[3] Beyond this generality, however, I venture no comment on the economic (or social) results of the reduction inequality.

As Part of a Tax System

One important aspect of the role of death taxes is their relation to other elements of the tax system. The importance lies not in the total yield, for it is not large enough to permit significantly lower rates of other taxes. The importance I have in mind lies in strengthening what in most cases are, or would otherwise be, weak spots, at least to my way of thinking.

For one thing, death and gift taxes constitute the only progressive element other than the income tax. Views about the desirability of progression differ. However, since progression is part of national policy, use of death and gift taxes offers a method of achieving the objective. In principle they have some advantages over income taxes; the chief, perhaps, is that they fall on the net results of a full lifetime of economic activity.[4] Moreover, they probably have less adverse effect on incentive to work and on the building of personal financial independence (and family business) than higher income tax rates yielding the same revenue. Our death taxes, unfortunately, are very far indeed from models of smooth, even, and equitable progression.[5] Yet they are at least somewhat progressive in a system built largely on proportional and even regressive elements. Most of their yield certainly comes from upper wealth or income groups, so that, viewing the system as a whole, they can be considered progressive.

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[2] Even with the information on the marital deductions claimed, any estimate of tax according to family wealth rather than reported estate is subject to an extremely wide margin of error, especially if the family is interpreted to include children and grandchildren. Yet for the purposes at hand this is the more important point because fortunes are more truly family than individual matters.

[3] The income tax, of course, operates powerfully in the same direction.

[4] When he is taxed on his net estate, the owner of a business in effect receives about as full offset of losses as could be reasonably desired.

[5] Since I have developed this point more fully in a recent article, I shall not use my limited space here to repeat the argument. See C. Lowell Harriss, Sources of Injustice in Death Taxation, National Tax Journal, vol. VII (December 1954), pp. 289-308.

Death taxes reach owners of two types of property that generally escape income tax—capital gains not realized before death and municipal bonds. Since there appears to be little practical prospect of broadening the income tax to close the loopholes offered owners of such wealth, the estate tax prevents—crudely, of course—complete, permanent avoidance of tax on such property by many owners. Much the same can be said concerning wealth accumulated from receipts that are not fully taxed because depletion allowances exceed the owner's investment.[6]

Federal credit for State death taxes materially enhances the practical power of States to impose estate and inheritance taxation. The amount of the credit is another matter; from various points of view it may seem either too large or too small. Yet if there were no credit, interstate competition as places of residence for persons of wealth would unquestionably develop to the point that significantly progressive death taxation by the States would be extremely risky. Even flat-rate and rather low death taxes might seem unwise. Elimination of Federal taxation of estates—sometimes proposed as a device for increasing the ability of States to use this revenue source—would, in fact, curtail State power unless a credit were retained to enforce a minimum national standard.

The gift tax helps somewhat to protect income tax, as well as estate tax, revenue. Incidentally, States with income taxes benefit a little from the Federal gift tax. However, the relation between effective estate and gift tax rates so favors gifts that death and income tax revenues are protected less than Congress seems to have intended originally. The absence of a Federal credit for State gift taxes helps explain the failure of States to adopt such taxes to protect somewhat their death and income taxes.[7]

Trustification of Property

One major economic effect of estate taxes results from the opportunity under the law to reduce the total tax over the years, reduce it substantially, by placing property in trust. Consequently, the use of trusts is stimulated by the taxes in their present form. Although there is no doubt about the tendency, no data for measuring it are available.[8] Thus, knowing that over 25 percent of gifts reported on 1950 gift tax returns were of property in trust, we still cannot say how much of this use of trusts was due to the tax system. Certainly some, probably much! And the extent will grow as the tax-saving advantages of trusts are recognized more widely and as wills now being made come into effect.

What, then, is the economic significance of trusteeship of wealth? More cautious and conservative investment is one result. Although

[6] Are there cases of the opposite sort in which death taxes put especially heavy burdens on property which may be taxed no less (or even more) than other under the income tax? Conceivably, this may be the case with common stock in estates which must be valued for tax purposes at abnormally high levels, especially if dividend income has in fact been subject to double taxation—a point beyond the scope of this paper.

[7] Where State gift taxes succeed in reducing gifts, Federal income- and death-tax revenues are increased.

[8] See J. K. Butters, L. E. Thompson, and L. L. Bollinger, Effects of Taxation: Investment by Individuals, Graduate School of Business Administration, Harvard University, Boston, 1953, pp. 370–372. Thustification of property has grown not only to save death taxes but for other reasons as well. Pension plans must now play a much more important role than death taxes.

trusts made today generally permit investment beyond the restrictive limits of the past, the tendency is to stick to relatively "high quality" assets. Another, and related, is greater emphasis on rationality in making investment decisions; specialized, technically competent personnel generally guide the decision making. While the wisdom of trustees will vary widely, their influence will make the preservation of wealth more likely than if heirs were given greater responsibility and freedom for investment. The dissipation of inheritances that can come from foolish investment or reckless spending by heirs who are free to use their property is largely prevented by trusteeing wealth. The economy as a whole, as well as the particular families involved, will benefit from any such reduction of folly and waste.

On the other hand, the conservative and restricted nature of trusts removes wealth from markets where it might be available for more venturesome and risky investment. Fortunes in trust cannot, as a rule, be used for financing some of the most dynamic parts of the economy. Even the beneficiary of a trust seeking capital for his own business often cannot use assets which under a freer system would have been available to him. Yet it is the large concentration of wealth that can finance the scrutiny of new ventures and afford to take the extreme risks that are involved in true economic pioneering.[9] Of course, there is no way to determine how much, if any, of the wealth now in trust for rich families would in fact be used to finance dynamic ventures intelligently were it not for trustification. It is easy, perhaps, to romanticize a bit about the part existing fortunes would play in financing the expansion of economic frontiers, especially by new businesses. There can be no doubt, however, that much wealth now in trust cannot conceivably be used for such purposes; in addition there are assets which in fact will not be used for dynamic economic growth even though the trustees are not absolutely prohibited from doing so.

However, there develops a group—not large in relation to the whole population—receiving income (about $2 billion a year before income tax) from trusts whose capital assets they do not fully own or control and may not consume. Although the social and economic effects of such a development are not obvious, they will hardly assume the relative importance of those associated with rentier groups in some civilizations in the past.

Encouragement of Inter Vivos Gifts and Transfers to the Surviving Spouse

As intimated earlier, the differential between estate and gift tax liability on many distributions of property is large enough to encourage transfer of property before death. There is also gift (and income) tax inducement to spread gifts among numerous heirs. A somewhat wider and earlier distribution of wealth results. Moreover, there is "skipping of generations" to avoid taxable transfers.

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[9] Giant corporations now perform some of the venturesome undertaking once left more to individuals; the giants seeking funds for expansion may at times get them by sale of new common stock to trusts. There is little basis for judging how adequately established firms do the job or what gaps they leave that might be filled by use of private fortunes. My own feeling, which may be largely prejudice, is that innumerable opportunities will not be developed by firms large enough to draw, directly or indirectly, on wealth in trust.

Children and grandchildren will get property at a younger age than if their elders had no tax incentives to distribute assets before death and to spread gifts. Some transfers will be in trust, some outright. The effects are very difficult to isolate and identify.

The marital deduction, among other things, leads to more ownership of property by women, especially elderly women. This ownership carries substantial elements of control (to qualify for the marital deduction). Here the tendency is to keep some of wealth but not all in the hands of a senior member of the family. The results in terms of investment and family life will vary widely. Conceivably, however, an apparently technical feature of the tax law may have significant economic and social effects.

Liquidity

Estate taxes must be paid in cash (or selected issues of Federal debt). One result is that the tax creates an incentive to get an estate liquid before death. Inconvenience is likely if settling the estate is delayed by difficulties of obtaining cash. Worse still, if enough assets are not liquid, losses may result from the tax induced pressure to sell after death at less than the best terms possible in the long run. Forced sales, even if the element of force is somewhat concealed or mitigated, can bring losses and death is evident, not concealed. Liquidity under pressure may be extremely disruptive, and persons of wealth properly fear the results perhaps unduly.

In addition to some flexibility in valuation, the statute permits executors to apply for additional time up to 10 years to pay tax. A study some years ago found that relatively few estates requested such extensions and that additional time was granted wherever the need appeared to warrant it.[10] In the great majority of cases, however, estates had been made liquid enough before death to pay tax without forced sale of illiquid assets; this is probably still the case, but recent tabulations do not show the asset composition of estates. Certainly owners of wealth make greater efforts to get their estates liquid before they die than they would if the tax were substantially lower.

Liquidity involves costs to the economy as well as to the taxpayer. The productivity of highly liquid assets, as measured by their yield, is lower than the productivity of many other types of wealth. The owner may sacrifice yield year after year because, not knowing how long he will live, he liquidates earlier than turns out to be necessary. The economy loses because wealth held in cash, savings accounts, Government bonds, or other such assets is not available for financing important types of economic growth, especially in equity form. A businessman accumulating highly liquid assets to pay death taxes cannot use the funds to finance the expansion of his business. The person with inherited wealth, the professional man, and the business executive are less attracted by venturesome business propositions because of death tax liquidity needs. The tax pressures to put wealth into highly liquid form reduce somewhat the funds available for uses that stand the chance of being most productive. The total amount of property thus shifted from higher to lower productivity is undoubtedly small

[10] C. Lowell Harriss, Liquidity of Estates and Death Tax Liability, Political Science Quarterly, vol. 64, ch. 4 (December 1949), pp. 533-559.

in relation to national wealth. Yet it is probably several times the death tax payable in any one year. Even then it will not be likely to affect the broad functioning of the economy so much as particular segments—relatively small local businesses that have good potential for growth but inadequate capital.

One form of the shift to greater liquidity is the purchase of life insurance. Liquidity is not the only reason why life insurance appears desirable to many persons with enough wealth to be potentially liable for death tax. Yet it is one, and more insurance is certainly sold than if death taxes created no liquidity problems. Life insurance involves costs to the insured (and to the economy).[11] In addition to the obvious costs of company operation, life insurance involves costs in the form of higher liquidity and lower productivity than some other type of investments. Virtually all assets of life insurance companies brings yields distinctly below those of equity investment in industry after industry—more conservatism, less venture. There is no way of judging how much death tax payment considerations increase the purchase of life insurance and thus involve costs in addition to those of the tax itself. (No one knows what use would be made of funds otherwise.) The extent may be appreciable in relation to the amount of tax, but it is tiny in relation to the whole economy. To some extent the action is illogical and perhaps more often excessive, spurred by skillful selling that may exaggerate liquidity needs. Many owners of wealth may not be able to judge their own best interest, especially since the time of their death is uncertain.

Liquidity needs present especially difficult problems for persons having an appreciable part of their wealth in a closely owned business. This is more true of holdings of common stock or partnership interests than of preferred stock and debt. For one thing, probable valuations may be highly uncertain—for a variety of reasons, including the uncertain effects on the firm of the loss of the decedent's participation. Hence the amount of cash needed to pay the tax is not known, perhaps by a wide margin. (When the net estate exceeds about $2 million, each dollar of change in valuation alters tax by 50 cents.) Even more serious, however, is the problem of arranging to get cash with a minimum of additional loss. The share involved (e. g., enough to pay just the tax) may not be large enough to carry control. If so, potential buyers may have good reason to keep bids well below the level of otherwise comparable securities traded more widely. Owners of minority interests in closely held firms may suffer highly disappointing treatment and may be foolish to pay nearly as much as the securities might seem to be worth. If, on the other hand, control is involved, the selection of buyers may be limited to a very narrow group—those with enough capital and an interest in managing the type of business involved. The terms will be subject to great uncertainty. Heirs obviously forced by tax to sell may be compelled to accept what in some respects is a ridiculously low price. Moreover, problems of continuity of management must often be faced, and tied in with disposition of the firm's assets; if this is left for solution in the pressures after the death of a chief official, the resulting

[11] Other tax savings may offset such costs to the insured but presumably at equal loss to the general body of taxpayers. One nonliquidity reason for buying life insurance is to make convenient use of certain gift-tax avoidance devices.

complications can be serious. For these and other reasons the risks of delaying liquidation until after death may truly be excessive.

Skillful use of gifts over a period of years can sometimes help materially, by reducing the total tax and spreading the liquidation problem. Or the property owner may accumulate liquid assets (perhaps in the form of life insurance) before death. As already indicated, this method deprives the firm of the use of wealth in ways that may be highly productive, retarding growth. Getting the funds out of the firm will also involve income taxes that might be saved (building up capital gains that would otherwise not be realized before death).

Another type of solution is the arrangement of a merger. By consolidating (in a tax free reorganization) with a corporation whose securities are traded widely, an owner can go far toward solving the liquidity problem and without incurring serious income tax penalty. Here is one explanation of some mergers in recent years.[12] To help where merger is not the solution, Congress has acted twice to ease the income tax aspects of getting liquid funds out of the firm to pay estate tax. Yet the fundamental death tax problems remain.

The family owned business faces difficulties that need never worry business giants. The smaller firm finds continuity of ownership and management as an independent entity harder because of death taxes. The net result is to burden the closely owned business, to drive it, if possible, to merge with a larger, more widely owned, firm. To this extent, as well as for their effects on growth, death taxes conflict a little with other features of national policy.

Liquidity problems are now greater than inherently necessary. They could be reduced. Today, law and practice put a premium on making the estate liquid before death. No useful purpose of public policy is served thereby. True, there are valid nontax reasons for many property owners to want to get their estates in form that permits prompt settlement. The Government, however, gains nothing from such liquidity except the miniscule temporary advantage of earlier payment (i. e., the only loss from a shift of policy would be some slight postponement). In principle, the line of solution is simple—allow as a matter of right to every estate generous time (up to perhaps 5 years) for payment of tax on assets of low liquidity (with modest interest rates, none at all perhaps if the asset yields no income); additional time would be given on proof of need. The estate might also be permitted to pay by turning over assets themselves at the valuation used in computing tax liability. Adoption of such proposals would not eliminate the problem entirely but would reduce its seriousness.

PHILANTHROPY

One social gain from private accumulations of wealth is that they have been used at times for financing art, religion, education, charity, and other such desirable activities—grouped here as philanthropy. Although estate and gift taxes cut these fortunes, the effects on philanthropy are mixed.

On the one hand, death taxes by reducing the wealth available to heirs tend to discourage generosity; on the other hand, the deduct-

[12] J. K. Butters, John Lintner, W. L. Cary, Effects of Taxation: Corporate Mergers (Graduate School of Business Administration, Harvard University, Boston, 1951), ch. II.

ibility of charitable contributions reduces the cost of gifts that qualify so that the net loss to the donor and his heirs is less, at times much less, than the gain to the recipient agency. Moreover, a person planning to make philanthropic bequests has an added incentive to make them before death in order to reduce income as well as death tax. Consequently, some of the effects of the estate tax in encouraging (or not discouraging) philanthropy may be reflected in income, rather than in death, tax figures. One thing does seem beyond dispute philanthropic gifts will be larger when they are deductible than when they are not. The provisions of our law have encouraged philanthropy, compared with a law like the British which grants deductibility in far fewer situations.

Estate tax figures available show few conclusive trends in recent years; in 1951 the percentage of charitable, etc., bequests to gross estate was one sixth below the 1922 35 average, hardly a striking change. Any such decline seems to me unfortunate for our society, but the one shown, especially if it is offset somewhat by larger gifts during life, is not big enough to be decisive.

Effects on Capital Accumulation and Business Policy

Estate taxes were once condemned because they reduce personal fortunes and, it was argued, national wealth. Space does not permit discussion of this issue. Even if it has some validity, however, the net amounts today are insignificant in an economy the size of ours. Productive capacity depends upon things of vastly greater importance than death taxes. Except for considerations already discussed-- especially those growing out of liquidity needs the taxes have no discernible effect on business policy. Prices, financial structure, wages, location, competition, and other aspects of business are not influenced by estate and gift taxes (with the exceptions noted).

Miscellaneous

Other effects may be noted though they are of less importance than those already mentioned. The taxes lead to costs of compliance and administration. The effort and resources used to comply with and enforce these taxes are small in relation to the whole economy, but in total they do represent use of some very high skills, more per dollar of revenue, I imagine, than any other tax. It would be nice if the talents required by these taxes were free for more creative contribution. Some estates are involved in litigation or in other ways have settlement held up because of tax.

Concluding Statement

American death and gift taxes are certainly not major elements of our economy—nothing like income, sales, or property taxes. Yet in a few respects—beyond those of raising revenue—they exert influences which are of some importance. Unfortunately, the information needed to measure the size and assess the significance of these influences is very inadequate. Some of the effects are undesirable, but this is true of the consequences of any tax. Compared with other sources of revenue, death and gift taxes still seem to me relatively better than

the place they now occupy in the tax structure as measured by their revenue yield. In other words, greater relative use of death and gift taxes would permit lighter use of taxes which in my judgment have greater defects.

Yet this conclusion must be modified, for it depends upon the kind and structure of death and gift taxes involved. Although my assignment does not include discussion of this point, I should like to make clear my belief that considerable improvement could be made. It would take the form of substantial broadening of the base, especially in the form of including life estates and other such interests, cumulating gifts and bequests into a single levy on gratuitous transfers, lowering the rates at the upper levels, and making other changes to remove inequities and ease payment. Rate reduction at the top seems desirable to permit serious efforts to close loopholes, to lessen the tremendous pressures toward avoidance that are inevitable in a tax like this, and to mitiate the inequities that are associated with these taxes in a world of flexible property arrangements, fluctuating assets values, and differing life spans and family composition.

RECOMMENDATIONS FOR REVISION OF FEDERAL ESTATE AND GIFT TAXES

BORIS I. BITTKER, Yale University

INTRODUCTORY

The subject assigned to me by the committee is recommendations for revision of Federal estate and gift taxes. But changes in the present system can be proposed and debated intelligently only after there has been an agreement on the objectives of the Federal estate and gift taxes, a subject that has been assigned to another consultant. Although I do not want to trespass on his ground, I think I should at least set out briefly the presuppositions upon which my recommendations are based.

First, the Federal estate and gift taxes are not important sources of Federal revenue and, unless the need for Federal revenue falls off in a drastic and unanticipated manner, these taxes could not be converted into substantial revenue sources in the near future. Since World War II, they have yielded from $0.5 to $0.9 billion per year, out of total Federal revenue of $40 to $70 billion per year. Even the outright confiscation of medium and large estates would not produce more than $2 to $3 billion a year. The Federal estate and gift taxes, then, are not and could not possibly become serious competitors of the Federal income tax, or even of the Federal alcohol and tobacco taxes, in the production of revenue.

Secondly, it is my belief that these taxes are not important tools of Federal fiscal policy. Like any other taxes, they have their effects on the national pattern of consumption, savings, and investment. No doubt Professor Harriss, to whom the committee has assigned the subject of the economic consequences of the Federal estate and gift taxes, will illuminate this obscure relationship for us. But unless he produces some unexpected new data, I suspect that we will be left with the

conviction that the impact of these taxes on consumption, savings, and investment is far more attenuated than is the impact of the Federal income tax and of the various Federal excises. And even if the relationship between estate and gift taxation and consumption and investment could be plotted with accuracy and the effect of changes in these taxes could be forecast with assurance, the total contribution that they could make to our economic stability would of necessity be slight. For these reasons, then, I do not look upon these taxes as important tools of Federal fiscal policy.

In my opinion, then, the objective of these taxes is neither to raise substantial amounts of revenue nor to stabilize the economy. Their function, rather, has always been the reduction of economic inequality brought about by inherited wealth. Although the Federal estate tax, to which the gift tax is ancillary, was enacted during World War I, its immediate roots may be found in speeches of Theodore Roosevelt on the subject of economic inequality and earlier in the popular labor and agrarian movements of the late 19th century. There have, of course, been divergent opinions on the appropriate level of taxation, but over the years the Congress has adhered with substantial consistency to this conception of the objective of the Federal estate and gift taxes. It is an objective that commands a wide acceptance not because of a desire for economic leveling itself, but because so many persons—in many countries and through the ages—have believed that restraints on inheritance serve to open up economic opportunities for all.

It is on this conception of the Federal estate and gift taxes (stated with extreme brevity and deliberately oversimplified, to avoid trespassing on Mr. Eisenstein's territory), then, that my recommendations rest.

1. Rates

Although for some years there has been no change in the estate and gift tax rates as such, their actual weight has been drastically lightened, most notably by the "martial deduction" and "split gift" provisions of the Revenue Act of 1948 and, more recently, by the abandonment in 1954 of the "premiums paid" test for taxing life-insurance proceeds. Both changes in effect reduced the tax rates for many taxpayers; there have been some other changes in the statute that in effect increased the rates, but the increases are probably small by comparison with these reductions. Our information about the actual weight of these taxes is very unsatisfactory. There has been one study of matched estate and gift tax returns,[1] and a further study along this line by the Internal Revenue Service itself would be useful, especially if the effect of the 1948 and 1954 statutory changes referred to above could be interpolated into the statistics. A summary that I compiled recently from Treasury statistics indicated an effective Federal estate tax rate (for returns filed in the period 1947–50) of about 27 percent for gross estates of 1 to 2 million dollars and of about 49 percent for gross estates of $5 million or more.[2] These figures, which are necessarily crude because of the form of the published statistics, do not reflect the 1954 change in the taxability of life insurance at all, and they reflect the 1948 "marital deduction" provision only to a limited

[1] Pechman, Analysis of Matched Estate and Gift Tax Returns, 3 National Tax Journal 153 (1950).

[2] Bittker, Federal Income, Estate, and Gift Taxation (Prentice-Hall, Inc., 1955), p 894.

extent. Moreover, they do not reveal the extent to which the estate tax was avoided by the use of lifetime gifts. Our inquiry, after all, should not be restricted to the tax cost of transmitting property at death; we must rather ascertain the aggregate tax, estate and gift, on the transmission of wealth from one generation to another.

In the light of the function of the estate and gift taxes, these estimates, crude as they are, suggest that a rate increase would be warranted. I recommend that this committee initiate a statistical study of the type suggested as the first step in reassessing the level of the estate and gift tax rates. The study should, of course, embrace the State transfer taxes, as well as the Federal levies.

2. Integration of the Federal gift and estate taxes

Under present law, the gift tax is independent of the estate tax, having its own schedule of rates, its own set of exclusions and exemptions, and its own criteria for ascertaining when a transfer of property is sufficiently complete to be taxed. A gift of property may be subject to gift tax on the ground that the donor has relinquished so much control that he should no longer be regarded as the owner, but the same property may later be included in his estate because the transfer was not sufficiently complete to satisfy the estate tax's standards. In such a case, the gift tax paid during life may be credited as a "downpayment" on the estate tax (subject to some complicated restrictions); while this mitigates the shortcomings of the existing structure, it does not serve to justify it. Moreover, the overlapping applications of the 2 transfer taxes have become more numerous in recent years as the result of an abandonment by the courts of an earlier tendency to construe the 2 taxes, whenever possible, as in pari materia.

Many commentators have called attention to this problem of overlapping application of the estate and gift taxes. Of course, there may be transfers that ought to be subject to gift tax without relieving the donor of estate tax on his death: and I do not subscribe to the common view that overlapping is necessarily objectionable. But we now have a haphazard system under which overlapping occurs without plan or purpose, and under which the gift tax will be credited only within certain limitations that have little or no connection with the standards that govern taxability.

Moreover, overlapping of the estate and gift taxes is not the only undesirable product of the existing independent structures. The gift tax contains its own exemption of $30,000 per donor (which rises to $60,000 for a married couple taking advantage of the "split gift" provision), available in addition to the estate-tax exemption of $60,000 (or, in effect, $120,000 if the "marital deduction" is employed). Full employment of the 2 exemptions permits a married man with $180,000 of property to give $60,000 during his life to his children and to divide the remaining $120,000 between his wife and children at death, without payment of either gift or estate tax.[3] (Any part of the widow's $60,000 left on her death could be bequeathed by her without estate tax, because of her own $60,000 estate-tax exemption.) If the lifetime gifts had not been made, however, and the husband had left $120,000 to the children and $60,000 to the wife, his taxable estate

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[3] In point of fact, an even larger amount could be transferred without payment of gift tax, by virtue of the gift-tax exclusion that will be discussed in the next recommendation.

would be $60,000 (i. e., $180,000 less marital deduction of $60,000 and exemption of $60,000).[4] The gift-tax exemption cannot be carried over for use at death. Along with the independent gift-tax exemption goes a lower schedule of rates for those lifetime gifts that exceed the exclusions and exemption. Property given away during life, in other words, is subject to a lower transfer tax than the same amount of property held until death.[5]

We have only very skimpy information about the extent to which the separate transfer tax systems are in practice exploited by taxpayers. Except for a possible inference that lifetime gifts to avoid the heavier estate tax are made primarily by those in the highest brackets, we do not know how extensive is the practice of lifetime gifts, what types of property are involved, or to what extent the transfer tax savings may be offset by higher income taxes. It has sometimes been suggested that a separate set of exemptions and rates for lifetime gifts serves the policy of encouraging the relaxation of economic control by older taxpayers, with a concomitant increase in the managerial role of younger men and women. Assuming that this is desirable and that gifts are actually employed to transfer property where there is a difference of economic outlook between donor and donee, it should not be overlooked that despite the elaborateness of our estate-tax structure, there is more than one way by which the donor can insure a continuity of his investment policies.

I recommend that the estate and gift taxes be integrated as to standards of taxability, except where there are persuasive reasons for applying different standards. An excellent foundation for an integrated structure was laid 8 years ago by a distinguished advisory committee to the Treasury Department, working jointly with the Treasury's experts.[6]

3. *Gift-tax exclusion*

When the gift tax now in effect was first enacted, it granted an annual exclusion for each donor of the first $5,000 of gifts made in any 1 year to each donee. (Gifts of future interests did not qualify for the exclusion.) The amounts of this annual exclusion has been twice reduced; it is now $3,000. But in 1948, Congress enacted the "split gift" provision (now found in sec. 2513 of the Internal Revenue Code of 1954), by which a married donor may give as much as $6,000 per year to each of any number of donees without tax. Thus, a married man with 3 children may transfer $18,000 annually to them tax free; over a 20-year period, for example, this would come to $360,000. (The amount would be increased by the income produced by the donated property, and this income might be subject to a lower income tax than would have been imposed on the donor had he retained the

[4] If $90,000 were left to the wife and the balance to the children, the husband's estate would be only $30,000 (i. e., $180,000 less marital deduction of $90,000 and exemption of $60,000). But then the wife's taxable estate would be $30,000, assuming that she lived on the income alone and that there were no changes in the value of the assets (i. e., $90,000 less exemption of $60,000).

[5] Property subject to the estate tax takes the value at death as its basis for computing gain or loss on a sale by the heir, while property subject only to gift tax ordinarily has as its basis in the hands of the donee the donor's cost. This tends to encourage the holding of property until death, and it may offset the tax advantages of lifetime gifts for some families and some types of property. These "basis" provisions merit reexamination by this committee.

[6] Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation With the Income Tax (1947), prepared jointly by an advisory committee to the Treasury Department and by the Office of Tax Legislative Counsel.

property until death.) Moreover, the children would not necessarily have received complete control over the property, especially as a result of a statutory change (sec. 2503 (c)) enacted in 1954.

For a married donor, then, the annual exclusion is in effect larger today than it was in 1932. During the same period, of course, most Federal tax exemptions—especially the income-tax exemptions—have been drastically reduced. This is obviously not a reason for changing the gift-tax exclusion, but it does perhaps suggest an inquiry into its function. It was intended to make unnecessary the reporting of Christmas and birthday gifts and similar transfers of modest amounts. But the literature of "estate planning" treats the gift-tax exclusion as an important tool for shaping intrafamily transfers so as to avoid both gift and estate taxes. I do not know how many families consistently employ these elaborate schemes for "exploiting" the gift-tax exclusion that are put forward with such persuasiveness, indeed urgency, by the estate planners. No doubt many donors never adopt the plans that are pressed upon them; and of those who commence to act according to such plans, no doubt many abandon them soon afterward. But even if only a few donors make this use of the gift-tax exclusion, it is serving quite a different purpose from what the Congress intended. I should think that an exclusion of $500 would be quite adequate to protect ordinary Christmas and birthday gifts from the requirement of reporting, the function that the Congress envisaged for the gift-tax exclusion. Beyond this, gifts may properly be treated as transfers of the type that should be reached by the gift tax, once the donor's lifetime exemption of $30,000 is exhausted.

4. *Life insurance*

The inclusion of the proceeds of life insurance in the estate of the deceased has been a perennial problem to the Congress. From 1942 to 1954, the estate tax was imposed on the proceeds of life insurance if the insured retained until his death any of the "incidents of ownership" of the policy (such as the right to obtain its cash surrender value) or if he had paid, directly or indirectly, the premiums. In 1954, the "premiums paid" test was dropped from the statute, and ownership of the incidents of control by the decedent was made the sole test for taxing the proceeds to his estate. The theory was that even though the policy was paid for by the insured, if he had surrendered the incidents of ownership during his life, the transfer should be treated like any other lifetime gift because the donee had been vested with control over the policy. The argument is superficially appealing, but in my opinion it is fallacious. It overlooks the most distinctive feature of life insurance: that it is basically an instrument for providing for one's heirs. The fact that the donee of a policy can cash it in (ordinarily at a sacrifice of important values) seems to me, if not irrelevant, at least relatively unimportant. For many years, the estate tax has reached property in trust if the donor retains the income for his life, even though the donee may be able to sell his remainder interest at will. Similarly, the full value of property held in joint tenancy is taxed to the husband (if he paid for the property and dies first), even though during his life the wife could have obtained half of the property by partition. There are numerous other examples of transfers that are incomplete for estate-tax pur-

poses, notwithstanding the donee's ability to turn the gift into cash during the donor's life. If any thread runs through these instances, it is that the transfer is testamentary at its core, notwithstanding the extent of the donee's rights during the donor's life. Life insurance belongs in the same category.

For these reasons, I recommend a return to the premiums paid test for taxing life insurance.

5. Transfers in trust

For some years, the estate tax has been levied on property transferred during life if the transferor retained until his death any of certain vaguely specified powers of control over the property. The tax is imposed whether he retains such a power by himself or vests it jointly in himself and another person. In the case of a joint power, it is irrelevant that the other person who must join with the transferor to exercise the power may have an adverse interest, e. g., an economic motive for refusing to join with the transfer in a proposed exercise of the power. The income tax, on the other hand, distinguishes between powers held by the transferor jointly with an adverse party and powers held by him jointly with a nonadverse party; only those joint powers that fall in the latter category are charged against the transferor for income tax purposes. The theory, of course, is that the transferor of property has relinquished effective control over it if he can alter his disposition only with the consent of a person with a financial stake in the status quo. In my opinion, there is no reason why joint powers should be judged by different criteria in applying the two taxes. The standards should be correlated and, while there is an air of unreality about the concept of an "adverse" party when a member of the immediate family is involved, the income tax's criterion is more consonant than the estate tax's with the current recognition of bona fide intrafamily gifts.

A related problem is the power vested in a third party alone. The income tax quite realistically equates such a power with one vested jointly in the transferor and a third party. The estate tax, however, draws a distinction between the two, for no reason that I can perceive. The estate tax should be correlated with the income tax at this point also.

There is yet another point at which there is an unwarranted divergence between the estate and income taxes. Following the decision of the Supreme Court in the Clifford case, a set of standards to govern the income-tax liability for certain categories of transfers in trust was developed, initially by the courts, then more systematically by Treasury regulations, and finally by the Internal Revenue Code of 1954. As enacted by Congress, these standards differentiate among the many powers that may be retained by a transferor (or be vested by him in a third party), imposing the income tax on him as the price of retaining certain powers while relieving him of liability with respect to others. The distinctions are based on the nature of the power, the length of time it is retained, the relationship among the transferor, the person who possesses the power, and the persons affected by its exercise, etc. The estate tax, on the other hand, has long been imposed whenever the grantor retains the power to "alter, amend, revoke, or terminate" a trust or other transfer. While some trivial or restricted powers may escape the statutory phrase, it is clear that it

reaches many powers that Congress thinks are not important enough to justify the imposition of income tax on the transferor. This area ought to be reexamined. In general, if a power may be retained with impunity under the income-tax law, it ought not to call forth an estate tax on the transferor's death.

Gift-tax liability in this area is in an unsettled state, owing to the lack of any statutory standards, but in general the gift tax has been interpreted by the courts consistently with the estate tax. In the absence of persuasive reasons to the contrary, changes in the estate tax should be accompanied by parallel changes in the gift tax.

6. Powers of appointment

For many years the Federal estate-tax law contained only a rudimentary provision relating to powers of appointment. During this period a person could be given virtually the same degree of control over property as an absolute owner, but the property would not be subject to Federal estate tax on his death. In 1942 the law was drastically revised in the direction of uniformity between the possessor of a broad power of appointment and the absolute owner of property. In 1948 the law was changed again to provide that only general powers of appointment (as defined by what is now sec. 2041 (b) of the Internal Revenue Code of 1954) are subject to estate tax. Under this provision, a person may be vested with a substantial degree of control over property—sometimes virtually absolute control—without having it included in his estate.

It is not easy to justify excluding from a decedent's estate property that he could have used during his life as he desired. Moreover, while property subject to the control of a disinterested fiduciary should not be included in his estate, a person having (for example) the unlimited power to divide property among his relatives as he chooses or to allow it to go to charitable institutions, instead, should be treated as an owner.[7] The principal argument to the contrary starts from the fact that under present law the life tenant of a trust is not taxed on his death; it is urged that to permit taxpayers to take advantage of this feature of present law without employing the rigid pattern of a life estate with remainders over, certain powers of appointment should be exempt from estate tax. But this amounts to saying that a loophole through which property can be transmitted free of a generation of estate taxes should be enlarged. Proposals to close the loophole itself are not without their complexities, but surely there is no warrant for enlarging it.

I recommend a complete overhaul of the powers of appointment provision, to the end that significant powers held by a person related to the potential takers of the property will be subject, as a general rule, to estate and gift tax. At the same time, the treatment of life estates should be reexamined.

[7] With provision, of course, for imposing the burden of the tax on the recipients of the property in question, as under sec. 2207 of the Internal Revenue Code of 1954.

APPENDIX

AVERAGING, CUMULATIVE ASSESSMENT AND RETIREMENT INCOME PROVISIONS

William Vickrey, Columbia University

INCOME DEFERMENT SCHEMES

Many provisions have recently been introduced into the income-tax law, and still others are being advocated or are in the air which have as their purpose the exemption of amounts of income in one way or another set aside for the payment of retirement benefits or for use as a means of maintaining income after the main earning period has passed. In their most blatant form these provisions and proposals not only exempt the income set aside but also either exempt the corresponding benefits entirely when it is realized or in some cases provide for application of the capital-gains rates. While this is in effect what occurs with some forms of social-security and life-insurance benefits, to permit it to occur without very careful limitation of the exempt benefits to relatively minor amounts represents a flagrant breach of the principles of the income tax.

In the more reasonable forms of such proposals, however, the income set aside for future use is eventually taxed when it is made available. In such cases the proposals amount to a combination of tax deferment and averaging, and would perhaps not be too objectionable were it not that their specialized form creates incentives to observe certain forms in investment that seem on the whole undesirable. If such proposals are justifiable at all, presumably it would be still better to have a completely general provision that would be available alike to all taxpayers and which would not require the funds to be tied up in any special manner.

CUMULATIVE ASSESSMENT AS AN ALTERNATIVE

Actually the legitimate aims of such proposals can be achieved in a much simpler and more general way by the application of the cumulative method of assessment, which would not only eliminate discriminations among taxpayers that now occur because of differences in the way their income happens to be allocated between years, but would also provide automatically for partial refunds of past taxes in years of very low income, or very low tax burdens in years of reduced income. In this respect it would be the complement, for medium and high incomes, of the carry back of unused exemptions.

Unlike the more usual forms of averaging provisions, which tend to get more and more cumbersome as the number of years of averaging

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is increased, cumulative assessment contemplates carrying a running account with the taxpayer from year to year; the only figures that need to be carried forward from year to year are the accumulated tax balance, the cumulated income balance, and the date with which the accumulation process is deemed to have started. No other reference to the past is required, and it is not even necessary to file the successive returns of the taxpayer together: All that is necessary is to continue carrying forward the 3 figures from 1 year's return to the next, possibly by means of stubs, much as in New York and many other States the information on automobile license forms is carried forward from 1 license to the next. The amount of recordkeeping and administrative work required is substantially less than with any of the various average schemes that have been proposed, with the possible exception of the exponential averaging plan in which each year's tax base is obtained by forming a weighted average of the previous year's tax base with the current year's income. But the large number of simplifications which the cumulative method facilitates in various other directions and the more satisfactory behavior of the tax burden and the patterns of payment which it produces make of it much more than merely an elegant averaging device; cumulative assessment is in fact a key to the solution of a wide variety of income-tax problems.

THE UNDERLYING CONCEPT OF CUMULATIVE ASSESSMENT

Cumulative assessment in effect treats the entire income received by an individual since a specified initial date as a unit to be assessed as a whole at rates graduated with due regard to the period over which the income was received; past income-tax payments are treated as deposits in an interest-bearing account, the balance of which is to be credited against the tax liability thus finally computed. Ultimately, therefore, no taxpayer will be penalized because his income was concentrated in a few years, or because it happened to be realized for tax purposes in 1 year rather than another. It will be seen at once that this method of assessment makes it possible to drop or suspend a vast assortment of rules and regulations that operate primarily to determine the time at which income is realized, since the ultimate tax burden is not affected by them.

AUTOMATIC RETIREMENT BENEFITS

But the important matter in the present context is that cumulative assessment makes possible a universal and equitable approach to the problems to which the various retirement fund proposals are attempted solutions. To begin with, without any special provisions, cumulative assessment brings the ultimate tax burden of those whose earned incomes are concentrated in a few years of productive work into line with those whose investment incomes are more evenly spread out over the years. In addition, if a taxpayer comes to his retirement years with little or no income other than the small amount of interest on his savings accumulated for his retirement, the normal operation of cumulative assessment will, through the application of rate schedules to his aggregate income that are appropriate to longer and longer periods gradually revise his aggregated tax liability downward and so provide for the payment of refunds from his accumulated tax account,

which will operate to supplement his other retirement funds in a manner somewhat similar to the results produced by the carryback of unused exemptions for persons with lower incomes; for that matter nothing prevents the two types of refunds from being paid concurrently. A wide range of effects can be produced, as desired, by appropriate adjustment of the rate schedules applicable to incomes accumulated over different periods of time.

SUPPLEMENTARY INCOME DEFERMENT

Over and above the normal operation, however, with cumulative assessment it becomes possible, without introducing new discriminations, to offer relatively unrestricted opportunities for deferring the realization of income for tax purposes, where this corresponds to a genuine need for liquidity on the part of the taxpayer and does not merely represent an attempt to arrange for eventual tax avoidance. For example taxpayers may be permitted to select any of their assets and designate them as a retirement reserve writing their basis down to zero and taking an immediate deduction from income for tax purposes, thus reducing immediate taxpayments; when these assets are later disposed of, their full value would be then reported as income. This option could be offered freely and with few restrictions, since in the end there would be no avoidance of the proper tax burden, only a change in the timing of the payment of taxes; moreover there would be no excuse for asking for a special capital gains rate in case the realization is concentrated in a single year since the operation of cumulative assessment would prevent the application of unduly high bracket rates.

FLEXIBILITY OF CUMULATIVE ASSESSMENT

Besides being a convenient method for dealing with the retirement income problem, cumulative assessment is an extremely flexible device capable of being adapted with little or no additional complication to producing a wide variety of patterns as these may be deemed to be more or less desirable. The tax schedules for the various assessment periods can be so correlated as to produce the effect of a simple averaging of income over time, or they can be arranged to have the effect of allocating income over the years in accordance with any standard pattern deemed to be appropriate, or they can be adjusted to reinforce or mitigate the retirement refund characteristic, and this to differing degrees at different levels of income. All of these adjustments can be made with no change whatever in the procedure or additional computation by the taxpayer. For special circumstances, such as taxpayers living abroad for 1 or more years, correlated adjustments can be made in the accumulated income and in the accumulated tax-deposit account.

Even though cumulative assessment would be simple enough in practice to apply to all taxpayers alike, it is entirely feasible to limit its application, at least at first, to upper bracket taxpayers. For taxpayers subject only to the first bracket rate, there would be relatively little difference between the results of cumulative assessment and the results of a simple carryback of unused exemptions, so that there would be no undue discrimination in thus limiting its application. Upper

bracket taxpayers could then compute their tax in 2 parts, a basic tax at the first bracket rate and the cumulative assessment for which an additional exemption of $2,000 ($1,000 for joint returns) would be allowed. This would allow the new method to be applied at first to a relatively small number of more sophisticated taxpayers. It would even be possible to restrict the initial application even further by putting the first 2 or 3 brackets aside in a normal tax, since the degree of progression in this range is not sharp enough to give rise to much discrimination.

THE GENERAL VERSUS THE PIECEMEAL APPROACH

At any rate it would be of every great advantage to begin as soon as possible, on however a restricted scale, to apply a general and fundamental scheme for dealing with the problems connected with the distribution of income over time, so as to avoid a further proliferation of detailed and cumbersome provisions designed to take care of this, that, or the other special situation. Because such provisions often must be narrowly circumscribed in order to prevent abuse, they frequently provide another area for the intrusion of tax considerations into decisions that should preferably be taken on their economic merits. Cumulative assessment, on the other hand, opens the door to the neutralization of the income tax on a vast scale, so that decisions that now require careful examination into the tax angles will be freed of capricious tax consequences so that they can be made more exclusively on their intrinsic economic merits. Cumulative assessment is not only an attractive approach to the retirement problem but provides the key to a simple, uniform, flexible, and equitable treatment of a wide range of thorny problems such as lumpy income, depreciation, accelerated amortization, annuities, capital gains, maintenance versus improvements, expensing versus capitalization, depletion, reserves of all kinds, trust fund payments, and the like.

TIMING OF TAX PAYMENTS

It is perhaps worth noting specifically that with cumulative assessment the taxpayments remain reasonably closely in step with the income reported as realized, so that the difficulties that arose with simple averaging schemes such as that of Wisconsin, where large taxpayments based on past incomes became due in years of lowered income, will not arise. Indeed, the general tendency of the method is to accentuate the drop in taxes that corresponds to a drop in income, while mitigating the increase in tax corresponding to a temporary rise in income. Moreover there is no interference with any desired countercyclical variation in rates; indeed, countercyclical rate policy is favored in that such a policy will no longer lead to capricious discriminations in tax burden according to the degree to which individual incomes fluctuate with or counter to the general cycle, so that there will be less objection to sharp or frequent rate changes.

SIMPLICITY OF PROCEDURE

From the point of view of the taxpayer, the procedure required under a cumulative assessment scheme is quite simple. The taxpayer

carries forward three figures from the return for the previous year: the cumulated income, the tax deposit balance, and a code number indicating the beginning of his cumulation period. He computes interest at say 5 percent on the tax balance, adds this to the tax balance and on the other hand includes it in his net income for the current year. The net income for the current year (after exemptions, etc.) is then added in to the cumulated income, and on this total a tax is computed (in the same manner as at present) according to the schedule corresponding to his code number, against which is then credited the previous tax balance, including the interest, and the result indicates the tax due. As compared with the computations required on a straight annual basis, the only new elements are the carrying forward of the 3 figures from the previous return, the application of an interest rate, 3 additions, 1 subtraction, and the selection of the tax table corresponding to the code number. There is probably no other reform of the tax laws that promises to save the taxpayer so much in the way of problems and headaches in return for so little in the way of additional arithmetic.

On the administrative level, the only new requirement is that the figures carried forward from the previous return will require checking. While the most straightforward method of doing this might well be to file the returns for a particular taxpayer together, even this could be avoided by the simple expedient of attaching to each return a stub to be filled in by the taxpayer with his name, address, and the three figures to be carried forward for the subsequent year. When the return is filed with this stub attached, it will then be an extremely simple matter to compare the figures to see that they correspond with those on the return, stamp the stub certifying to this correspondence, and then detach the stub and return it to the taxpayer who would then be instructed to attach the stamped stub in filing his return for the subsequent year. The figures carried forward to this subsequent return could then be checked against this stub without having to refer to the files or collate the returns in any way. The entire compliance and administrative burden involved in cumulative assessment would seem to be far less, for example than that now involved in handling the returns and payments of tentative tax.

Unlike most averaging proposals, cumulative assessment entrains no additional difficulties in cases where past returns are reopened for additional assessment, or other adjustment. It is in nearly all cases entirely unnecessary, with cumulative assessment, to carry the adjustments or corrections through the returns for the intervening years. It is entirely possible, indeed, to carry whatever adjustment is made in the net taxable income directly as an adjustment to the cumulated total income of the last year for which a return has been filed, or even, if the delay is not too great, to leave the adjustment to be incorporated in the cumulated income of the next return.

POTENTIALITIES OF CUMULATIVE ASSESSMENT

The recent trend in the income tax law has been to proliferate at an alarming rate the number of special provisions, among which it is already becoming hard to distinguish those that correspond to a genuine need or hardship and those that represent the success of a

well organized interest group in getting its scheme past an overworked and bewildered Congress. The ordinary taxpayer is having increased difficulty in ferreting out the various provisions from which he might benefit, the businessman is increasingly afraid to make a move without securing expert counsel concerning the tax consequences, the distorting influence of specialized tax provisions on the organization of the economy is becoming increasingly pervasive, and the amount of nonproductive effort that is going into tax expertise is growing. Cumulative assessment is the one way in which this growth of complexity can be arrested, by substituting a rational, coherent, general, and automatic provision for these special sections.

Cumulative assessment has somehow acquired the reputation of being a complicated and unworkable scheme. Complicated it may have appeared at first in the context of the relatively simple income tax of the 1930's. Even then, the complication was far more one of concept than one of practical application. In the context of today's law the practical complexities of cumulative assessment appear trivial. Even if all that the adoption of cumulative assessment were to accomplish would be the warding off of further agglomerations, one would have to consider cumulative assessment as a net simplification rather than an added complexity. And when it is considered that cumulative assessment could well result in the eventual discarding of up to a third of the present income-tax regulations, it would appear not as an added complication but rather as a master stroke of simplification.

Even were the practical difficulties all that anyone has imagined, an adequate appreciation of the widespread benefits to be realized would seem to indicate that the difficulties would be well forth facing. Greater equity in the distribution of the tax burden; elimination of concern over the precise dating of transactions; automatic supplements to retirement funds; greater freedom and effectiveness in countering recessions via tax cuts; the basis laid for a rational approach to the capital gains problem; eventually the elimination of concern over amortization, depreciation, expensing, capitalization, and the like; and the gradually more and more complete exorcising of the tax consequences ghost from the management table; these are gains for which even a substantial increase in complexity would seem well worth while, and the more so if on balance the complexity vanishes as the remainder of the tax law is accommodated.

Cumulated assessment would be worth considering were the only issue involved the proper treatment of income earned over a limited productive period. But in the larger context it would seem foolish to brush it aside without full examination merely because when each of the problems to which it offers a solution is considered singly, it may not appear to be an outstandingly attractive solution. In the context of tax reform as a whole, it warrants careful consideration as a key element.

PERCENTAGE DEPLETION—A CORRESPONDENCE[1]

REX G. BAKER, general counsel, Humble Oil & Refining Co.; ERWIN N. GRISWOLD, dean, Harvard Law School

[EDITOR'S NOTE. On September 18, 1950, Dean Erwin N. Griswold made a speech before the tax section of the American Bar Association,[2] in which he referred to "gross inequities of the law in favor of the oil and gas interests."

[A number of newspaper accounts of the speech reported this as an attack on the percentage depletion provisions of the Internal Revenue Code.[3] On the basis of these reports, Mr. Rex G. Baker, general counsel of the Humble Oil & Refining Co., wrote the letter that began the correspondence reproduced herein. Neither author had any intention to publish these letters at the time they were written. No revisions have been made except to eliminate those parts irrelevant to the percentage depletion controversy and to add footnotes where it has been thought useful to refer to source materials.]

SEPTEMBER 22, 1950.

DEAR DEAN GRISWOLD: You will recall our conversation in Washington concerning the percentage depletion allowance for oil and gas wells.

Your remarks before the tax section regarding the depletion allowance received widespread publicity, and I am afraid they will be very damaging to the producers of oil and gas in view of your reputation and the responsible position you occupy in the educational world.

Both in peace and in war the country must have and is very dependent upon oil and gas. Our civilian economy and the national safety would be jeopardized if we failed to maintain adequate reserves of petroleum and a backlog of reserve producing capacity. This means that it is essential to our country's welfare and safety that the exploration for oil and gas within the United States be continued at an accelerated rate due to increasing demands for petroleum and its products year after year.

The exploration for petroleum is an extremely costly and hazardous business. Oilmen must lease vast areas, must spend large sums in geophysical operations, must drill very expensive wildcat wells, of which 4 out of 5 on the average are dry holes, and must then make enormous expenditures of money in developing proven or semiproven acreage. Risk capital is not invested unless there is hope of reward.

The producer of oil depletes his capital asset. If he is to stay in the business he must find and develop new sources of supply. If the depletion allowance were taken off, our present tax laws would tax away a large portion of his capital.

It must be remembered that a large percentage of exploratory activity is carried on by the independent wildcatter. He often spends a lot of money and goes broke without finding anything. To say that he would be protected by charging off losses ignores the fact that until he finds oil he has no income against which to charge off his losses. This is quite typical of the wildcatter. If he finally succeeds in finding oil he creates new capital and must be rewarded for the risks he has taken. This reward can be adequate only if the depletion allowance is maintained.

The fact of the matter is that the oil industry has consistently spent in exploratory effort a good deal more than the 27½-percent depletion allowance. It has thus had to look elsewhere for funds with which to help finance its quest of oil.

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[1] This correspondence appeared in the Harvard Law Review, vol. 64, No. 3, January 1951, and is reproduced here with the permission of the authors and the Harvard Law Review.

[2] See 36 A. B. A. J. 999, 1057 (1950).

[3] Internal Revenue Code, sec. 114 (b) (3), provides as follows: "In the case of oil and gas wells the allowance for depletion under sec. 23 (m) shall be 27½ percent of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under sec. 23 (m) be less than it would be if computed without reference to this paragraph."

The 27½ percent depletion allowance was established in 1926. Congress has made searching inquiries on several occasions since as to the necessity for the depletion allowance and the wisdom of maintaining it at 27½ percent. Each time after full investigation and inquiry it has sustained the 27½ percent allowance. This fact alone should, it seems to me, cause anyone to be sure of his ground before he launches an attack upon the depletion allowance.

Herewith I enclose some material which I believe you will find helpful in your future consideration of this matter: a booklet entitled "Let's Keep on Hunting Oil," some statistical data which will show that the 30 leading oil companies have found it necessary to secure new capital by issuing stock and borrowing, that their net worth has consistently been lower than the comparable figures of manufacturing companies, that a large percentage of the net investment of the 30 leading oil companies is in oil and gas producing facilities, data showing the ratio of dividends to net income, the cost of replacing crude petroleum, this cost having steadily risen, financial information for the 25 leading oil companies which shows moderate incomes, and a chart showing a comparison of petroleum prices with the price of coal and all commodities. This chart shows that the public have been the beneficiaries of the depletion allowance in the form of low prices for petroleum products.

Your attention is also invited to the hearings before the Committee on Ways and Means of the House of Representatives relating to the 1950 revision of the revenue laws.[4]

Yours sincerely,

REX G. BAKER.

SEPTEMBER 25, 1950.

DEAR MR. BAKER: Thank you very much for your letter of September 22, which has reached me this morning. I particularly appreciate its fair and restrained tone. This is in considerable contrast with the attitude which is often taken on this matter by others in your area.

As a matter of fact, I said nothing at all in my speech in Washington about percentage depletion. My remarks were directed entirely to the so-called in oil payment provisions which had been added to the bill by the Senate.[5] This seemed to me, and still seems to me, to have been a rather clear matter of special privilege. Naturally I am pleased that it was finally eliminated by the conference committee.

As I have indicated, I did not talk about percentage depletion and had no thought of doing so. There is lots to talk about there, though. In the first place, I would want to make it plain that I have never advocated eliminating the depletion allowance. That would be taxing capital. There would be no more sense in it than in eliminating the depreciation allowance.

Nor do I disagree with you at all as to the importance of oil in our economy, and the desirability of encouraging the industry, particularly with respect to exploration. I do think, though, that there is real reason to question whether the present 27½ percent depletion allowance is not excessive, whether it does not cost more than other ways of achieving the same results, and whether a very large proportion of the benefits do not now go in fact to persons who are not the ones who do the exploring and take the risks.

How about direct subsidies to explorers, for example? Might this not be a better way and, at the same time, a cheaper way? We use subsidies in maritime shipping and elsewhere in our economy. It might be a much more effective stimulus than the present backhanded way of doing it through the depletion allowance.

For example, may I call your attention to the sentence in your letter which reads as follows: "To say that he would be protected by charging off losses ignores the fact that until he finds oil he has no income against which to charge off his losses." I think you will agree that this is really no argument, since it is equally applicable to the percentage depletion deduction. The wildcatter gets

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[4] Hearings before Committee on Ways and Means on H. R. 8920, 81st Cong., 2d sess., 49-60, 100 101, 119, 133-134, 177-309, 733-740, 818-895, 901-926, 1267-1269, 1282-1286, 2975-2985, 2999-3001, 3017-3026, 3028-3029, 3040-3046 (1950).

[5] The Revenue Act of 1950, as reported by the Finance Committee of the Senate, provided that the amount received from the sale of the right to obtain a stated amount of production from an oil, gas, or mineral property, while retaining a continuing interest in such property, should be treated as proceeds from the sale or exchange of a capital asset. H. R. 8920, 81st Cong., 2d sess., sec. 214 (1950) (as passed by Senate); see S. Rept. 2375, 81st Cong., 2d sess., 66, 91 (1950).

no depletion deduction until he finds oil. In other words, the method I suggested then, as far as this point is concerned, would be just as effective, indeed, even more effective (because I would allow a 100 percent deduction until all principal costs had been recovered while percentage depletion allows only a 27½ percent deduction) than is the percentage depletion allowance.

You must know of situations where the present system of taxing oil production works out outrageously. I hear about actual cases from time to time, and they must come to your attention much more frequently. What I would like to see us do is to work out a system which would maintain adequate incentive and stimulate further production of oil without granting enormous tax advantages to drones and others who take little or no risk. I think it is a very real problem and it would be a great contribution if people in your area, who are familiar with the situation, would devote themselves toward developing a sound and sensible solution to it.

At any rate, having the benefit of percentage depletion, it would seem to me to be the heart of wisdom for persons interested in the oil industry not to jeopardize that advantage by seeking to get additional tax favors which are less warranted. I refer, of course, to such things as the "in oil" provision, and others which are suggested from time to time. There is a good deal of feeling about percentage depletion but it is very likely that nothing can or will be done about it. I would point out, though, that the community property problem was finally solved, though it seemed for many years at least as difficult. The surest way that I can think of to focus attention of other parts of the country on the percentage depletion situation, and possibly to produce fairly strong reaction, is to push it even more in the way of tax privileges.

Very truly yours,

ERWIN N. GRISWOLD.

OCTOBER 11, 1950.

DEAR DEAN GRISWOLD: I did not have an opportunity to hear your speech in Washington. My information came from remarks made by people who did hear it and from press reports. It is reassuring to be told that you had nothing to say in your speech about percentage depletion. As for the "in oil" payment provision referred to, I quite agree with you that this proposed legislation was not justified. I do not know who sponsored it. It is my belief that no responsible person in the oil industry did so. I, too, am pleased to know that the conference committee eliminated this measure from the bill that was finally passed.

It helps clarify our thinking for you to state that you have never advocated elimination of the depletion allowance. I agree with you that to do so would amount to taxing capital. The question is at what point the depletion allowance should be placed in order to encourage the generation of risk capital so essential in finding oil. Those of us in the oil industry who have lived close to the subject believe that the 27½ percent depletion allowance is more than justified.

The rate of 27½ percent for the depletion allowance has resulted over a period of years in a depletion which has been very nearly equal to the actual expenditures for finding oil by the industry. A survey by the Mid-Continent Oil and Gas Association of companies producing approximately half of the oil in the United States showed that in the period 1925-48 the expenditures for finding oil were within 10 percent of the allowable depletion. In 3 of the 5 years, 1944-48, the expenditures for finding oil exceeded the allowable depletion of this group of producers and for the 5-year period, 1944-48, allowable depletion was within about 6 percent of the expenditure for finding oil. These close relations indicate that the allowable depletion does have a direct effect on expenditures for finding oil and that the amount is not excessive in relation to the capital risked in the search for oil.

The rate of 27½ percent for depletion was determined by Congress after study of experience on the part of the industry in the years immediately prior to 1926 when this method was first adopted. The rate has been reexamined subsequently a number of times and approved by Congress in spite of attack by the Treasury Department. The depletion provision has encouraged the search for oil, resulting in great discoveries and supplies. Even if the rate of 27½ percent had been too high at one time, it has become part of the industry's cost and price structure so that any change in the rate now would tend to affect supply and price.

You raised the question whether the 27½ percent depletion allowance does not cost more than other ways of achieving the same result. Percentage depletion probably costs less than any other way which could be devised to compensate

for the risks involved in the exploration for oil and to encourage the necessary amount of exploration. This is probable from an economic standpoint, because the provision stimulates efficiency on the part of operators, since depletion is limited to 50 percent of the net profit margin. The operator has, in addition to the normal stimulus of profit from efficiency, the further attraction of a tax incentive under the present law. The depletion provision also attracts into the search for oil some capital that otherwise never would be risked in the industry, some of which adds to the discovery of oil and some of which is lost forever.

Direct subsidies to explorers probably would cost more and be less effective than percentage depletion. In the year 1949 there were 14,109 dry holes drilled in the United States. The average cost of these wells was at least $50,000 and the total cost was about $700 million. The Treasury Department has never claimed that taxes could be increased by any amount approaching such a figure through a change in percentage depletion. Even if Government subsidies involved paying only part of the cost of dry holes instead of the complete cost, the cost of the program might be greater than $700 million a year because of the additional number of dry holes that could be encouraged by the subsidies. A drilling contractor, unable to find sufficient work to keep all of his rigs busy, for example, very probably would be led by subsidies into drilling wells even if he did not expect to establish production. Efforts to limit the cost of the subsidy by controlling the drilling location of wells would involve the Government in endless details and expense regarding geology, geophysics, and other matters, and subject the industry to stifling controls by men in Government who know nothing about the business of finding oil.

Subsidies in maritime shipping are closely related to the fact that the Government has imposed regulations on the shipping industry which result in high costs relative to the merchant marine of foreign countries. There is no comparable reason for subsidies in petroleum production. The oil-producing industry feels that it is entitled to reasonable tax treatment to avoid the taxation of the capital which it creates through the discovery of new reserves, but it does not seek subsidies which at best would be destructive of efficiency, difficult of interpretation and administration, and extremely expensive to the taxpayers. Oilmen are by nature individualists and are opposed in principle to Government subsidies.

You further inquire whether a very large portion of the benefits from the depletion allowance does not go to persons "who are not the ones who do the exploring and take the risks." Statistics cited by the Treasury Department in its latest proposal to reduce percentage depletion make it clear that the great majority of the benefits go to the companies—both small and large—which are now engaged in exploration and development.[6] All of the large oil companies, which produce more than half of the oil in the United States, are engaged in extensive and expensive exploration and development programs. A review of the annual reports of these companies demonstrates the vast sums of money, running into the billions of dollars, which have been poured into the search for and development of new reserves within the past few years. The small operators, similarly, are spending sums proportionately as large considering their production. It is not true, as sometimes alleged, that the small operator searching for oil today sells his property upon development of production. Occasionally some operators sell producing properties, principally to put their estates in liquid condition to pay inheritance taxes, but the great majority of the operators who discover production today develop their properties and produce them. Such operators are receiving the benefits of the reasonable tax provisions applicable to oil production as a result of taking risks in exploration and development.

The purchaser of a proved property, who is still taking considerable risks with respect to the amount of recoverable oil and the future price, generally pays a price which means that percentage depletion is of no benefit to him because it is less than cost depletion. At the present time, for example, developed oil reserves in the ground generally sell for about $1 a barrel which exceeds the percentage depletion, amounting to a maximum of 71 cents a barrel on the present price of $2.58 a barrel. If the percentage depletion provision is applicable and appears to place the purchaser in a position to save taxes, it influences the price he is willing to pay for the property and so results in a benefit to the operator who found and developed it. An inflationary trend which raises the price of all commodities may result in tax benefits even to a purchaser whose cost depletion at the time of the purchase exceeded the prevailing percentage depletion, but that

[6] Hearings before Committee on Ways and Means on H. R. 8920, 81st Cong., 2d sess. 49–60 (1950).

is reason for criticism of the conditions which bring about inflation and not for criticism of the operator who purchased an oil property on the basis that it was a reasonable investment at the prices then prevailing.

Perhaps the criticism that the benefits of percentage depletion go to persons who are not the ones who do the exploring and taking of risks is meant to apply to royalty owners. Even the royalty owner, however, may take risks and there are, in fact many royalty owners who are also engaged in exploration and drilling. In fact, many independent operators regularly buy royalties as part of their business. Basically, however, the reason for application of percentage depletion even to the royalty interest is to protect the capital of the royalty owner which arises from the discovery and development of oil. The royalty owner, as much as the producer, has a known capital value as soon as production is established and is entitled to protection of that capital value before his income is subjected to the ordinary tax rates.

In your comments relative to the "in oil" provision you seem to imply that percentage depletion is an advantage amounting to a tax favor, even though you can see it is warranted more than the provision regarding oil payments.[7] In the opinion of the oil industry the percentage depletion provision is merely a recognition of the penalties inherent in the risks involved in finding oil, and is necessary to avoid a tax penalty amounting to taxation of its capital to which it should not be subjected. Percentage depletion merely places the oil industry, insofar as the taxing of capital is concerned, on an equal footing with other industries which do not create new capital through discovery of hidden resources.

Yours sincerely,

REX G. BAKER.

OCTOBER 14, 1950.

DEAR MR. BAKER: The figures which you cited in your last letter are interesting and significant. However, they do not, I believe, take account of the fact that a large proportion of these expenses are deducted in computing income taxes, in addition to the percentage depletion deduction. I am referring, of course, to the optional deduction allowed for "intangible drilling costs," and other similar deductions.[8] The figures you give would be more persuasive to me if they showed a comparison between the costs on the one hand, and the aggregate deduction on the other. By aggregate deduction, I mean not only percentage depletion, but also the deduction allowed for intangible drilling costs and other expenses. I do not believe that the comparison would be nearly as favorable as the figures you give indicate. Indeed, I should think this might be a major weakness in your argument.

Now let me turn to the last paragraph of your letter. The basic difficulty here, it seems to me, is one which is rarely disclosed in discussions from the oil country. This is the "discovery" allowance which is implicit in percentage depleton. I know of no other area in our tax law where very large increments in capital value are wholly exempt from taxation. You say that percentage depletion is necessary to enable the industry to preserve its "capital." But this is obviously using capital in a double sense, and in a sense which is not applicable to other taxpayers. For other taxpayers, that capital, recoverable through depreciation, or on sale, or otherwise, is their investment in the property. Only in the oil business do "discoveries" become capital for tax purposes. Frankly, I find some trouble seeing why this should be so.

You suggest that this is necessary because of the "risks involved in finding oil." I do not minimize these risks. I know that, in a sense, they are very great. However, I think a pretty good case can be made for the proposition that large outfits, like the Texas Co., or the various Standard Oil companies do not take very substantial risks, except in a sense analogous to that in which it is said that the New York Life Insurance Co. takes risks. Or, to put it another way, when the operations are on a large scale, as in the life insurance business, the probability that things will come out somewhat as planned is very great. I do not mean to say that the probability is nearly as great in the oil industry as in the life insurance business. Nevertheless, experience has shown over the past 20 years that the big oil companies stand a high probability of success. They have no difficulty recovering the costs of their unsuccessful ven-

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[7] See p. 365 supra.

[8] United States Treas. Reg. III, sec. 29.23 (m)—16 (b) (1943).

tures from the products of their successful ones. I really seriously question whether it can be shown that percentage depletion is a necessary compensation for risks taken in these cases. The situation with respect to wildcatters, and the problem of stripper wells, are quite different. But the big companies account for a very large proportion of the production. It is far from clear to me that percentage depletion is ever necessary either (a) to compensate them for risks taken or (b) to safeguard their capital investments.

Very truly yours,

ERWIN N. GRISWOLD.

OCTOBER 16, 1950

DEAR DEAN GRISWOLD: Enclosed is a section of yesterday's Houston Chronicle which contains a good deal of information concerning the oil and gas industry.[9] It will give you some idea of the enormous cost involved in finding and developing oil and gas, and of the tax burdens borne by the industry.

Yours sincerely,

REX G. BAKER.

OCTOBER 20, 1950

DEAR MR. BAKER: It was good of you to send me the oil progress section of last Sunday's Houston Chronicle. I have looked at this with much interest.

I must confess, though, that I am still not impressed by the "tax burdens borne by the industry." I have no doubt that the industry presents many problems and bears a good many burdens. But its tax burdens would surely seem to be lighter than those carried by most other industrial enterprises. Take a look someday at the proportion of taxes to net income for 3 large oil companies, on the one hand, and 3 large nonoil industrial enterprises, on the other. The figures are astounding.

If you say that you are not talking about the big companies, but about the little fellows, then I think we might meet on common ground. But a very high proportion of the tax benefit goes to the big companies.

Very truly yours,

ERWIN N. GRISWOLD.

OCTOBER 26, 1950

DEAR DEAN GRISWOLD: It is a pleasure to receive your letters of October 14 and 20 on the subject of taxes paid by the oil industry. Your interest in this subject leads me to set forth a few additional points about the operations of the oil industry, for it seems that the lack of general understanding of the peculiarities of oil production is one of the principal reasons why the tax provisions relating to oil production are often criticized.

A crucial point, as brought out in your letter of October 14, is the question of the contribution of the developer of oil production and the measure of the capital which he is entitled to recover free of tax. Two points seem pertinent on this question.

In the first place, let us consider 2 individuals investing $500,000 each, 1 in the search for oil and the other in an office building. The individual searching for oil may spend $100,000 on each of 5 different leases and establish production on only 1 of the leases. The other individual erects an office building with his $500,000. Would it be fair to allow the oil operator to recover as capital on his productive lease only the $100,000 that he put into that lease? If the individual is to risk his money in the search for oil it would seem that he would do so only with the prospect that he would recover more than the $500,000 spent on all of his ventures if he is successful. There is always the chance that he may find no production with his investment and all of his capital may be lost. To offset that risk there must be the attraction of a reward commensurate with his success if he finds oil. Another individual might venture $500,000 in the search for oil and discover twice as many barrels of reserves as his competitor, due to skill and good fortune. In this latter case he has made a contribution to society which is worth twice as much as that of his competitor. As soon as the oil is discovered and developed it can be sold in place, without being produced, for a known capital value, and, in case of such sale, taxes are on the basis of capital gain rather than current income.

[9] Houston Chronicle, October 15, 1950, sec. E.

The second point is that a producer of oil realizes two distinct kinds of income: namely, a capital gain on the sale of an asset which has been held for a long period of time and a short term income on the operation of a producing property. The capital gain is measured by the difference between his investment in establishing the production and the price at which he could sell the oil in place and turn it over to someone else who would then make the current profit on the operation of the producing property. The percentage depletion provision results in substantially the same rate of taxation as would result from the separation of income into its 2 component economic parts and the taxation of 1 part as capital gains and 1 at current income tax rates. In the absence of such consideration in the income tax laws, operators discovering and developing oil would be encouraged to sell their oil in place rather than to continue in business. It would seem to be in the public interest for tax policy to permit and encourage successful operators to stay in the business rather than to sell their properties to others who may have been less successful in the search for oil.

You raise the question whether the operations of large oil companies do not in effect reduce the risks of this business to those comparable with a life insurance company and suggest that the probability that things will come out somewhat as planned is very great. I am sure you would find that the life insurance companies do not consider their business in any way comparable with that of oil production, else with their large funds they would already have entered this business. A life insurance company not only knows the risks but also the precise amount of money which it is going to spend and take in. The company engaged in the search for oil has no such assurance. It only knows that if it has average experience more than 1 out of 3 wells that it drills will be dry, but it has no way of knowing how much oil its productive wells will develop or what the value of that production will be when the oil is produced over a period of 20 or 40 years. A decline in the price of crude oil, for example, such as occurred between 1926 and 1933, can wipe out the apparent profits anticipated on the basis of cost and price realizations at the time of the investment. Naturally, the investments of the oil companies made during the depression seem very successful, but so do practically all other investments made at the same time. That fact does not provide any assurance against a decline in prices. The big oil companies are definitely taking very substantial risks which may break them as well as make them in the future. The Humble Oil & Refining Co., for example, has spent millions of dollars in Florida and to date established only a very small production. Unless our efforts and luck in that area improve, we stand to lose a very large sum of capital that Humble has risked in the venture. If we do lose our investment, we can deduct it in calculating our income tax payments just as any other business could deduct its losses on an unsuccessful investment, but that does not return to us the capital which Humble has risked. In the year 1949 alone Humble's dry-hole costs were $32,267,000, and even after consideration of the reduction in income taxes due to such loss it is clear that we risked and lost a very substantial sum of money. We can have no hope of realizing a return on that investment. Indeed, the investment itself is wiped out.

One final observation may help to throw additional light on the question of the oil industry's risks and the relation between its costs and deductions. I mentioned in the previous letter that a survey by the Mid-Continent Oil & Gas Association showed a close relation between the expenditures for finding oil and the allowable depletion. In your letter of October 14 you ask about the optional deduction allowed for intangible drilling costs. The same study previously referred to shows that the investment of the companies included in the survey in drilling and equipping productive wells exceeded their expenditures for finding oil. The sum of the expenditures for finding oil and for drilling and equipping productive wells was approximately twice the total allowable depletion of the companies for the period 1925–48. The investment in drilling and equipping productive wells was recovered only once as a deduction of intangible drilling costs and depreciation of tangible drilling costs. I did not mention this fact in my previous letter because percentage depletion relates to the depletion of the oil itself and, therefore, to the expenditures incurred in the search for oil rather than to the tangible and intangible investments in drilling, which are recovered through the option to expense intangible drilling costs and the depreciation of other drilling costs. This evidence is quite significant on the point which you considered a weakness in my previous argument.

In your letter of October 20, 1950, you suggest that we look at the proportion of taxes to net income for 3 large oil companies on the one hand and

3 industrial enterprises on the other. The point you are referring to can be illustrated from the comparison of the reports of United States Steel and Humble. In 1948 United States Steel showed a net income before Federal income taxes of $230 million, compared with Humble's net income on the same basis of $240 million, while United States Steel paid Federal income taxes of $100 milion and Humble paid $54 million. In 1949 United States Steel paid $126 million in Federal income taxes on a net income before taxes of $292 million, whereas Humble paid Federal income taxes of $18 million on an indicated net income before taxes of $138 million The explanation of the difference in the effective rate lies, of course, in the fact that a considerable part of Humble's net income really represents capital gain on the sale of its oil, and this capital gain should be taxed at 25 percent rather than at the normal corporate income-tax rate, also in the fact that Humble is taking its depreciation on intangible drilling costs as it makes such investment rather than spreading the depreciation over the life of the properties. If Humble were to quit drilling or to reduce its drilling operations, the effective income-tax rate would materially increase. Over a period of time the only difference between the effective tax rate on a steel company and an oil-producing company would be because of the percentage depletion, which is thoroughly justified in order to afford fair treatment of the capital gains realized on the sale of oil as it is produced.

I have taken the liberty to write at length on points suggested by your letters because you have shown a genuine interest in an objective inquiry about the facts with respect to the tax provisions on oil production. We find in our own operations that the business of exploration for and development of oil and gas is very complicated and not always fully understood even by some of the operators engaged in this business. It has been my endeavor to set forth information which may help to give you a better picture of the problems of oil production. We believe that the problems and peculiarities of the oil-producing business warrant and require the tax provisions now applicable with respect to percentage depletion and the option to expense intangible drilling costs.

Sincerely yours,

REX G. BAKER.

NOVEMBER 6, 1950.

DEAR MR. BAKER: Please let me thank you for your letter of October 26. I have read it with much interest, and I would like to make certain observations.

In the first place, it seems to me entirely clear that the costs of any oil operations should be fully deductible from income, including subsequent income from other operations, where there is no current income against which the costs may be deducted. Taking as an example the situation given near the beginning of your letter, if a person spent $100,000 on each of 5 different leases, and established production on only 1 of the leases, I would allow the full $500,0000 to be deducted against income, either current income from any source if there was such income, or against subsequent income from any source. This could be done by a system of carryovers. If the present 5-year limit [10] on carryovers is not enough, I would have no objection to its being extended. I am entirely in favor of taxing no more than the net income of oil operations. I still find it somewhat difficult to see why we should tax less than that net income, which may be, and often is, the result of the 27½-percent depletion allowance, which goes on without limit, and without relation to (a) actual depletion sustained or (b) the aggregate amount invested by the taxpayer in oil production.

The rest of your letter is devoted to what seems to me to be the heart of your argument. In substance, you seem to be saying that all income from oil production should, in effect, be taxed as capital gain, and that this gives an adequate justification for the present depletion allowance. This argument, I must confess, I find very hard to follow.

Is it not clear that income derived from oil production is business income? Is there any other sort of business income which is taxable as capital gain? When the grocer sells you a can of peas, he sells you property, but the gain is taxable as ordinary income, no matter how long he has held the peas. The same is true of a manufacturer, or of a real-estate operator. Indeed, the same is true of every other sort of business income. Why should income derived from oil production be treated in any other way? Perhaps the answer is that all income should be treated as capital gain. That would of course be attractive, and it would not result in discrimination between different types of business activity.

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[10] Internal Revenue Code, sec. 122.

as is the situation now. But it would hardly produce the revenue which, for better or for worse, is necessary under current conditions.

You mention the fact that in the year 1949 alone Humble's dry-hole costs were $32,267,000. But every nickel of that was deducted against other income, and Humble was not taxed on anything in excess of its net income. On the contrary, Humble paid taxes on much less than its economic net income, as can easily be shown by comparing the company's net income, in its reports to stockholders, and the much lower figure for net income which was undoubtedly given on its income-tax return as a result of the 27½-percent depletion deduction. It is true that Humble risked and lost a lot of money on dry holes. But it is also true that it made even more money on other activities. And no one suggests that it should be taxed on anything more than its net income, after making full allowance for all the losing ventures. Frankly, I find it very hard to see why the dry-hole costs, fully allowed as tax deductions, have any bearing on the justification of the depletion allowance. There are many other industries which have to risk large sums, without any immediate or current tax deduction. I need to refer only to the steel industry for an illustration. There, large sums must be spent which are capital costs, and not deductible at all, except through carefully measured and limited depreciation deductions. In this respect, it seems to me that the oil industry has a great tax advantage, quite apart from the unlimited depletion deduction.

When all is said and done, your argument seems to boil down to the proposition that income from oil production should be taxed as capital gain. This appears near the end of your letter where you state that the percentage depletion deduction "is thoroughly justified in order to afford fair treatment of the capital gains realized on the sale of oil as it is produced." This argument sems to me to be clearly unsound. I can see no reason why, if valid at all, it would not be equally valid to all other income from production. Take, for example, the income from farms or from manufacturing The farmer produces property. The manufacturer produces property. Yet no one has ever seriously argued, I believe, that their gains on the sale of this property should be taxed as capital gains, or that they are capital gains. The income from the conduct of the business is clearly business income. Oil production is clearly a business. I can see no reason why the income derived from the business of oil production should not be taxed as ordinary income. I repeat that I refer only to the net income, after full allowance for all costs incurred and for all capital actually invested in the business. But the percentage depletion deduction goes far beyond this. It gives a very large deduction, which bears no relation either to costs or to actual capital investment. I am still puzzled why anyone should think that it has a proper place in a fair and equitable tax system.

I have no hostility to the oil industry. On the contrary, I admire its great achievements, and its great contributions to the country, its economy, and its defense. But there are also many other forms of activity which contribute greatly to the country, its economy, and its defense. Why should they not all be treated the same? Why should the oil industry be the recipient of a tax deduction, enormous in the aggregate, which bears no relation to its costs, or to the capital invested in oil production?

Very truly yours,

ERWIN N. GRISWOLD.

NOVEMBER 8, 1950.

DEAR DEAN GRISWOLD: Your letter reveals the difficulty that even a man of your ability has in understanding the real nature of the oil business and the risks involved in finding and producing oil. After all, the basic principle involved in the depletion allowance is rather simple. The man who explores for oil must invest vast sums of risk capital. He may lose this capital altogether on unsuccessful ventures. He may through luck or skill succeed in finding an oilfield. If he does, he creates new capital. In producing that oil he depletes the corpus, and if the taxing away of his capital is to be avoided he must have a depletion allowance. Only in this way can he, under our existing tax rates, have enough left with which to do further exploratory work with the hope of finding new reserves to replace those depleted by production.

There is no way to compare his real situation with that of the steel manufacturer or the farmer mentioned in your letter. The man who builds a steel mill can depreciate every dollar of his investment in time, and through depreciation get his capital investment back tax free. The farmer who raises a crop does

not deplete the corpus of his farm, for he is able to grow a new crop year after year. Therefore, any sums he may realize from the sale of his crops are ordinary income. Of course, he can charge off depreciation on his tools and equipment because they wear out and must be replaced.

Thus in its essentials depletion does nothing more than afford the oilman an opportunity to replace his capital. This is exactly what is done with the owner of the steel mill who is allowed depreciation on his plant investment. To me this analysis is simplicity itself and I cannot see how its validity can be questioned.

I sincerely hope that you will be able to come to Texas some day. Perhaps you would enjoy a trip to the oilfields and an opportunity to witness the widespread wildcat operations which are taking place in this part of the country. Then I believe you could better understand why the enormous risk capital involved in operations must be regenerated out of the depletion allowance on the oil that is found and produced.

Sincerely yours,

REX G. BAKER.

NOVEMBER 27, 1950.

DEAR MR. BAKER: It seems to me that your position boils down essentially to one matter, namely, that oil producers are entitled to special tax treatment because their income is essentially capital gain.

The argument that the present percentage depletion allowance is necessary to enable you to recover your actual cost will not stand up, particularly as applied to a company like yours. I have made it plain that you, or any other oil producer, should be able to recover all of your actual investment before any tax liability is incurred. As a matter of fact, though, the combination of the deduction of intangible drilling costs plus percentage depletion gives you, and most oil producers, a deduction far in excess of your costs. I have no doubt, for example, that the aggregate of these two deductions taken by Humble in the years since percentage depletion became available is far in excess of the aggregate of Humble's actual costs in those years. There is no other type of business enterprise in this country which receives deductions in excess of costs through depreciation or otherwise.

In the case of certain independent wildcatters, it may be that a succession of dry holes will produce costs which cannot be offset, under present laws, against subsequent income. This should be largely taken care of, however, by the present provision of the law allowing losses to be carried forward for 5 years. If this is not enough, I would have no objection whatever to any change in the law which would make it plain that no oil producer was subject to tax until he had received deductions equal to all of his costs which had not previously been effectively deducted from gross income.

Let us try to test your capital-gains argument. Suppose we had a tax, like the English tax or the Canadian tax, in which capital gains are not taxed at all. Could you successfully maintain the position that income from oil production is not subject to tax at all, because it is capital gain? It seems to me that the answer to this is quite plainly "No."

The tax systems which do not tax capital gains all draw the line closely between what they regard as capital gain and profits from "trade or business." It is clear that the operations of oil production are a trade or business, within this concept, as well as under our own law.

We do not have to speculate about this. The Canadian income tax is a clear example. Under that law, capital gains are not taxed. But it has never been seriously suggested, as far as I know, that the income from the production of oil and gas in Canada should be wholly exempted from tax on the ground that it is capital gain. On the contrary, it is clear that it is regarded as income from trade or business, and subject to tax as income. It is true that there is special allowance for depletion under the Canadian tax law. This may, however, be a reflection of the special deduction allowed in the United States law

On the whole, it seems to me that the best position you have developed is the capital-gain one. Even on that basis, though, I think you claim too much. Under our law capital gains are taxed, though at a maximum rate of 25 percent. But the percentage depletion deduction is supposed to reflect the old "discovery value" allowance. The effect of this was to make the capital gain on the discovery of oil (or other mineral) wholly exempt from tax. In other words, discovery value—and therefore percentage depletion, to some extent—clearly goes too far. I think I could understand a provision which said that income from oil

and gas production should be taxed as capital gain, and which, accordingly, completely eliminated the percentage depletion deduction. Trying to get both capital gain treatment, and the percentage-depletion deduction, as in the recently defeated provision about "in oil" payments, is clearly trying to get too much. And if income from oil production was taxable as capital gain, I should feel that, under current conditions, the present 25 percent rate was far too low.

However, it still seems to me that taxing income from oil production as capital gain would be quite wrong. Such income is clearly income from the conduct of a trade or business and is not capital in its nature, even though it arises, in a sense, out of increases in the value of property. After all, the income of any manufacturer or retailer likewise arises out of increases in the value of property, namely, the property which is manufactured or sold. Such income, however, is clearly not capital gain. There is no better reason, as far as I can see, why the business income of oil producers should be taxed as capital gain merely because it is derived by selling the property that they produce.

You suggest at various places in your letters that the oil producer should be able to get tax free "the capital he has produced." I do not know any other line of activity in which a person recovers tax free any capital he may have produced. Even in the case of capital gains, the basis for determining gain or loss will be only the amount actually invested in the property. It is only the oil industry which gets a return free of tax in excess of its actual capital investment.

Thus, the percentage depletion allowance turns out to be nothing more than a special subsidy. If that fact were more generally understood, I cannot help wondering whether the present allowance would be continued unmodified.

Very truly yours,

ERWIN N. GRISWOLD.

DECEMBER 12, 1950.

DEAR DEAN GRISWOLD: As I interpret your letter of November 28, you insist that oil producers receive special and unwarranted tax treatment and that all their income should be taxed as ordinary income, despite the fact that in your letter of September 25, you concede that oil producers are entitled to a depletion allowance, merely questioning the advisability of placing it at 27½ percent. Actually, the depletion allowance is applicable to relatively few oil-producing properties. In practice, cost depletion applies to the poorer properties. Furthermore, percentage depletion is limited to 50 percent of net income derived from a producing property. Thus, in general, it is improper to refer to 27½ percent depletion rate as applicable to all oil properties.

The producer of oil receives two different kinds of income. He realizes a capital gain or loss on the sale of an asset held over a long period of time and a normal income on the operation of a producing property. The income-tax law authorizes the taxation of income and not capital. Therefore, any capital gain from the sale of an asset held over a long period of time should not be taxed as normal income. Only the income derived from producing operations can justly be taxed as normal income. Consequently, the depletion allowance, which makes it possible to avoid the taxing away of capital, does not give special treatment to the oil industry and is completely justified. This is proved by the fact that the profit figures for the oil industry clearly follow the same pattern as for other industries.

There is no evidence that the tax provisions have resulted in advantage for oil producers as compared with businesses in general. The fairness of a tax cannot be judged by merely looking at the most successful operators, but must be tested instead by considering the average results for all operators.

The function of such profits as are realized after taxes is to direct investment capital into different activities in proportion to need. There is no evidence that profits have been so high as to attract any more capital into the oil industry than is needed. While the oil industry has constantly expanded, the expansion has contributed greatly to the maintenance of low prices for fuels, to economic progress, and an expanding economy. If the profit rate on oil production had been reduced by higher taxes, the capital attracted into the industry would have been reduced; additions to oil reserves would have been less. The smaller supply of energy would have retarded economic progress in the United States, and the price of gasoline and other petroleum products to the consuming public would have been materially increased.

Thus, it seems clear that the wisdom of the depletion allowance is more than justified, and experience has demonstrated that the depletion allowance is not

excessive but has been only enough to generate new risk capital required in exploring for oil.

Yours sincerely,

REX G. BAKER.

EROSION OF THE FEDERAL CORPORATION INCOME TAX BASE

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Tax proposals and legislation which make the headlines usually focus attention on tax rates or individual exemptions. Of greater long-run importance, however, may be the far-reaching changes in definition of taxable income. The number of these changes over recent years, most of them technical and complex and each usually affecting only a relatively small group of taxpayers, runs into the hundreds. Most people are interested only in tax features which affect them and they either are not interested or do not understand other changes and their indirect effect on all taxpayers. Most individuals and groups agree, in the abstract, on the current need for high taxes to finance the Government and avoid inflation, but when it comes to specific tax rates and structural features they favor preferential treatment for themselves and high taxes on all other taxpayers.

This paper considers from a broad point of view the effects of tax-base erosion, that is, the narrowing of the tax base as a result of exemptions and other tax provisions. It considers the subject, however, only with reference to the measurement of corporate income and some noncorporate business income. In doing this, the paper has a threefold assignment:

(1) Identify the specific provisions, especially recent statutory changes, in present corporation income-tax law and administration which narrow the present corporate income-tax base.

(2) Estimate the dollar amounts of erosion, both in total and for each specific feature, if possible.

(3) Estimate how much present corporate income-tax rates could be lowered if the corporate tax base were broadened by eliminating all eroding features, assuming that the present amount of revenue from the corporate income tax is maintained.

Erosion of the tax base has become a popular term among tax students and practitioners in recent months. It represents an evaluation of the effects on the tax base of the trend in tax legislation toward special treatment for an increasing number of special groups, with the result that a substantial amount of income is not subject to taxation at the regular rates.[2] The direct effects of a narrower tax base are higher tax rates, larger budget deficits, or a combination of both.

The corporation income tax is rated "our second best tax."[3] This tax, the largest revenue source for most years 1913–43, has been the

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[1] The author is associate professor of economics, Oberlin College, on leave with the Division of Research and Statistics, Federal Reserve Board. The views expressed herein are the personal ones of the author and do not reflect the views of the Board. This paper was presented at the 48th Annual Conference on Taxation in Detroit on October 19, 1955. It is reproduced here by permission of the National Tax Association.

[2] W. L. Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, Harvard Law Review, March 1955; Walter W. Heller, B. U. Ratchford, L. L. Ecker-Racz, et al., Symposium on Practical Limitations of the Net Income Tax, Journal of Finance, May 1952, pp. 185–242.

[3] R. Goode, Corporation Income Tax, p. 217 (1951).

second best revenue source of the Federal Government, over fiscal years 1944–56, providing approximately 30 percent of budget receipts. Present record high corporate tax rates, continuing after reductions in individual income taxes and excise taxes have become effective, cause the regular corporate tax to operate nearer capacity than any other of our major Federal taxes. The present 52-percent rate compares with 38 percent in 1946–49, 40 percent in 1944–45, a high of 19 percent during the 1930's and a range of 11 to 13.5 percent during the 1920's. With the current and prospective high rates, tax considerations are more important in business decisions than if rates were lower, both as to what action to take and the form in which to act.[4]

In addition, high rates, coupled with knowledge that some taxpayers already enjoy preferential treatment, spur others to try to obtain special treatment for themselves. And with high rates each different interest group can make a persuasive case that incentives or tax equity can be improved without undue revenue loss if only their type of activity is excluded from the full burden of ordinary tax rates. Also under high rates Congress tends to be more liberal with relief provisions.[5]

The recent report of the British Royal Commission (Radcliffe Commission) opposed the use of the tax mechanism to encourage selected economic activities. Referring to tax allowances used to stimulate investment in certain assets, the Commission said:

> * * * direct taxation at least is best resigned to a rather rigid principle of impartiality between taxpayers and that a democracy supported by universal suffrage ought to be peculiarly careful to guard itself against experiments in discriminatory taxation. * * *
>
> * * * from a public standpoint, discrimination by industry is not unreasonably associated with the pressure group and the parliamentary lobby.[6]

Most provisions leading to erosion are not loopholes in the strict sense of unintentional or unforeseen avenues of tax avoidance. More frequently, they represent favorable treatment granted with the intention of promoting objectives deemed to be more important than revenue and equity considerations.[7] The dominant consideration may be to provide an incentive to some highly desirable activity such as defense-plant expansion, to relieve a depressed area or industry such as coal, to help small business, or to remove existing discrimination by extending special tax treatment to comparable industries or types of income.[8] These considerations are largely responsible for narrowing the tax base, and are "the big, unsettled issues involving social and political judgments rather than narrow structural and revenue considerations."[9]

Erosion of the tax base might go so far that it would threaten public confidence in our entire tax system. Tax justice depends not only on tax administration and enforcement which are uniformly fair for all taxpayers but also on tax legislation which the public believes to be equitable among different taxpayer groups. Loss of confidence

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[4] See, for example, D. T. Smith, Effects of Taxation: Corporate Financial Policy (1952).
[5] The Revenue Act of 1951, for instance, in which the major changes were rate increases on personal and corporate income, included 34 sections which reduced the tax burden generally or on some special group. Ratchford, op. cit., pp. 203, 208.
[6] Royal Commission on the Taxation of Profits and Income, final report, secs. 418, 426 (Cmd. 9474, 1955).
[7] Roy Blough, The Federal Taxing Process, pp. 394–396 (1952).
[8] Cary, op. cit., sec. III.
[9] L. L. Ecker-Racz, op. cit., pp. 230, 233.

in either tax legislation or enforcement would lead to wholesale attempts at avoidance and evasion, especially if, as seems likely, rates on personal and corporate incomes continue high.

Tax-base erosion and high rates thus chase each other in a vicious circle. High rates both contribute to business action designed to minimize taxes and create pressure to escape from high rates by special legislation. This activity may snowball, with those unable to find a legal route to avoid taxes resorting to illegal tax evasion.

The antitax base erosion approach to these dangers is to widen the various tax bases and to reduce rates, thus reducing the impact of tax considerations on private economic decisions. It is pertinent to note that the NAM listed as a guiding principle for its current Federal tax program:

> The Federal tax system should be broadly based * * *. [This] means a broad spread of tax methods and * * * that each method should involve the largest possible tax base, that is, with as few exemptions or exclusions as possible.[10]

STANDARDS FOR AN UNERODED TAX BASE

What does "erosion of the corporate income-tax base" mean? At one extreme, all deductions and exclusions could be regarded as erosion; this would mean a gross-receipts tax. Another arbitrary yardstick would be to class all changes which have narrowed the tax base after a given date, say 1945, or 1920, as erosion. It would be helpful to have some objective measure of an uneroded tax base, such as the Department of Commerce estimate of corporate profits. Unfortunately, the Commerce concept of corporate profits proves an inadequate standard for tax purposes.[11]

Rejecting these approaches makes necessary some yardstick to differentiate between desirable and undesirable deductions and exclusions. Two standards are used in this paper for determining what constitutes erosion in specific instances. First, taxable income in most cases should correspond to commonly accepted business measures of net income consistently followed. Income for tax as well as for business purposes should be determined by matching revenues with the costs and expenses incurred in producing those revenues. Section 446 (a) of the 1954 code, in language similar to that which has been in law since 1918, prescribes:

> GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

D. T. Smith and J. K. Butters point out that differences between business and taxable income are numerous and important.[12] Three broad categories cover most of these:

(1) "Differences in timing of various income and expense items." Some differences are matters of judgment, such as rate of obsolescence; others vary as to degree of certainty, such as reserve for contingencies.

(2) "Differences arising from use of surplus charges and credits for

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[10] A Tax Program for Economic Growth, pp. 7–8 (January 1955).

[11] Shortcomings for tax purposes of the Commerce concept of profits include: its interest in national aggregates while tax laws and collectors must deal with individual firms; its concern with only current production, excluding gains and losses on transfers of existing assets; its elimination of income from foreign sources; and its treatment of non-Federal income taxes.

[12] Taxable and Business Income (National Bureau of Economic Research, 1949), ch. 1.

business purposes * * * not accepted for tax purposes." All changes which indicate taxable capacity must pass through net income for tax purposes; direct adjustments to surplus are not sufficient.

(3) "Differences arising from policy decisions to accord special treatment to certain type of income or expense." Smith and Butters summarize their position (at p. 22) on this special treatment for items such as capital gains and losses, percentage depletion, and carry-over of losses:

> * * * they do not have any counterpart in business accounting, nor do they arise as inherent elements of any underlying broad concept of taxable income. On the contrary, they represent deliberate congressional decisions to adopt for tax purposes rules based on criteria other than a correct determination of income in any sense of the word.

In part the purposes of determining income subject to tax differ from purposes behind the measurement of business income. To protect the public interest by maintaining revenue and preserving equity between different taxpayers, congressional legislation and Treasury regulations often must limit business discretion in reporting certain income and expense items available under accepted accounting practice. This is necessary primarily to get uniform or closely comparable measures of taxable income for different taxpayers for each year. A serious limitation of this approach is that accounting principles provide a flexible and shifting body of conventions rather than a fixed standard. In many cases tax accounting has forced observance of different rules than had previously been used for business purposes alone. As a result, there has been some interdependence between tax and business accounting.

The other standard on which this paper leans is that taxes be neutral between different types of economic activity. Tax neutrality is used here in the sense that taxes be levied without discrimination and without favor between different forms of income, between different categories of expenditure, and between different industries. This viewpoint emphasizes revenue and equity and is consistent with an overall stabilization policy. Absolute neutrality is not possible, but at least relative neutrality can be a guide and the basic intent.[13] Thus some of the following decisions as to what constitutes erosion necessarily will be subjective, with reasons presented within the space limitations.[14] Readers who disagree with inclusions and omissions on this list may find the dollar estimates helpful in calculating a total based on their own list of eroding features.

Thus our guides for discovering and measuring erosion in the corporate income-tax base will be the twin standards of tax neutrality and of taxable income generally coinciding with accounting concepts of business income.

The second assignment, after identifying a specific provision in the present law which erodes the corporate-tax base, is to estimate the dollar amount of leakage. To do this, the tax base under present law

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[13] It is impossible to collect and spend approximately $70 billion a year without many effects and repercussions on the economy. Federal tax and fiscal policy goals now include prosperity, high employment, a stable price level, and economic growth, all decidedly unneutral objectives. But tax rates and structure can contribute to these aggregate goals without singling out particular industries or types of economic activity for preferential treatment.

[14] The only prejudice in this paper known to the author is the inclination, other things being equal, to choose that measure of income which gives the largest tax base.

must be compared with the possible tax base with all erosion eliminated, forcing suggestions as to possible changes to stop the leakage. These suggestions are not intended to be tax-policy recommendations, nor will they be defended here as necessarily the best of several possible ways to restore a broader, more equitable, and more accurate tax base. But some tax changes are necessary in order to quantify the amount of leakage from the current measure of taxable corporate net income; these proposals are unavoidable byproducts, not the major objective of this paper. Perhaps, on other grounds, you or I would prefer to retain provisions of the present law, or to end erosion through different changes. Estimates of loss to the tax base from different tax provisions are sometimes crude and often indicate the lower or midpoint of a range of possible amounts.

The problem of the corporate-tax base differs from the individual in two ways. First, changes in revenue generally come from rate changes. There are no general exemptions to raise or lower to vary the base. Secondly, corporate taxable net income has been reduced largely by legislation deliberately granting preferential treatment to different income and expense items. There is relatively little evasion by underreporting or overdeducting.

Because of the nature of the subject—the overall effect of specific provisions on the tax base—it is more important to cover the many provisions that permit erosion—in some cases a little sketchily—than to deal exhaustively with what appears now to be the major sources of erosion. The specific elements of erosion now in the corporate income-tax base are considered in the following order:

I. Revenue excluded from the tax base.
II. Expense deductions.
III. Preferential tax treatment for certain sources of income.
IV. Special treatment for certain industries.
V. Miscellaneous.

The conclusion presents an estimate of possible rate reductions if corporate net income subject to tax were broadened to include all leakages attributed to erosion in this paper.

To put the changes contributing to erosion in perspective, it should be noted that a number of tax changes have broadened the corporate-tax base in recent years. For example, the corporate-tax base has been extended and leakage reduced in the following fields: Collapsible corporations and nonrelated activities of educational and charitable organizations in 1950 previously tax-exempt cooperatives, mutual savings banks, and savings and loan associations in 1951, and preferred stock bail outs and amortization of premiums on bonds with short-call dates in 1954.[15] During 1955, Treasury spokesmen have taken a firm stand against requests for tax deferral on pension funds set aside by the self-employed and for exemption from excise tax to stimulate production of color and UHF television sets.[16]

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[15] Acceleration of payment of corporate income taxes under the laws of 1950 and 1954 might be regarded as a type of tightening, although this does not affect the measurement of taxable net income.

[16] Testimony by Secretary of the Treasury Humphrey before House Ways and Means Committee, June 27, 1955 and by Assistant to the Secretary of the Treasury Dan Throop Smith before a subcommittee of the House Ways and Means Committee, October 5, 1955.

I. Income Excluded From Tax Base

Interest on tax-exempt securities of Federal, State, and local governments has been excluded from the Federal tax base since the beginning of the income tax. This tax exemption depends largely on possible constitutional barriers to taxation by one level of Government of the activities and obligations of other levels under our Federal system. This exemption is also defended as a means of promoting public works by State and local governments which possibly have smaller tax potentials than the Federal Government.

The growing volume of State and local issues threatens ever-increasing amounts of interest income wholly exempt from the Federal income tax. During 1955 there will be approximately $1 billion of interest on these outstanding obligations. This total has been increasing recently at a rate of almost $100 million a year.

Ownership of tax exempts shifts primarily with relative corporate and individual tax rates.[17] Current corporate tax rates make these issues relatively more attractive to financial institutions subject to regular tax. In early 1955, commercial banks held over $13 billion of State and local issues and other corporations subject to regular tax over $4 billion, compared with about $14 billion held by individuals. These ownership data indicate about $400 million of corporate tax-exempt interest income in 1955, a clear loss to the corporate-tax base.

The Federal Government unilaterally ceased new issues of tax-exempt securities in 1941, an important antierosion step. Commercial banks own over 90 percent of the 3 remaining partially tax-exempt issues and other taxable corporations most of the rest, exempting only from normal tax about $90 million of 1955 corporate income. Even this loss will not continue beyond 1960 if the Treasury continues to retire these issues at their first call dates.

Tax-exempt securities—Gross amount outstanding, selected years, 1913–54

[Billions of dollars]

Year	Wholly tax exempt			Partially tax exempt, Federal	Private holdings		
	Total	State and local	All Federal		Commercial banks	Other institutions and corporations	Individual
1913	5.6	4.6	1.0	....	1.3	1.5	1.7
1922	13.0	10.0	3.0	20.4	5.1	8.4	16.6
1929	20.9	16.9	4.0	13.9	7.0	8.7	14.7
1937	35.0	19.3	15.7	25.4	17.4	14.4	18.5
1946	15.9	15.7	.2	21.3	17.7	3.8	11.3
1952	29.3	29.1	.2	7.4	16.4	4.6	11.1
1954	39.5	39.5	....	3.4	15.7	7.8	14.3

Source. See footnote 17. 1954 data from FDIC, SEC, and Federal Reserve Board.

Note.—Data are for June 30 of the different years, except year-end data for 1954.

II. Expense Deductions

This section is divided into two parts. The first deals with expenses which recover the cost of durable assets, which render service

[17] G. E. Lent, The Ownership of Tax-Exempt Securities, 1913–53, Occasional Paper 47. (National Bureau of Economic Research, 1955.)

for a period of more than 1 year. The second part of this section deals with all other expense deductions.

A. RECOVERY OF CAPITAL COSTS

The deductions under this heading account for the bulk of all erosion in the corporate income-tax base.[18] The principle of deductions to recover actual costs of capital assets is well established. But controversy does arise over the amount of dollars recoverable through tax-free deductions, the time period over which deductions are taken, and the pattern of distributing these deductions over years of use. By the tax-neutrality and business-income standards, deductions for depreciation, depletion, and exploration and development costs are excessive currently by more than $6 billion a year.

1. Depreciation

(*a*) *Basis.*— In the United States, both tax and business accounting have rejected replacement cost and continue to use original cost as the basis for depreciation charges. Depreciation based on original cost appears more neutral and equitable between different types of assets than would use of replacement cost.[19]

(*b*) *Service lives*—The usual accounting practice for both business and taxable income has been to spread original cost over estimated useful life. For tax purposes, bulletin F of the Internal Revenue Service suggests service lives for a wide variety of business plant and equipment items. It is debatable whether bulletin F data reflect accurately current average service lives for all items and for particular items. Some evidence indicates that bulletin F lives are too short, thus favoring the taxpayer.[20] On the other hand, many business representatives contend that bulletin F lives are based on the depression experience of the 1930's and fail to reflect the greater usage and faster obsolescence on equipment currently in use. They also claim that individual company differences in service life experience are not recognized, although a 1953 change in Internal Revenue Service regulations may reduce business complaints on this score.[21] As the author is unable to evaluate the conflicting claims, no net error is attributed to average service lives used for ordinary depreciation and consequently no erosion.

A limited amount of capital additions is charged to current expense. The Department of Commerce estimated $938 million of charges to current expense for tools and other small unit cost items for 1950. If a switch to depreciation accounting were made, the tax base would

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[18] Smith and Butters concluded from their study covering 1929-36 that "book profit typically exceeded statutory net income, but usually by less than 10 percent," with this excess approximately offset after tax audit. In mining and public utilities, book profit often exceeded statutory net income by 50 percent or more, largely due to differences in depletion and depreciation accounting (op. cit., p. 167).

[19] E. C. Brown, Effects of Taxation: Depreciation Adjustments for Price Changes, pp. 63-78 (1952).

[20] For example, studies indicate that the actual years of use of certain assets exceed their respective bulletin F lives. See Raymond Goldsmith, Studies in Income and Wealth, vol. 14, pp. 20-24, on buildings; R. Nassimoene and D. G. Wooden, Growth of Business Capital Equipment, 1929-53, Survey of Current Business, December 1954 pp. 18, 20 on transportation equipment; A. P. Brodell and A. R. Kendall, Life of Farm Tractors, SM 80, Bureau of Agricultural Economics, June 1950. In view of the expressed wish of the present Secretary of the Treasury to encourage private investment in plant and equipment, the recent reprinting of the 1942 edition of bulletin F without change of service lives is circumstantial evidence that the lives it presents are not too long on the average.

[21] Internal Revenue mimeograph No. 183, May 11, 1953: "* * * It shall be the policy of the Service generally not to disturb depreciation deductions and revenue employees shall propose adjustments * * * only where there is a clear and convincing basis for a change."

be increased immediately by perhaps $800 million, but this increase would be temporary and would disappear in a few years after the transition from expensing to depreciation, except to the extent that these expenses continue to increase. Conceptually depreciation accounting is correct for these items, but the accounting and inventory problems raised by capitalizing most of these expenditures would be very great for both private business and the Internal Revenue Service. Consequently only an arbitrary amount of $100 million a year is recorded as erosion due to improperly expensing depreciable assets.

Accelerated amortization allowing tax writeoffs over 5 years for plant and equipment costs is inconsistent with tax neutrality and often with accounting concepts of business income.[22] As of June 29, 1955, about $18.3 billion of the cost of emergency projects are eligible for rapid amortization; this is 60 percent of the value of the outstanding certificates of necessity. Assuming that no additional certificates are issued, the Treasury estimates that the excess of accelerated amortization over straight-line depreciation will reach a peak of $2,020 million this year and decline thereafter, becoming a negative figure after 1959.

If this program were terminated now, it will be 1975 or later (depending on ordinary service lives of property certified under this program) before the cumulative tax base of corporations with these facilities will be equal to what their taxable incomes would be without accelerated amortization.

If accelerated amortization remains permanently in the tax structure, the cumulative tax base will never catch up with the same base without these fast writeoffs. The size of the gap will depend on the dollar value of assets certified for 5-year tax amortization and the average service lives of these assets.

(c) *Time pattern of deductions.*—The most difficult problem here is whether the double-rate declining balance and sum of the year's digits methods, first authorized by the 1954 code, contribute to erosion of the tax base. Both new methods, like the traditional straight-line method, spread recovery of cost over the full expected service life. But, unlike the equal annual deductions with the straight-line method, the pattern with declining balance and digits methods concentrates larger deductions for depreciation during the early years of an asset's service life.

On two main grounds, the more liberal timing patterns are being classed as erosion of the tax base: (1) The evidence is debatable whether the new methods improve the accuracy of measuring net income. The American Institute of Accountants holds the new depreciation methods as well as the traditional straight-line method are among those which meet the requirements of being "systematic and rational." It continues:

> In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years (these methods), may well provide the most satisfactory allocation of cost.

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[22] Secretary of the Treasury Humphrey described this program as "an artificial stimulus— not of universal application but is bestowed only upon some who especially qualify * * *." Statement before Subcommittee on Legal and Monetary Affairs, House Government Operations Committee, July 18, 1955. See also American Institute of Accountants, Research Bulletin 27, November 1946.

The AIA recognizes that some firms will use declining balance or sum of the years' digits depreciation for tax purposes but continue straight-line depreciation in general accounting.[23] Certainly if these new methods were superior for the correct measurement of all business income, the AIA would not have approved this double standard. Apparently at least a third of American businesses do not except to adopt the new methods, some giving the reason that the new methods would distort net income figures. Other firms will switch for tax purposes only, continuing former methods for financial accounting.[24]

If future receipts are discounted, the equal annual deductions under the straight-line method already imply greater net earning power in the early years of use, rather than later. A shift from this method requires proof that the decrease in usefulness is greater than allowed for by straight-line depreciation.[25]

(2) Treasury spokesman and both House and Senate committee reports, referring to the 1954 depreciation changes, placed primary emphasis on the increased incentive to modernization and expansion of plant and equipment rather than on improved measurement of taxable income.[26]

Thus the 1954 depreciation changes seem to represent another erosion of the tax base. And unlike accelerated amortization which is temporary and selective, the declining balance and sum of the years' digits methods are permanent and available to all new durable assets with service lives of 3 years or more used in trade or business. For a single asset the erosion of the tax base resulting from larger deductions in the early years of use is only temporary, but for the whole stream of new assets the reduction in taxable income and tax receipts is permanent. If the average annual level of investment in plant and equipment remains constant, the cumulative loss in the tax base would increase gradually over a replacement cycle, representing a permanent saving for taxpayers and a permanent revenue loss to the Treasury, estimated at $19 billion by the staff of the Joint Committee on Internal Revenue.[27]

But if investment in plant and equipment continues to increase at the historical rate of 3 percent per year, this liberalization of depreciation deductions will continually reduce annual taxable income below the corresponding figure with straight-line depreciation. This direct reduction in taxable corporate income, assuming a 3-percent annual growth in investment and adoption of the new methods for only 60 percent of eligible assets, is estimated at about $1 billion in 1955, increasing to over $4 billion a year by 1965. After 1965, the annual loss will decline for a few years and then beginning in the 1970's increase each year at the same rate as the increase in investment. The cumulative loss will increase every year. Additional depreciation erosion

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[23] Journal of Accountancy, December 1954, pp. 757–758.

[24] National Industrial Conference Board, Business Record, February 1955, pp. 70–75; Mill and Factory, November 1954, pp. 73–74.

[25] Cary Brown, The New Depreciation Policy Under the Income Tax: An Economic Analysis, National Tax Journal, March 1955, pp. 81, 82–83.

[26] 83d Cong., 2d sess., The Internal Revenue Code of 1954, hearings before the Committee on Finance, Senate, vol. I, p. 95. Secretary Humphrey testified regarding the depreciation changes: "* * * the purpose is to stimulate employment, plant expansion, and modernization." Committee on Ways and Means, H. Rept. 1337, pp. 22–24, and Committee on Finance, S. Rept. 1622, pp. 25–29.

[27] 83d Cong., 2d sess., Committee on Ways and Means, H. Rept. 1337, p. B13. This estimate assumed all eligible assets are depreciated by the more liberal new methods.

estimated at about one-fourth of corporate figures will accrue to individuals in trade or business each year.

Investment in durable producers' goods may expand more rapidly due to the depreciation changes; this would tend to enlarge the tax base. Offsets to erosion in the tax base probably result from every tax incentive and selective reduction; the problem faced in this paper is how the whole array of selective reductions compares with an equivalent overall rate reduction.

Direct reduction in taxable income due to depreciation erosion

[In millions of dollars]

	Calendar year			
	1955	1956	1960	1964
Corporations:				
Accelerated amortization	2,020	2,012	−355	−1,098
1954 code	900	1,500	3,300	4,100
Expensing capital additions	100	100	100	100
Total	3,120	3,612	3,045	3,102
Individuals: 1954 code	200	400	800	1,000

Source: Accelerated amortization data from statement by Secretary Humphrey before the Subcommittee on Legal and Monetary Affairs, House Government Operations Committee, July 18, 1955 (Treasury Department mimeograph); 1954 code estimates derived from the author's Depreciation and the 1954 Internal Revenue Code, Journal of Finance, September 1955, pp. 326, 344. The estimates here are 60 percent of the excess of sum of the year's digits over straight-line depreciation, with 80 percent of this result allocated to corporations and the remainder to individuals. Estimates are adjusted to recognize that assets in year of acquisition are depreciated at only half a full year's rate.

The conclusion on depreciation is that leakage here narrows the 1955 corporate tax base by over $3 billion a year, and this annual tax base loss will continue in the $3- to $4-billion range for the foreseeable future.

2. Depletion

Present depletion deductions are probably the most glaring and most widely condemned source of erosion in the corporate income-tax base. These deductions may also be the ones which have been most liberalized and extended over the past 15 years.

Corporations have been permitted a tax deduction for the exhaustion of oil and mineral resources since 1913. In economics and in our tax law, the principle is well established that the gradual exhaustion in use of a well or mineral deposit represents a cost of production for which deductions should be allowed in computing net income. Controversy exists as to timing and total amount of depletion deductions allowable.

On the basis of tax neutrality between different industries and economic activities, deductions from income over the life of a property would be limited to original cost, with annual tax-free recovery reflecting the portion of the total deposit which is extracted during the year. Using the business-income yardstick, there would be depletion deductions based on actual cost or in some cases no deductions at all for depletion.[28] Full recovery of actual cost under cost depletion would

[28] Smith and Butters, op. cit., pp. 80–84. Some businesses make no deduction for depletion due to the difficulty of estimating the future life of a deposit accurately.

correspond to tax treatment of depreciation or amortization for other capital assets.

Existing legislation allows taxpayers owning an economic interest in mineral deposits the choice of a depletion deduction based on cost or percentage depletion. Percentage depletion gives an annual deduction equal to the smaller of a statutory percentage of gross income from mineral property or 50 percent of net income from the property before any allowance for depletion. Total tax-free deductions under percentage depletion are not limited or even necessarily related to capital cost. Annual percentage depletion deductions are related to production, prices, net income, and statutory percentages. There is no ceiling on the total amount of these deductions and over the life of a property they may total many times a taxpayer's actual investment costs. Thus percentage depletion deductions diverge from allowable deductions which conform either to tax neutrality or to business-income concepts and are an important element of erosion.

The dollar estimate of the excess of percentage over cost depletion is based on Treasury studies of those corporations which accounted for 75 to 80 percent of all depletion allowances claimed by corporations during 1946–49.

Year	Number of corporations	Allowable depletion	Adjusted-basis depletion	Excess of allowable over basis		
				Amount	Percent of allowable	Percent of net income
1946	352	$555	$75	$480	86.5	38.4
1947	344	839	79	760	90.6	35.0
1948	260	1,291	77	1,214	94.0	36.3
1949	260	1,120	61	1,059	94.6	40.1
Total		3,805	292	3,513		
Weighted average					92.3	

Sources: 1946 and 1947 data from Revenue Revision of 1950, hearings before the Committee on Ways and Means, House, 81st Cong., 2d sess., vol. I, pp. 194, 197; 1948 and 1949 data from E. E. Oakes, Incentives for Mineral Industries, the President's Materials Policy Commission, Resources for Freedom, vol. 5, pp. 14–15. Admittedly adjusted-basis depletion is not identical to cost depletion but is based on cost less allowable depletion (larger of percentage or cost depletion) in prior years.

NOTE.—See also an interpretation of the 1946–47 data by D. H. Eldridge, Tax Incentives for Mineral Enterprise, Journal of Political Economy, June 1950, pp. 222–240.

This table indicates that total allowable depletion deductions were at least 10 times depletion deductions based on cost. As legislation in 1951 and 1954 further liberalized percentage depletion and extended the opportunity to expense (currently or deferred) exploration and development costs so they never are charged to a depletion basis, allowable depletion may now be nearer 20 times cost depletion. These figures conceal a wide variation between individual products. Percentage depletion deduction as a multiple of cost depletion during 1946–49 varied from a high of over 200 for sulfur to 19 for oil and gas down to about 3½ for copper and coal. Note that oil and gas accounted for more than 80 percent of all depletion deductions.

Allowable depletion compared with adjusted-basis depletion for certain products, 1946–49 combined

[In millions]

	Allowable depletion	Adjusted-basis depletion	Allowable as multiple of adjusted basis	Product percent of total allowable
All products	$3,805	$292	3 7	100 0
Oil and gas	3,143	167	18.9	82 8
Sulfur	61	(1)	(1)	1.6
Coal	136	38	3.5	3 6
Copper	182	49	3.7	4 8

[1] Allowable depletion for sulfur was less than $300,000 for all 4 years combined. Individual years' totals were too small to be reported in tables. Thus allowable depletion for sulfur was at least 200 times the amount of adjusted-basis depletion and possibly much more.

Source: Computed from Treasury depletion studies of several hundred large companies for 1946–49, op. cit.

The most recent Statistics of Income indicate corporate depletion deductions of $2,126 million for 1952. Corporate depletion in 1955 might amount to $2.5 billion, assuming increased dollar volume and another $100 million from the liberalization of depletion by the 1954 code. Ninety percent of this total gives $2.25 billion as the conservatively estimated amount of corporate income excluded from taxable income due to overgenerous percentage depletion.[29]

Erosion of the tax base due to depletion has been rapid in recent years and perhaps has now come to a position of equilibrium, at a position of great liberality, with percentage depletion now available to every metallic and nonmetallic mineral from anorthosite to zinc, including even oystershells and peat. Under section 613 (b) of the 1954 Code, only "soil, sod, dirt, turf, water, and mosses, or minerals from sea water, the air, or similar inexhaustible sources" are not eligible for percentage depletion.

But this hope—that there will be no further erosion from depletion—is probably too optimistic. Industries entitled to a low rate of percentage depletion are continually pressing for higher rates; pass-through of depletion deduction opportunities to corporate stockholders in extractive industries has been requested. A Federal circuit court recently held that the value of finished brick could be used in the income measure for percentage depletion.[30] If this view prevails for brick, other industries will push for equal treatment, possibly even to the value of gasoline for a vertically integrated oil company.

The statutory history of depletion is a superb example of at least three types of tax changes which erode the corporate tax base.

The initial break from cost depletion came in 1918 when Congress allowed, to the discoverer only, tax-free deductions based on value of property at the time of the discovery or within 30 days thereafter. This was probably the first instance under the Federal income tax where increment of value after 1913 was not taxed. Usually, of course, discovery of oil or minerals increases the value of a property substantially over cost. This higher value was justified as an incentive

[29] Since corporations account roughly for 80 percent of all depletion, an additional $500 to $600 million of depletion erosion would be estimated for the 1955 individual income-tax base. Revenue Revision of 1950, hearings before the Committee on Ways and Means, House, 81st Cong., 2d sess., vol. I, p. 180.
[30] *Cherokee Brick & Tile Co.* (122 Fed. Supp. 59 (5 CCA, 1954)).

to exploration and discovery to meet the World War I emergency. A comparable situation arose during World War II when percentage depletion, restricted until then to oil and gas (1926), and sulfur, metal mines, and coal (1932), was extended in 1942 to 3 nonmetals and in 1943 to 10 additional nonmetallic minerals. This expansion of percentage depletion was limited to the period of the war emergency, to encourage production of minerals believed to be scarce for meeting the wartime demands. After both wars, these incentive features first introduced to meet temporary emergencies were not rescinded nor allowed to expire, but instead remained permanently in the tax structure. The first generalization is that temporary tax incentives are difficult or impossible to terminate.

A second observation from experience with depletion is that simplification of tax administration is often advanced at the expense of revenue or equity or both. To overcome administrative difficulties from the use of discovery value,[31] percentage depletion was allowed in 1926 for oil and gas wells. A figure of 27½ percent of gross income was chosen, apparently to give approximately equal dollar deductions under the new method as had been available under the discovery value method. But this percentage method became more valuable as tax rates rose far above the 1926 corporate rate of 13.5 percent and as price levels increased, causing a high revenue cost to the Treasury and arousing the envy of other industries still restricted to cost or discovery value depletion. And the percentage depletion method, as noted above, unlike the cost and discovery value methods, has no overall limit so that deductions continue as long as a property is producing income.

A third lesson is that it is difficult to limit tax favors to just those who discover a new oil or mineral deposit or even to a few selected entire industries, however justified this special incentive is on grounds of relative risks or probable scarcity relative to needs for economic growth and national security. The other extractive industries regarded the availability of percentage depletion at liberal rates to a few industries as unfair discrimination and a tax deduction to which they were equally entitled. Politically the have-nots broke the dikes against percentage depletion in 1947, 1951, and again in 1954. Coverage was extended, percentage rates were raised, processes covered were broadened, and even mine residues were made eligible for percentage depletion. Apparent discrimination against certain industries was ended by extending the liberal deductions to all.[32] Companies exploiting sand and gravel pits and oystershells now qualify for percentage depletion along with oil companies and uranium prospectors, though at different rates.

The incentive value of percentage depletion for certain scarce minerals has been blunted by extending the favors to all. One problem is that there are no yardsticks to indicate the incentives needed to get the socially desired amount of investment in different fields. Congress has no guide to determine which industries are entitled to per-

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[31] Such questions as what was a new discovery, determination of value just after the discovery, and whether the owner was the discoverer plagued tax administrators.

[32] No reduction in depletion rates has ever been voted by Congress. In 1954 every amendment extending percentage depletion was passed in the Senate. It was impossible even to get the necessary 10 Senators to request a record rollcall on any of these votes. See Congressional Record, June 30, 1954, especially pp. 9301–9319.

centage depletion and what depletion rates produce the needed amount and distribution of investment in the extractive industries.[33]

The economic defense of generous percentage depletion results from national policy to provide an incentive or subsidy for certain selected minerals for reasons of national security. But on grounds of tax neutrality, tax equity, and conformity to business income accounting practice, the excess of percentage over cost depletion reflects erosion in the income-tax base. In fact from the standpoint of accounting or economics, it is questionable whether these deductions are properly called depletion since they do not relate to any capital sum which is being exhausted. In some cases the income against which the statutory percentages apply includes not only extraction but also processes which are essentially manufacturing in character, such as finished brick or industrial talc.

The excess of percentage over cost-depletion deductions reduces corporate taxable net income by about $2¼ billion in 1955 and this figure, under existing legislation, will tend to increase with an expanding economy.

3. Exploration and development costs

Exploration and development costs are closely allied with the problem of depletion for mineral and oil producers. Current tax legislation allows these producers the option of capitalizing or expensing development and, with qualifications, exploration costs.

Oil and gas producers have enjoyed this option since 1917, first by Treasury regulation, now codified by the 1954 Internal Revenue Code. Intangible drilling and development costs include all costs of labor, fuel, repairs, materials, and construction, except cost of assets which have a salvage value, the latter assets being depreciated. The development costs eligible for expensing account on the average for about 75 percent of the costs incurred in bringing in a well.[34]

The Revenue Act of 1951 extended this option even more fully to mining. A taxpayer with mining interests may now decide each year for each mine to expense or capitalize development costs. Mine exploration and development costs can be deducted currently or set up as deferred expense to run over the life of ore benefited. In either case a deduction in lieu of cost depletion is given, but percentage-depletion deductions continue undiminished. Before 1951 all development costs in excess of current net income from a property during the development stage had to be capitalized.

This option to expense what are essentially capital costs is another loss to the tax base. Tax neutrality and conformity to business accounting would require that these costs be capitalized and amortized over the life of the assets or, if the assets cannot be moved, over the life of the mineral deposit, if it will be exhausted before the assets are fully depreciated.

The erosion here is twofold. First, the option to expense development costs allows deductions to be taken sooner than if these costs were capitalized and deducted gradually over a period of years. This

[33] The President's Materials Policy Commission, op. cit., vol. I, pp. 33-35. The Commission recommended that percentage depletion be retained because of its strong inducement to risk capital to enter the minerals field. It also recommended that no depletion rates be raised above the 1952 level and that recent additions to minerals eligible for percentage depletion be reexamined to see if incentives are needed for their production.

[34] Oakes, op cit., p. 17.

means that total deductions to any given date are larger than if these costs were spread over several years. Secondly, expensing of development costs combined with percentage depletion allows double deductions for the same costs. To the extent that development costs are expensed, there is no need for depletion to recover investment. If 75 percent of the cost of an oil well is expensed, only the remaining 25 percent remains to be recovered tax free through cost depletion. But with percentage depletion, the annual and total deductions bear no direct relation to capital costs but depend on gross and net income. The dollar amount of deductions under percentage depletion is not influenced by the election to capitalize or expense.

Thus, with the expensing of development costs, percentage depletion becomes more than ever an additional deduction which must be justified on grounds other than recovery of costs for these are recovered through expensing. Leasehold costs cannot be expensed but they are usually in the form of royalty payments. Development costs may be offset against income from all sources, a feature which has attracted corporations (and individuals) primarily interested in other industries to finance new oil wells, thus reducing or even eliminating their taxable income while building up their capital assets.[35]

The Treasury study for 1946-47 cited above reported that 96.8 percent of all corporate development costs were claimed by oil and gas producers and that these deductions were about two-thirds of the excess of percentage over cost depletion. Applied to 1955, this suggests about $1.5 billion of costs which are expensed in addition to being recovered through percentage depletion. Without percentage depletion, to avoid any erosion these costs would still not be expensed but would be capitalized and deducted gradually over the life of the assets or the life of the well whichever is shorter; from this point of view erosion would be at least $1.1 billion a year at first, declining gradually as annual depreciation charges accumulate for all such property in use.

The great value of these tax-saving features to the oil industry is documented by published 1954 annual reports. The following table compares the tax position of 3 companies which specialize in crude oil production, 24 large oil companies combined (whose annual reports were available), and all corporations. Note that the effective tax-rate increases from 9.2 percent for Tidewater, to 22.6 percent for 24-company aggregate, to 48.1 percent for all corporations.

Federal taxes and effective tax rates for oil companies and all corporations, 1954

	Net income before tax	Federal income tax	Effective tax rate	Per share	
				Earnings before tax	Federal income tax
	Millions	*Millions*	*Percent*		
Tidewater Associated Oil Co.	$88.0	$8.5	9.2	$3.45	$0.32
Humble Oil & Refining Co.	174.8	28.5	16.3	4.86	.79
Skelly Oil Co.	36.1	6.7	18.5	6.28	1.16
24 large petroleum companies	2,541.0	575.0	22.6		
All corporations	34,042.0	16,369.0	48.1		

Source. Annual reports; Department of Commerce estimate of corporate profits and Federal tax liability.

[35] J. K. Butters, L. E. Thompson, L. L. Bollinger, Effects of Taxation: Investments by Individuals, pp. 201-202 (1953). Some investors regard investments in the oil industry as a source of tax-exempt income, competitive with State and municipal securities.

Since the Revenue Act of 1951, mining companies may expense a limited amount of exploration costs, even if for a productive property. The limit on such costs of a mining taxpayer was raised to $100,000 a year and $400,000 total by the 1954 code. The cost here is relatively small, although taxpayers are increasing their tax saving by incorporating each mine separately. Exploratory expenses above these limits by mining corporations must be capitalized. Only exploratory expenses which lead to dry holes may be expensed currently by the oil and gas industry. This conforms to neutrality and accounting concepts.

4. *Other capital expenditures*

Recent legislation further eroded the income tax base by permitting several other types of capital expenditures to be written off as current expenses, instead of requiring that they be capitalized.[19] Dollar estimates of the erosion are available only for the soil and water conservation item.

(*a*) *Circulation expense.* The option to deduct currently expenditures to establish, maintain, or increase the circulation of a newspaper or magazine was granted in the Revenue Act of 1950.

(*b*) *Research and experimental expenditures.* The 1954 law codified the option for taxpayers to expense currently, treat as deferred expense or capitalize these expenditures.

The treatment is more liberal than permitted by regulations under the 1939 code, although Revenue Service practice before 1954 was to permit such expenditures to be capitalized or expensed at the taxpayers' option, if done consistently.

(*c*) *Soil and water conservation expenditures.* Before 1954, these expenditures were added to the capital value of the land and were recoverable for tax purposes only upon sale of the land. The 1954 code permits farmers to expense these costs up to 25 percent of gross farm income, with any unrecovered costs carried over to following years. This provision is primarily a tax subsidy to a particular type of capital improvements. This provision will probably reduce taxable income (largely individual) from farming about $30 to $50 million in 1955.

(*d*) *Corporate organization expenditures.* The new code for the first time allows a corporation to amortize nonrecurring organization costs over 5 years. Formerly these costs could be deducted only if the corporate charter provided a limited corporate life.

B. OTHER DEDUCTIONS

1. *Compensation of officers*

Sizable and growing amounts of corporate tax deductions are for perquisites to executives and other employees. Although these benefits in lieu of higher pay differ in form between management and labor, the tax problems are similar.

The tax-free deductions of certain partially personal expense is a widespread business practice. Everyone can cite spectacular cases of high living by "expense-account artistocracy" from his own observation. Business cars, meals, world-series tickets, Broadway shows, nightclubs, vacations, reciprocal Christmas gifts, country-club mem-

[19] H. Silverson, Taxation and the Self-Employed: A Study in Retrogression. American Bar Association Journal, January 1955, pp. 50-54.

berships, and company airplanes are examples of these deductions. It is debatable to what extent these expenses are legitimate business expenses.[37] Lower tax rates on business might lead to a reexamination of some more extravagant practices. Others believe these expenditures vary with the level of profits.

Best opportunities to claim the least-defensible deductions exist for closely held corporations, self-employed professionals and retailers, and farmers because their expenses do not have to be justified to outsiders other than the tax collector. The double problem with corporations is to determine which expenditures are justified and how to locate and disallow other expenditures. Perhaps the enforcement problem, in terms of both cost and interference with customary business practice, limits exclusion of these questionable deductions to the more flagrant cases. No accurate estimate of possible tax-base erosion from these practices is possible.[38]

2. Employee fringe benefits

Over the past decade, the greatest rate of growth for any deductions has occurred for pension plans and other fringe benefits. With pensions, annuities, and other forms of deferred compensation, the problem is: Who should be taxed when? This question has been solved by making the employee taxable at the time he receives payments under these private plans, so the tax is only delayed, not avoided. But since these plans operate continuously and with increasing buildup of the amount of deferred compensation, the Treasury suffers revenuewise from this delay. Corporate deductions for amounts contributed under pension plans increased from $766 million in 1945, the first year this was reported separately, to $2,552 million in 1952, and over $3 billion by 1955.

Employer contributions to social-security benefits are a form of deferred compensation which is tax deductible to the employer while all the benefits are entirely exempt from individual income tax. Deductions for employment taxes levied on employers are estimated at over $3 billion for the current fiscal year.

Other fringe benefits, such as hospitalization and medical care, life insurance, employee clubs, vacation resorts, subsidized meals and housing, and perhaps guaranteed annual wage payments, are tax deductible to the employer and tax free to the employee.

The 1952 issue of Statistics of Income itemized deductions for employee benefits other than pensions for the first time, in the amount of $630 million. An estimate of $800 million to $1 billion seems reasonable for 1955. These benefits provide income which affects ability to pay as much as other types of income now subject to tax. Present treatment discriminates against employees and self-employed who received none or less than the maximum coverage of tax-free fringe benefits, to supplement their taxable incomes. And the opportunity

[37] Summer H. Slichter questioned whether such expenses are alleged sales promotion and public relations and reciprocal giving of Christmas gifts are in the real interest of stockholders. He blamed high corporate income taxes and the much lower capital-gains rates for encouraging these "questionable practices." New York Times, July 30, 1955, p. 20.

[38] A popular article made a crude estimate that expense accounts represent perhaps one-fourth of 1 percent of all expenses, based on one medium-sized company (E. Havemann, "Expense Account Aristocracy," Life, March 9, 1953). This ratio, if applied to all corporations, would indicate about $1¼ billion of deductions for expense accounts for 1955. The reader may estimate or guess what fraction of this amount does not represent legitimate deductions.

to avoid income taxes on personal compensation encourages labor and management to gang up by converting wage and salary payments into tax-free services with Federal revenues and other taxpayers the losers. This tax-avoidance possibility tends to move our society "back to the status of a barter economy." [39] Ratchford summed up the dangers if this tendency is continued:

> Perhaps the time will come when the individual unfortunate enough to receive all of his wages in money will have an impossible tax burden. [40]

In view of the great difficulty of reversing prevailing practices, the most that may be feasible is to limit by statute business fringe benefits which are tax deductible to a percentage of payroll, to prevent further erosion of the tax base from compensation plans. The rule discussed below recommended by the Treasury on refunds by cooperatives might apply here: the corporation (cooperative) can deduct only those payments which become taxable income to the employee (patron). Pensions and other fringe benefits, as well as dividends, require better integration of corporate and individual income taxes.

The main question here is to whom should be taxed these approximately $3 billion of employer social-security taxes and also $1 billion of other fringe benefits. These dollar amounts are listed separately from other elements of corporate tax base erosion, because solutions might better be handled through the individual income tax.

3. Contributions or gifts

Corporations are permitted tax deductions for charitable contributions up to 5 percent of net income before deducting charitable contributions. The 1954 law made two liberalizing changes to permit a carryover of contributions in excess of the 5-percent limitation, and to insulate the amount deductible for contributions for any year from any subsequent net-operating-loss carryback. Both changes encourage regular annual contributions.

Tax deductions for charitable contributions put the Government in the position of encouraging certain types of private activities through tax subsidies. Regardless of how commendable these activities may be, this preference conflicts with tax neutrality and may be a misuse of the tax system. Here accounting concept of business income and tax neutrality conflict; a persuasive case can be made that many of these contributions do indirectly benefit the contributing business and therefore are legitimate business expenses. The higher the tax rates, the greater the Federal subsidy to these activities. Direct Federal appropriations are a more clear cut and democratic method, if these activities are to receive any Federal assistance.

Corporate deductions for contributions and gifts are estimated at about $500 million for 1955, projecting a rising trend from the $400 million of deductions in 1952.

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[39] Cary, op. cit., sec. IV D.
[40] Op. cit., p. 211.

III. Preferential Treatment for Certain Sources of Income—Capital Gains

The tax treatment of corporate capital gains in recent years has been a major and growing source of tax avoidance. The Revenue Act of 1942 extended to corporations for the first time preferential tax treatment on capital gains. Since then, several types of ordinary income have been converted by legislation into capital gains for tax purposes. This form of erosion appears to be still an open frontier based on statutory changes in 1951 and 1954.

A good solution for corporate capital gains is to tax them as ordinary income, with unlimited deductions for losses. The case for this revision is even stronger for corporations than it is for individuals. Many capital gains or losses represent realization of changes in value which have taken place gradually over a period of years. Taxing such gains at ordinary rates in a single year would be unfair to individuals, without any income-averaging provision and under steeply progressive rates. But the corporate-income tax has only a 1-step progression and allows averaging of losses over an 8-year period.

If all corporate capital gains were taxed as ordinary income, this would increase 1955 corporate income subject to normal and surtax rates by about $2 billion.[41] With the 1955 average effective corporate-tax rate estimated at 47.3 percent compared with the alternative rate of 25 percent, this indicates a direct revenue loss of about $450 million on 1955 corporate income. The average revenue gain for future years probably will be smaller than this, especially with unlimited deduction of losses in bad years.[42]

Before 1942, capital gains and losses had been included in corporate income subject to normal and surtax rates.[43] The 1942 act also shortened the holding period to 6 months and reclassified certain business assets for capital-gains treatment. These changes, together with the high wartime tax rates, made the 25-percent long-term capital-gains rate very attractive.

Conceptually, capital gains and losses for corporations result from sale or exchange of capital assets. Capital assets are "fixed assets the owner expects to hold for the income they yield in money or services, not to use up quickly or to sell soon." [44] This yardstick would classify plant, equipment, and long-term investments as capital assets, and would definitely exclude inventory-type assets. And gains and losses on sale of borderline assets would be consistently classified either as ordinary income or capital gains and losses, not the present double standard. This double standard gives eligible taxpayers the preferential low tax on certain gains and the more valuable deduction from ordinary income if losses result on the same type of transaction.

The 1942 breakthrough permitting preferential tax treatment has led to erosion via two paths. First, the preferential tax treatment for certain types of transactions has changed business practices to convert

[41] Statistics of Income for 1952 reported for net income corporations an excess of long-term capital gains over short-term capital losses of $1,280 million. Business is improved over 1952, and the stock market, despite recent setbacks, is at high average level, suggesting increases over 1952.

[42] This would enhance built-in flexibility for contracyclical effect.

[43] There had been limitations on corporate deductions for capital losses beginning in 1932.

[44] L. H. Seltzer, The Nature and Tax Treatment of Capital Gains, pp. 48–49 (1951).

ordinary income into capital gains. This search for capital gains may take the form of selling a valuable asset, such as patents or plants, or even selling all assets, instead of obtaining ordinary income by operating the property. Capital-gains treatment also contributes indirectly to other erosion. It is used as an argument to justify special percentage depletion allowances on the grounds that percentage depletion is a reasonable counterbalance which prevents small operators from being forced to sell appreciated mineral properties to big companies for capital gains.[45]

The second well-worn path is to obtain legislation sanctioning equally favorable tax treatment for special industries. A number of assets which closely resemble inventory now receive the preferential capital-gains ordinary-losses treatment.

1. Timber

Taxpayers owning or having a contract right to cut timber held more than 6 months were given this option by the Revenue Act of 1943. The 1954 code overruled administrative interpretations and extended this treatment even to Christmas trees. The 1954 statute also granted sublessors the same privilege previously available only to owners. If alternative tax treatment is provided for any capital gains, this treatment would apply to a landowner who held a timber plot without cutting the timber while it grew toward maturity and then disposed of it. But large commercial operations now make timber a crop which by selective cutting and reseeding yields a salable product each year. Projecting from 1952 Statistics of Income data for the forestry, lumber, and paper industries, roughly $250 million of 1955 corporate income from timber is taxed only at the capital-gain rate.

2. Unharvested crops

The Revenue Act of 1951 made unharvested crops which are sold along with the land held more than 6 months eligible for capital-gains treatment. A 1951 estimate placed the revenue loss at $3 million a year on account of all taxpayers.[46]

3. Livestock

Livestock held more than 12 months for draft, breeding, or dairy purposes became eligible for capital-gains treatment in 1951, retroactive to 1941. Farmers are encouraged to hold animals for 1 to 2 years and then sell, with a regular annual flow to market. So long as the animals are held beyond 1 year, the farmer is in a position to indicate the purpose for holding each animal. The erosion here primarily applies to animals held for breeding; a good case exists for classifying draft and dairy livestock as capital assets subject to depreciation. The entire sale price of livestock might be a capital gain since cash-basis farmers can expense costs of raising the livestock. The gate may be open for widening the preferential treatment; the 1951 Senate bill included turkeys with livestock, but the turkeys disappeared in the conference committee. Poultry raisers may now claim discrimination.

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[45] R. G. Baker and E. N. Griswold, "Percentage Depletion—A Correspondence," Harvard Law Review, January 1951, pp. 361-382.

[46] 82d Cong., 1st sess., Report of the Committee on Finance, S. Rept. 781, Revenue Act of 1951, is used for this and other revenue estimates from the 1951 act.

The annual revenue loss from this lower rate of tax was estimated at $15 million.

4. Coal royalties

The 1951 act extended the preferential capital gains rate to coal royalties received from the disposal of coal owned more than 6 months. This change was justified both as a relief measure for a depressed industry and as an extension to coal royalties of the treatment previously available to timber, moving about $50 million from ordinary income to capital gains tax treatment.

5. In oil payments

When an economic interest in an oil or mineral property is assigned in return for "in oil or in mineral payment right," the proceeds constitute capital gains according to certain recent court decisions.[47] "In oil payment right" is the right to payments based on production until a certain amount has been paid or for a prescribed number of years only. This arrangement converts ordinary income into capital gains and percentage-depletion deductions accompany the income. Fortunately the Treasury has not acquiesced in these decisions.

In addition securities held by traders (since 1934), commodity futures, and sale of five or fewer lots from real property acquired for investment (beginning in 1954) are classed as capital assets and taxed as capital gains.

These assets which now qualify for capital-gains treatment are very similar to inventory or stock in trade. Transactions in these assets would best be included in computation of ordinary income, on the ground that they are not capital assets.

Business depreciable assets and real property.—Other assets which do justify the classification of "capital assets" include real property and depreciable property used in trade or business.

Section 117 (j), which had allowed capital gains treatment on gains but deductions from ordinary income for losses only on "involuntary sales and conversions," was amended in 1942 to include depreciable assets used in trade or business. The twin objectives of promoting mobility of capital assets and avoiding deterrents to early replacement of plant and equipment support this nonparallel treatment of gains and losses.[48] But these objectives conflict with tax neutrality and with the business income yardstick. Equity and neutrality call for consistent use of either capital assets or ordinary income treatment, i. e., parallel treatment of capital gains and losses.

The attraction of capital gains treatment has been increased by statutory changes which write off more rapidly the basis of the property. The 1954 depreciation changes and recent more liberal percentage depletion increase the opportunities to realize capital gains.[49]

Bank losses on sale of bonds.—Unlike other corporations which may offset capital losses only against capital gains, since 1942 banks have been allowed the full deduction from ordinary income of net capital

[47] *R. E. Nail*, 27 B. T. A. 33; *Ortiz Oil Co.*, 37 B. T. A. 656; 102 F. (2d) 508; *W. F. Weed*, 24 Tax Court No. 116.

[48] U. S. Treasury Department Tax Advisory Staff of the Secretary, Federal Income Tax Treatment of Capital Gains and Loss (1951), pp. 41–42.

[49] Large depreciation deductions in early years of use increase the possibilities for capital gains by resale of plant, equipment, and commercial real estate at a price above their tax basis. The Treasury is attempting to block this loophole by administrative action through Special Ruling, May 18, 1955.

losses on the sale or exchange of bonds and other debt instruments. Banks continue to enjoy the 25 percent maximum rate on net capital gains on sale of debt instruments. This differential between the tax rates on gains and on losses favors banks over other investors, except to some extent life insurance companies, which are not taxed at all on capital gains.

Under these provisions security transactions of banks can be motivated by tax considerations. As the bond market fluctuates, due primarily to other factors, many banks may attempt to decide each year whether that year will be a gain or a loss year, since the advantage of the tax differential is lost if gains and losses cancel out in the same year. If the bond prices appear to be high, all gains may be realized. After another year starts, if prices appear low, bonds now held with a relatively high basis may be sold establishing losses to deduct from ordinary income. Offsetting purchases may then be made to establish a low basis against which to realize future gains.[50]

All commercial banks realized net losses of 100 to 150 million dollars in each of 1952 and 1953, and net gains on securities of about $400 million in 1954. Based on current levels of bond prices, 1955 will be a loss year.[51] If banks' gains and losses on bond trading were taxed at identical rates, tax considerations would not motivate realization of largest possible gains or losses.[52] It is not possible to estimate future average annual net gains or losses on these transactions.

IV. Special Treatment for Particular Industries

A. Life Insurance Companies

Life insurance enjoys preferential treatment, apparently as deliberate policy to encourage individuals to make private arrangements to protect their dependents against loss of income in case of death. By tax-neutrality standards, the different aspects of this favorable treatment are elements of erosion.

If life-insurance companies were taxed as much like other corporations as their unusual operations permit, the so-called total income approach would apply regular corporate tax rates to their taxable income.[53] Taxable income would equal premiums plus investment income, including capital gains, less (1) expense deductions as provided for all corporations, (2) total amounts paid to policyholders, including policy dividends, and (3) net increases in policy reserves required by contract.

Taxable income under this approach would be the sum of "free investment income" and "underwriting income." Free investment income is the excess of net investment income over the contractual additions to policy reserves. For 1955, about 73 to 75 percent of expected net investment income must be added to reserves to meet av-

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[50] Banks can maintain their security portfolios practically intact by repurchasing the same issues after realizing gains and issues of slightly different maturities after realizing losses, thus avoiding "wash sales."

[51] Bank Lending Profits Dwarf United States Bond Losses, Journal of Commerce, October 10, 1955.

[52] The tax advantage of deducting losses on sale of securities from ordinary income might dampen the effectiveness of Federal Reserve anti-inflationary monetary and credit policy, by making banks more willing to realize losses.

[53] For a concise discussion of this and alternative methods, see Taxation of Life Insurance Companies, report to the Committee on Ways and Means, House, by the Subcommittee on Taxation of Life-Insurance Companies, ch. IV (1955).

erage interest rate written into policies. Underwriting income is any excess of loading charges over operating expenses and any gain from mortality experience more favorable than indicated by the mortality tables. The Treasury recommends this method.[54]

Under the possible laws which might apply to 1955,[55] only part of free investment income would be taxed and none of the underwriting income would be taxed. Capital gains or losses would not be included in taxable income, but the pending bill would extend the tax base to cover previously untaxed royalties and profits from operation of a business.

Free investment income is estimated at $750 to $800 million for 1955. Underwriting income was about $125 million in 1953;[56] a direct estimate for 1955 is not possible. This indicates an estimated 1955 life-insurance company tax base of about $900 million. The yield on this amount of taxable income at ordinary corporate rates would exceed $400 million, compared to $218 million expected from the pending House-approved bill, an indication of probable amount of erosion here.[57]

None of the 5 different approaches since 1913 to life-insurance taxation has brought much of the investment income added to policy reserves within any tax base, individual or corporate. These additions to reserves, amounting to about $1.5 billion this year, seem legitimate deductions by the insurance companies, but appear very eligible for the individual income-tax base. This in another instance of the problems of integrating the two income taxes, further complicated by problems of timing, bunching of income, and administrative complexities.

B. MUTUAL SAVINGS BANKS AND SAVINGS AND LOAN ASSOCIATIONS

Mutual savings banks and savings and loan associations were brought under the corporation income tax by the Revenue Act of 1951, but only earnings retained above 12 percent of deposits are taxable. However, accumulation of these tax-free reserves is much more generous than comparable treatment for commercial banks. Commercial banks are permitted to accumulate tax-free reserves for bad debts equal to three times a moving average of losses applied to outstanding loans and discounts. Tax-free reserves for bad debts of commercial banks are currently about 1.5 percent of loans and less than 1 percent of deposits.

Part of the problem here is the extent to which the tax laws should be used to encourage the building up of capital and reserves by these institutions which have no stockholders' equity comparable to that of commercial banks. Many States require these mutual organizations to retain earnings until reserves are specified percentages of deposits or shareholdings, varying from 5 to 10 percent for different States.

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[54] 84th Cong., 1st sess., Committee on Finance, Senate, Hearings on Tax Formula for Life-Insurance Companies, pp. 20–21 (1955). Policy reserves require net investment income of roughly a 2.6 percent rate against an expected rate of earnings of about 3.5 percent.

[55] The tax law which applied during 1951–54 has expired, ostensibly making the 1942 act effective. But a new bill, H. R. 7201, which would be retroactive to 1955 income, has passed the House and awaits Senate action.

[56] Computation based on data from The Spectator Insurance Year Book, 1954, pp. 218A–219A, assuming all dividends to policyholders are from premiums.

[57] Tax Formula for Life Insurance Companies, pp. 16–17. Yields estimated from other possible legislation against expected 1955 income: 1951–54 formula, $189 million; 1942 formula, $274 million; 1950 formula, $368 million.

If tax-free additions to reserves were limited to 5 percent of deposits—perhaps with some stair-step arrangement to allow higher percentages on the first few million of deposits—the present preferential treatment would be reduced and the tax base would be increased. Mutual savings banks' reserves were about 11 percent of deposits at the end of 1954; tax-free additions to their surplus and reserves increased over $100 million during 1954, approximately the same rate as the increase in deposits. Tax-free reserves of savings and loan associations were about 8.1 percent of 1954 savings capital, after a $303 million increase during the year. If a 5 percent maximum applied on additions to tax-free reserves, most of the $400 million added in 1954 might be taxable. However, this change might press mutual banks and savings associations to minimize taxable income by larger distributions to depositors and shareholders and by increased holdings of tax exempt securities.[58] Perhaps half of this $400 million would remain taxable to these institutions.

C. COOPERATIVES

The Revenue Act of 1951 first imposed the regular corporate income tax on undistributed profits of farmers' purchasing and marketing cooperatives which are not allocated to patrons. The underlying principle was that all net income of cooperatives should be taxable either to the cooperative or, if paid in cash or otherwise allocated, to the individual member or patron, except for refunds on items of personal expense. Court decisions, however, have held that certain noncash allocations of earnings on the books of cooperatives in the form of receipts with no market value, such as scrip or letters of intent with no payment date, do not represent taxable income to the patron.[59] To stop this leakage, the Secretary of the Treasury recently recommended that cooperatives, in computing their taxable income, be allowed to deduct in addition to cash distributions only those noncash allocations issued in a form that would be taxable to members receiving them.[60] This change, if enacted, would end tax-base erosion for cooperatives and/or their member-patrons which otherwise will be an estimated 100 to 150 million dollars in 1955. This tax measure would probably spur larger distribution in a form taxable to patrons so that perhaps only half of this amount would be added to the corporate tax base.

D. MARITIME INDUSTRY

Some preferential tax treatment is granted by legislation other than the Internal Revenue Code. The Merchant Marine Act of 1936, as amended, provides tax exemption or tax deferment on funds placed by shipping corporations in capital, special, and construction reserves.[61] Deposits in these reserves include depreciation based on a 20-year life, earnings above 10 percent after taxes on capital neces-

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[58] Competitive high payments to attract savings are primarily a problem for bank supervisory authorities, not a tax problem.

[59] *Farmers Grain Dealers Association of Iowa* v. *U. S.*, U. S., 116 Fed. Supp. 685 (S. D., Iowa, 1953).

[60] Letter to chairman, Committee on Ways and Means, House of Representatives, from Secretary of the Treasury, July 26, 1955. The proposal also recommended withholding at the bottom-bracket rate on cooperative income distributed or allocated.

[61] A report by the Secretary of the Treasury, Scope and Effect of Tax Benefits Provided the Maritime Industry, included in H. Doc. No. 213, 82d Cong. (1951).

sarily employed, gains on sale of ships, and, with Maritime Commission approval, additional earnings. The funds must be used for ship acquisition and reconditioning, but even though tax-free funds are used the effective depreciation charges on ships so acquired are based on total acquisition cost.

The annual revenue loss from this tax subsidy averaged $10 million a year from 1938 through 1951; more recent information is not available. Capitalizing this amount indicates tax base erosion of over $20 million a year.

E. WESTERN HEMISPHERE TRADE CORPORATIONS

The 1954 code continues the 14 percentage point tax credit for domestic corporations, practically all of whose business is done in Western Hemisphere countries, excluding the United States. This is clearly unneutral and the reduction in revenue base is erosion. The tax credit for Western Hemisphere trade corporations was $137 million in 1951 and $140 million in 1950, suggesting about a $140 million tax credit for 1955.

V. Miscellaneous Features

A. NET OPERATING LOSS DEDUCTION

Although there is no counterpart in business income for carry-back and carry-forward of business losses, conceptually this is not a factor contributing to erosion. This provision protects businesses from taxation of capital instead of income. The 5-year carry-forward, compared with the 2-year carry-back, reflects preferential treatment to encourage new businesses; this lack of symmetry indicates an element of erosion. However, this longer carry-forward is still consistent with the rule of avoiding taxation of capital.

The 1939 code employed the so-called economic income concept, disallowing certain income, expense, and tax-credit items which reduced the amount of loss to be carried over. The 1954 code follows more closely the statutory income concept of operating loss, allowing for the first time the excess of percentage over cost depletion to be included in the amount carried over and all tax-exempt interests to be excluded. Also the limitation on dividends-received deduction of intercorporate dividends to 85 percent of taxable income is now applicable only in an income year, not in a loss year. This feature makes domestic dividends worth more to a company with a net operating loss than to a company with taxable income.[62]

Capitalizing the estimated annual revenue loss of $30 million from these features indicates a narrowing of the tax base of about $70 million a year.[63] If the tax exemption of State and local interest and the use of percentage depletion is ended, as suggested earlier, this dollar amount must not be included in the erosion total to avoid double counting.

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[62] Journal of Taxation, June 1955, p. 343.

[63] Staff of the Joint Committee on Internal Revenue Taxation, Summary of the New Provisions of the Internal Revenue Code of 1954, pp. 21–23. This is source of most estimates based on 1954 code changes.

B. UNREASONABLE ACCUMULATIONS OF EARNINGS

Section 102 of the 1939 code provided a penalty tax on accumulation of surplus beyond legitimate needs of the business. The intent of this section was to prevent corporations from being used as tax-avoidance devices by high-income stockholders. The 1954 code made two eroding changes: the burden of proving that retention of earnings is unreasonable is shifted to the Government; any accumulation up to $60,000 need not be justified. Another change, making the special tax applicable only to the portion of earnings unreasonably accumulated, seem to improve equity and certainty. The eroding changes cause an estimated $10 million revenue loss a year. A 1955 change shifted the burden of proof to the Government for any cases pending under old section 102 which had not already been brought to trial.[64]

C. PRIVILEGE FOR CERTAIN UNINCORPORATED BUSINESSES TO BE TAXED AS CORPORATIONS

A new provision of the 1954 code permits unincorporated businesses with no more than 50 members to elect to be taxed as a corporation. This option is available only where capital is a material income-producing factor, or where at least 50 percent of gross income is derived from trading as a principal or from certain types of brokerage commissions. The companion section recommended by the President and passed by the Senate permitting certain corporations to be taxed as partnerships was eliminated in conference, leaving this provision to benefit a handful of taxpayers.[65] Other firms such as doctors, accountants, and lawyers doing business as proprietorships or partnerships do not qualify for this option. Because of this divergence from tax neutrality, the estimated revenue loss of $20 million for fiscal year 1955 is included in the erosion total.

D. OTHER

Undoubtedly there are other provisions which erode the tax base of net business income. Some tax features applicable to corporate reorganizations, partial distributions of both capital and income, family partnerships, and inventors and their "angels" probably permit additional leakages from the tax base. Other deductions might be questioned, such as cost of inventory under LIFO accounting, certain advertising expenses, payments on certain leases of buildings and equipment, and bad debts expense. One possibility of eliminating divergent tax treatment of interest and dividends would be to eliminate the deduction for interest, which amounts to more than $5 billion a year. The possibility of including net income of Government-owned commercial enterprises such as electric powerplants could be raised. This paper has not touched on tax provisions which benefit particular taxpayers or which narrowed the excess-profits tax base.[66]

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[64] Public Law 367, amending 1954 code, secs. 534 (b) and (c).

[65] Cary said this section "seems tailored to the needs of certain commission merchants in the South." Op. cit., sec. II B.

[66] Cary, op. cit.; Oakes, "The Revenue Act of 1951: Excess Profits Tax Amendments," National Tax Journal, March 1952, pp. 53-64.

CONCLUSION

The concluding and most pleasant task of this paper is to estimate the extent to which corporate tax rates could be reduced if all leakages discussed in this paper were eliminated from the tax base. The accompanying table summarizes our estimates:

(1) About $8.1 billion not now taxed would be added to the corporate tax base subject to regular corporate tax rates.

(2) An extra $620 million would be added to tax receipts by plying ordinary tax rates to income now subject to tax at favorable low rates.

(3) In addition, about $1 billion would be added to the individual income-tax base, with the possibility of an additional $5.5 billion if social-security payments, fringe benefits, and interest on life-insurance reserves were taxable.

The revised corporate tax base would be $48.7 billion and could yield an additional $4.4 billion of receipts under existing tax rates, $3.8 billion from the $8.1 billion increase in tax base plus $620 million by applying the full effective rate to income now taxed at lower rates.

If the present yield of $19.2 billion remains the goal, the broader tax base would allow the current effective rate of 47.3 percent to be cut to 38.3 percent and still raise the same revenue. This would permit the present rates to be cut about a fifth or by 9 percentage points to 21–43 percent.

BEST GUESS OF TOTAL EROSION IN BUSINESS INCOME-TAX BASE, CALENDAR YEAR 1955

Net income entirely excluded from tax base

[In millions of dollars]

	Corporate	Noncorporate
I. Exempt income Wholly tax-exempt interest	$400	.....
II. Expense deductions:		
Depreciation	3,120	$200
Depletion	2,300	500
Exploration and discovery	1,100	200
Other capital expenditures	(?)	40
Officers' compensation	(?)	(?)
Fringe benefits	.....	.....
Contributions or gifts	500	(?)
IV. Special treatment:		
Life insurance companies	400	.....
Mutual savings banks and savings and loan associations	200	.....
Cooperatives	50	50
Maritime industry	20	.....
V. Miscellaneous: Net operating loss deduction	[1] (70)	.....
Excluded from present tax base	8,090	990

[1] Not included in total to avoid double counting.

Amounts now in tax base but taxed at low preferential rates

	Amount	Revenue loss
I. Exempt income: Partially tax-exempt interest	$90	$20
III. IV. Preferential treatment:		
Capital gains	2,000	[1] 450
Western Hemisphere trade corporations		140
V. Miscellaneous: Unreasonable accumulation of surplus	(?)	10
Total revenue loss from preferential rates		620

[1] In addition, noncorporate farmers account for most of the estimated $20 million annual revenue loss on livestock and unharvested crops.

Possible reduction in effective corporate tax rate

I. Effective corporate income tax rate for fiscal year 1956: *Billion*

$$\frac{\text{Estimated corporate tax receipts, fiscal year 1956 } \$19.2}{\text{Estimated corporate profits, calendar year 1955 } \$40.6} = 47.3 \text{ percent.}$$

II. Revised effective rate possible with broader tax base:

(*a*) Corrected corporate tax base, calendar year 1955: *Billion*

Estimated corporate profits, calendar 1955	$40.6
Additional amount from end of erosion	8.1
Total	48.7

(*b*) Possible corporate tax receipts, fiscal year 1956:

Corrected corporate tax base	$48.7
Present effective corporate tax rate ..... percent	47.3
	$23.0
Additional receipts from end of preferential rates	.6
Total	23.6

(*c*) Revised effective rate to yield currently estimated receipts:

Current estimate of corporate tax receipts, fiscal year 1956	19.2
Additional receipts from end of preferential rates	.6
Corrected tax base ($48.6 billion) times (new effective rate)	18.6

$$\text{Revised effective rate} = \frac{\$18.6 \text{ billion}}{\$48.7 \text{ billion}} = 38.3 \text{ percent}$$

III. Percentage cut in revised from original effective rate:

$$\frac{\text{Change in rate}}{\text{Original rate}} = \frac{47.3 - 38.3}{47.3} = \frac{9.0}{47.3} = 19 \text{ percent.}$$

Tax bracket	Corporate tax rates		
	Current	Possible	
		A	B
First $25,000	30	21	24.3
Above $25,000	52	43	42.1

The most important question this paper raises but does not answer: Which is best for the economy, assuming a given revenue is required from the corporate income tax:

(1) A uniform corporate tax with income broadly defined and deductions strictly limited with rates of 21–43 percent?

(2) A corporate tax with certain incomes exempt or taxable at low rates and certain deductions more liberally defined, with higher regular rates of 30-52 percent?

An alternative way to pose this question is to ask to what extent tax rates and structure should be used to discriminate between different economic activities according to national economic needs and political pressures? Or, if the Government wants to stimulate certain activities, are tax favors preferable to direct subsidies?

If incentives for particular activities were removed from the tax system and put in the form of subsidies, the form and the amount of subsidy would be out in the open, subject to review with annual appropriation bills.

A Treasury spokesman very recently stated this same position:

> * * * special tax treatment would be in effect a concealed subsidy. If it is desirable for the Government to do something to promote the manufacture of these [color and UHF TV] sets, it would be better to have a direct subsidy so that the cost would be known.[67]

Once a preferential feature gets in the tax structure, it is lost to public view and even the amount of revenue subsidy involved becomes outdated with changing economic conditions and variations in tax rates. This permanence and obscurity are perhaps major attractions of tax favors for preferred groups.

Certain qualifications are needed here. Preferential tax treatment does tend to stimulate business activity in the favored industries. For example, the oil industry has probably been encouraged to increased discovery of reserves and greater productive capacity by preferential tax treatment; perhaps prices of oil products are lower due to generous percentage depletion and other deductions. But what has been the total effect on the economy? Taxes on other groups and prices for other products have probably been somewhat higher, probably deterring many other activities to a slight extent. The allocation of resources has been shifted in the direction of the tax-favored industries.[68] These incentive effects, for particular industries or for the entire economy, unfortunately cannot be measured accurately.

These absolute questions of tax policy can, of course, be avoided if the goal is to halt the progressive erosion of the tax base. Then the question becomes what are possible solutions to this growing erosion of the tax base? First it is necessary to prevent further erosion and then to retrieve some of the existing leakage in base and rates, optimistically assuming that this erosion is reversible.[69] Consideration of this subject might require some qualitative distinctions between the different types of erosion listed in this paper. Congress and the Treasury should be encouraged to resist using the tax system to stimulate different activities or to provide relief for particular taxpayer groups. The reward for a deaf ear to special pleas for tax favors would be lower rates for all taxpayers. One positive step would be stronger presentation of the general public interest before congressional committees. Roy Blough based on personal observation and study of 1942, 1947, and 1951 tax legislation hearings con-

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[67] Testimony of Dan Throop Smith, assistant to the Secretary of the Treasury, before subcommittee, House Ways and Means Committee, October 5, 1955.

[68] Heller, op. cit., pp. 200-202.

[69] Blough points out that not since the Revenue Act of 1937 has there been a law primarily directed at closing loopholes. Op. cit., p. 395.

cluded that "general public interests are not adequately represented in the pressures that are brought to bear by taxpayer groups on Congress."[70]

Basically more public education and understanding is needed if the political attraction of tax equity and tax neutrality is to be enhanced. Tax experts can help the public to a wider and fuller understanding of the overall effects of the recent trend toward erosion of the income tax base. With widespread public knowledge and political support, this trend could be reversed. A broader tax base and more uniform tax treatment would tend to minimize the importance of tax considerations on private decisions, to return the function of allocating resources more fully to the market place, improve tax equity, to simplify tax laws and administration, and to strengthen taxpayers' confidence in the tax system. But the most important and most pervasive gain from a broader tax base would be lower tax rates for all taxpayers.

PERCENTAGE DEPLETION ALLOWANCE FOR COAL

National Coal Association, Washington, D. C.

I. ORIGIN AND PURPOSE OF PERCENTAGE DEPLETION ALLOWANCE

The concept of percentage depletion as a deduction against income from mining, oil, and gas was first accepted as part of Federal income tax law in the Revenue Act of 1926. It was adopted as a practical solution and substitute for discovery value depletion. The allowance for cost or unit depletion was first allowed under the Revenue Act of 1913.

The Revenue Act of 1918 made certain basic changes in the tax law with respect to depletion allowances. It permitted the following bases for computing depletion allowance in the case of natural resource industries, the taxpayer being entitled to whichever basis would give the largest deduction:

1. Depletion based on cost.
2. Depletion based on March 1, 1913, value.
3. Depletion based on the fair market value of the property as of the date of discovery or 30 days thereafter, in the case of mines and oil and gas wells discovered on or after March 1, 1913. This discovery depletion was based mainly on the necessity for encouraging new discoveries of oil and gas wells and minerals. The necessity for such new discoveries had been made very apparent during World War I.

During 1924 and 1925, a special committee of the United States Senate investigated the tax determinations made by the Bureau of Internal Revenue. This committee concluded that the discovery depletion basis was not equitable and that the analytic appraisal method used by the Bureau in valuing properties was uncertain and too elastic for tax determinations. As a result, the committee concluded, unfair

[70] Op. cit., p. 41. For instance, all but 12 of the 150 organized groups testifying in 1947 clearly represented particular business, labor, agricultural, or professional interests. Viewpoints of business and producer groups were best represented. Tax experts generally represented clients' rather than public interests. Loc. cit., ch. 2.

competitive conditions existed among the taxpayers in the natural resource industries. In the Revenue Act of 1926 discovery value depletion was eliminated in the case of oil and gas wells, and percentage depletion was substituted therefor. The rate granted was 27½ percent of the gross income limited to 50 percent of the net income. This rate was selected in an attempt to allow about the same amount of depletion on the percentage basis as had previously been granted under cost and discovery value depletion. At the same time it was hoped that the percentage depletion method would spread the depletion allowances more equitably so as to put the taxpayers in the oil and gas industry on a fairer competitive basis.

In the Revenue Act of 1932 Congress replaced discovery value depletion with percentage depletion for coal mines (5 percent), metal mines (15 percent), and sulfur mines (23 percent). These percentages were arrived at by an investigation as to the relationship of the cost depletion allowed to the gross income for the period 1922 to 1926. Unfortunately for the coal industry, it had never secured any advantages from discovery value and very little advantage from March 1, 1913, values. The fact that coal was in competition with oil and gas was not taken into account in determining the percentage depletion rate for coal. As a result of these factors, coal was granted an unsatisfactorily low rate, and Congress partially corrected this situation in the Revenue Act of 1951 when it increased the percentage depletion rate for coal to 10 percent of the gross income (limited, of course, to 50 percent of the net income). In increasing this rate, Congress stated that—

> the 5 percent rate allowed in the case of coal is of little practical value, and that the coal mining industry is peculiarly in need of more favorable tax treatment because of the inroads on its potential markets by alternative sources of energy, particularly oil and gas.

II. THE IMPORTANCE OF COAL TO THE NATIONAL ECONOMY AND DEFENSE

It has been recognized for decades that coal is one of the most important natural resources in the country. Even in today's highly technical era of steel production, about 1 ton of coal is used for each ton of steel produced. Also, more than 50 percent of all electrical power is generated by the use of coal as a basic energy source. Winston Churchill stated during World War II: "War is made of steel and steel is made of coal. Coal is the foundation, and to a very large extent, the measure of our whole war effort." In war or peace the national economic strength is based largely on the production of steel and electrical energy.

However, in recent years there has been some tendency on the part of the public to regard coal as outmoded and no longer essential. Nothing could be further from the truth. In 1952 the President's Materials Policy Commission (the Paley Commission) recognized that in the not too distant future the United States will require a huge increase in coal production to satisfy the Nation's rapidly growing power needs and, eventually, to form the basis of a synthetic oil and gas industry to take the place of our vanishing reserves of natural gas and oil. In 1955 the Presidential Advisory Committee on Energy Supplies and Resources Policy recognized that the national security requires the maintenance of a sound coal industry capable of rapidly increasing its productive capacity for the national defense.

In spite of the glowing overoptimistic forecasts about nuclear power which have been given wide publicity in recent months, nuclear power probably will not contribute substantially to our energy requirements within the next decade. The world needs low-cost, practical energy. One day it may be available from nuclear power, but presently known methods for the use of such energy indicate it is much more costly than power from coal, gas, and oil. Further, top scientists have recently given public recognition to the fact that as yet we do not know how we can utilize nuclear power on a worldwide scale without endangering the continuance of mankind, because we do not yet know of any way effectively to dispose of large quantities of radioactive substances which result from nuclear power production.

It is reasonable and logical to expect that this Nation's dependence upon coal will increase with the passing years. Although coal production for the year 1954 was only 392 million tons, there are forecasts by reputable economists that the Nation will require coal at the rate of 1 billion tons a year within the next 20 years.

The Federal Government estimates that as of January 1, 1953, there were remaining coal reserves in the United States amounting to 1,899,739 million tons. Assuming a 50 percent rate of recovery, this is a supply sufficient to last for 2,400 years at the 1954 rate of production. By contrast, recoverable oil reserves as of December 31, 1954, were estimated by the American Petroleum Institute at 29,560,746,000 barrels (equivalent to 13.1 years' supply at the 1954 rate of production). Recoverable natural gas reserves as of December 31, 1954, were estimated by the American Gas Association at 211,710,-732 million cubic feet (equivalent to 22½ years' supply at the 1954 rate of production). It appears from these figures that in the future, as it does today, the United States will rely primarily upon coal for its energy supply.

While the Nation must rely upon coal as its primary energy source for the future, because coal is the only source with adequate reserves for long-range purposes, the remaining coal reserves are increasingly difficult to recover. The coal that has been mined to date has, of course, been mined from the more easily accessible deposits with the better locations from a utilization standpoint. In the future, recovery of coal will require more effort and expense than has been true in the past.

III. RECENT AND PRESENT ECONOMIC STATUS OF THE COAL INDUSTRY

The difficulties that the coal industry has encountered in recent years are a matter of common knowledge. The industry is highly competitive within itself as well as being competitive with other fuels and sources of energy. Many of the policies of the Federal Government have tended to cause the productive capacity of the coal industry to shrink below a safe level. For example, social-security legislation, with its attendant direct payroll taxes, has resulted in discrimination against the coal industry because the coal industry has an extremely high ratio between labor costs and income (between 60 and 65 percent of the price realized for coal at the mine is represented by labor cost—a far higher proportion than is true of oil and natural gas).

In addition to the natural advantages possessed by the oil and gas industries over the coal industry, the Federal Government has in many ways fostered and encouraged their inroads upon coal's markets. Recent congressional hearings have resulted in an awareness that the flood of imported residual oil, encouraged by Government policies, has seriously impaired the productive capacity of the coal industry. Oil and gas have been the beneficiaries of far greater depletion allowances than has coal. Under the accelerated amortization program of recent years, the oil and gas industries have been permitted tax benefits which have made possible the construction of facilities which will greatly assist in further inroads on coal's markets, while the coal industry has benefited very little under this program. The Federal Government sanctions State compacts which permit the oil- and gas-producing States to regulate the production of oil and gas in a manner which guarantees a profitable price for the producers. In the natural-gas field, Congress has granted monopoly markets to the producers without imposing sound principles of conservation and without regulating the sale of gas to large industrial consumers who could as well use coal, with the result that large markets of coal have been preempted by natural gas which is being used for wasteful purposes at uneconomic prices. Coal pays a tax on transportation in the amount of 4 cents per ton, while natural gas pays no such tax and imported oil pays transportation tax only on those rare occasions when it is transported inland.

Freight rates on coal constitute a very large part of the delivered price of coal. Nevertheless, these freight rates are constantly rising, partially due to the fact that the Federal Government through the Interstate Commerce Commission sanctions a rate structure which places on coal entirely too much of the burden of the railroads' unprofitable passenger business.

The only coal market which has shown a steady increase in recent years has been the electric power utility market. Even here the Government is spending billions of dollars in an effort to find some method by which nuclear power can compete with coal. Full-scale nuclear powerplants are in the planning stage and will be built if the Congress will appropriate funds to subsidize the construction and operation of such plants.

The cumulative effect of these conditions and governmental policies has not been insubstantial. United States Government statistics show that from 1925 to 1939, inclusive, the bituminous coal industry as a whole operated at a net loss. During World War II the industry operated at a small profit—less than 10 cents per ton, after taxes. During 1952, latest year for which statistics are available, more than 50 percent of the coal companies reported net losses, and the industry as a whole had a net profit after Federal taxes of only $33,481,000, barely over 7 cents per ton of coal produced.

IV. NEED FOR AN ADEQUATE DEPLETION ALLOWANCE FOR COAL

As previously agreed, the Nation will require in the not-too-distant future that the coal industry increase its production far beyond present capacity. Industry experts report that at the present time construction of a modern coal mine with the necessary coal preparation plant requires a capital investment in the neighborhood of $7 to $8

per ton of annual capacity. This high cost is due to numerous factors, including the inflation which has occurred in the national economy, the necessity for a high degree of mechanization to minimize labor cost (increasingly serious because of governmental policies and legislation which have directly resulted in high labor costs), increased expenditures to comply with Federal safety legislation, and the natural exhaustion of the more readily available (and therefore cheaper) reserves of coal.

Governmental economists have predicted that within 20 years the Nation will require 1 billion tons of coal per year. Present maximum capacity of the industry is slightly more than half that amount. If the industry must develop its capacity to almost double the present productive capacity, at a cost of $7 per ton of annual capacity, additional capital in the neighborhood of $2,800 million must be forthcoming in that period of time. In addition, existing capacity must be replaced as the deposits served by existing mines are exhausted and as mines are abandoned due to the loss of markets, a process which has taken a heavy toll in recent years.

It would take nearly 100 years to accumulate this necessary $2.8 billion through the process of conserving total profits, based upon the industry's net profit after taxes for the last year for which Government statistics are available.

With the coal industry's history of many years of losses, and low profits even in the profit years, investment capital will not easily be attracted for the necessary expansion of productive capacity. Certainly such investment capital cannot be attracted without equitable tax treatment in the form of percentage depletion.

Even the existing productive capacity of the industry cannot be maintained without an adequate depletion allowance. Loss periods in the coal industry are frequently of such duration that the net operating loss carryover and carryback provisions (which prior to enactment of the 1954 code entailed the loss of percentage depletion) are insufficient to permit balancing of income. Without an adequate depletion allowance income taxes in the years of net profit would absorb so much of the net profit that coal companies would be unable to weather the years of loss.

The needs of the coal industry for investment capital should receive the careful attention of Congress. Unlike most other industries, the coal industry has no adequate source of profits from which to obtain such capital. Because there is available to the Nation no other source of energy capable of supplying the Nation's long-term needs, this threat to the coal industry's productive capacity is a threat to the Nation's well-being.

It is submitted, therefore, that an adequate depletion allowance for coal is essential both to maintain existing productive capacity and to attract capital for the expansion of productive capacity which the national economy and the national security require. Without adequate tax incentives for the coal industry, the United States will soon join the ranks of the have-nots insofar as energy is concerned. If that happens, we will not be able to maintain our position of world leadership; we will not be able to maintain our standard of living; and we will be unable to defend ourselves.

UNITED STATES TAX POLICY AND FOREIGN INVESTMENT

The United States Council of the International Chamber of Commerce, Inc.

The United States council in this statement wishes to emphasize certain ways in which the growth and stability of the domestic economy is affected by foreign investment, and to emphasize certain ways in which such foreign investment is affected by United States tax policy.

I

1. The growth of the domestic economy is dependent upon an increasing supply of raw materials

In 1900 we produced 15 percent more raw materials than we consumed (excluding food); by midcentury we are consuming 10 percent more material than we produce. By 1950 the United States was completing its slow transition from a raw-material-surplus nation to a raw-material-deficit nation. This vast drain, greater today than yesterday, and inescapably greater tomorrow than today, upon domestic resources that cannot be renewed has become one of the most challenging problem bearing upon our continued growth. The President's Materials Policy Commission examining this problem in 1952 estimated, for example, that the domestic demand, some 25 years hence, for minerals as a whole may well be 90 percent higher than in 1950. Despite wide difference in judgment as to whether demand for some material will rise 50 percent or 100 percent or 200 percent, the central point remains—demand for everything can be expected to rise substantially if our economy is to continue its growth.

Based upon the premise that the growth of the economy should be related to the securing of an adequate and dependable flow of materials at the lowest cost consistent with the national security and with the welfare of friendly nations, the Materials Policy Commission estimated that by 1975 the United States will probably be producing from 75 to 85 percent of its needs and relying on imports for the balance. Indicative of the need for the United States to import in future decades is the Commission's observation that all the copper ever discovered in the United States would last only 25 years at the rate of consumption projected for 1975; all the lead would similarly last only 18 years; all the zinc only 30 years.

Assuming the pattern in future decades is not radically different from the present character of imports, a very substantial portion of our future import requirements will be produced abroad by subsidiaries or branches of United States corporations. For example, a study of the United States Department of Commerce in 1951 showed that about 25 percent of United States imports in the 1946–50 period were derived from United States-controlled companies abroad.

In addition to those foreign operations which are wholly or partially owned by United States investors, there is another group of foreign firms whose production furnishes an important source of imports for certain United States corporations. This other group is one which not only looks to the United States as an important market, but is largely dependent upon United States corporations for managerial advice, technical advice and assistance, short-term financial

assistance, and so forth. Also included in this group would be those foreign-owned firms which furnish auxiliary services and materials to large United States operations overseas.

To meet the needs of the future a tremendous expansion in foreign investment is necessary.—The size of the expansion may be suggested by the following comparison. Since the end of the Second World War private United States investment in mining and smelting abroad has averaged $50 million annually; this magnitude may be compared with the Commission's estimate that an investment rate of $100 million a year is now needed for the next 25 years to fulfill the free world needs for copper alone. Moreover, in view of the very substantial time necessary to bring a foreign operation into production, a sharp expansion in investment is needed in the near future if foreign production is to be adequate to meet our needs a decade or two from now.

2. The growth of the United States economy is dependent upon an expanding market

While most domestic industries may anticipate a sufficient expansion in the home market to absorb their increasing production, an important group of industries consider the foreign market of great significance to their profitable operations. In recent years some 3 million workers have been employed in the production of our exports and in service activities associated with them. Exports of leading agricultural products have traditionally represented exceptionally high percentages of production, but exports of machinery and a wide range of other products also comprise very substantial proportions of production. In 1952, for example, exports of track-laying tractors comprised 37 percent of their production; exports of construction machinery and textile machinery represented over 20 percent of production; and exports of wheel tractors, agricultural machinery, motortrucks, machine tools, office appliances and refrigerators make up between 10 and 15 percent of production. In addition to the agricultural products already mentioned, there are a wide variety of other products with export sales amounting to 20 percent or more of output. Examples in this group include lubricating oils, sulfur, rosin, and such chemicals as DDT, copper sulfate, carbon black, and penicillin. Even where the ratios are much lower, the significance of exports as a vital marginal element of sales and profits is considerable. This is true, for instance, of passenger automobiles, steel, and many textile manufacturers for which the proportions of output exported fall in the 3 to 7 percent range.

In maintaining and expanding this market for our exports, foreign investment plays a significant role.—Not only does it create additional demand for exports during the period when the capital goods are being exported but, of much more significance over the long run, also it tends to create further demand for United States exports. In part such additional demand reflects a continuing need for replacement parts and services. But undoubtedly the greater impact on the aggregate overseas demand for our products arises out of the role of foreign investment in paving the way for future trading relationships. Foreign investment may be expected to increase the income of the recipient countries with the consequent increased demand for all types of imports—not only the "traditional" imports from the United States but also other products which heretofore had been relatively unknown in

the foreign country or which could not previously have been afforded. Thus, the establishment of American enterprise overseas brings with it the introduction of numerous American materials and techniques heretofore not widely recognized in the foreign country. Moreover, United States investment in raising per capita income in the foreign country tends to create a permanently increased market.

3. The growth and stability of the United States economy is promoted by diversification of our industry

Within this country diversification, both on a product and area basis, has been proceeding at an accelerating rate in recent years. While there is certain no reason to believe that such opportunities are becoming more scarce, it is nevertheless worthy of note that a further avenue of diversification lies through foreign investment. Foreign investment serves to build strong and growing economies abroad. To the extent that these economies are able to maintain their growth in periods when the United States economy is subject to deflationary influences, this foreign strength serves to stabilize the United States economy. Such a period was the last half of 1953 and most of 1954. In this period the economy of Europe continued to expand while in the United States there was occurring a decline in industrial production. The continued high level, in fact, increased demand for United States exports and was one of the factors that checked the decline in United States production.

4. The growth and stability of the United States economy is increasingly dependent upon the growth and stability of the rest of the free world

In recent years one of the major premises of United States foreign policy has been the concept that our security is dependent upon the security of the rest of the free world. The Marshall plan, point 4, and other aid programs have recognized the relationship between the security of these countries and the establishment of conditions conducive to economic growth and stability and the progressive raising of living standards in these countries. Over $34 billion of public funds (excluding military-aid funds) have been provided in the last decade in furtherance of these objectives.

However, the kind and degree of economic development countries are seeking to achieve cannot take place without a big expansion of international private investment. Government funds alone are not suitable for that purpose and are, moreover, unlikely to be sufficient. Throughout most of this last decade the foreign policy of the United States has recognized that private investment must play a part in furtherance of these national objectives and has aimed at creating a climate abroad conducive to the free flow of capital. Private investment has the dynamic and realistic qualities required, by giving full scope to individual inventiveness, enterprise, and risk taking. Direct business investment, for instance, represents the best possible combination of capital, technology, and management.

In view of the need for private investment to assist in developing other countries of the free world, a further point should be noted. As stated above, an objective of our foreign policy is to create a climate conducive to the free flow of capital. Yet—in certain respects—our tax policy tends to thwart that effort. Our tax credit system fails to correct two undesirable results. First, the efforts of a foreign gov-

ernment to attract the needed capital for its development are thwarted. For example, if their tax structure is generally low or they make special tax concessions, the effect of such a move is negated since the United States Treasury takes in the difference when profits are brought home between the foreign tax rate and the current United States corporate tax rate of 52 percent. Second, as a result of this situation there is a tendency on the part of foreign governments to raise their tax rates applicable to United States subsidiaries or branches to the prevailing level of corporate taxes in the United States. The move has no effect on the profitability of operations to the United States corporations (through operation of the tax credit system) but merely results in a revenue loss to the United States Treasury and a gain to the foreign government. Where the operation of the United States tax system makes it difficult for a foreign country to attract United States private investment, the foreign government is less easily persuaded to take other steps aimed at creating a "good investment climate." Moreover, should the foreign government decide to forego such an attempt to attract United States private investment and instead decide to increase its tax revenues (at the expense of the U. S. Treasury) another unfortunate situation tends to be created—generally high levels of corporate taxation around the world exert a restrictive influence on private investment, be it domestic or foreign.

II

1. Recognizing foreign investment as a process contributing to the growth and stability of the domestic economy, the United States Council believes that the appropriate phases of public policy should continue to have as their objective the elimination or reduction of deterrents to private foreign investment

Major roadblocks in the path of a substantial expansion of United States private investment have been the subject of considerable study and discussion in recent years; and no general treatment of these problems is intended here. In view of the current field of investigation of the Subcommittee on Tax Policy, this statement of the United States Council will concern itself largely with the problem of repressive taxation as a deterrent to greater foreign investment.

2. With private foreign investment no less than with domestic investment the decision to invest is based, fundamentally, upon an estimate of relative profit possibilities

However, in the case of foreign investment, the investment decision involves an estimate of many factors not applicable to domestic investment. Several of these factors, noted below, have represented major deterrents to foreign investment and, in the opinion of the United States Council, should not necessarily be considered of lesser importance than the problem of taxation. In the postwar years the international political climate with its cold war tensions has represented one of the major deterrents to a greater outflow of American private capital. Secondly, there have been fears of expropriation or confiscation—such fears being based partly upon experiences in the 1930's and 1940's, and partly upon certain governments' apparently hostile attitudes with respect to the basic motivations of American investors. General conditions of inconvertibility of currencies represent a third

important barrier to the free flow of investment. Another significant impediment has been certain aspects of United States trade policy which have inhibited movement toward higher levels of trade, greater convertibility, and the freer flow of capital. And, of course, there have been the tax deterrents discussed later in this statement. Generally speaking, over the past several years various measures have been taken, or general international conditions have evolved, which have had the effect of reducing these and other deterrents to foreign investment. Obviously, however (no greater proof is needed than to examine the relatively small magnitude of private foreign investment), much remains to be done if the necessary volume of foreign investment is to be forthcoming.

In estimating potential profit possibilities, the private investor is primarily concerned with and attracted by the relative yield after tax. In proportion to the increase in the profit potential, whatever may be the factors which primarily affect that profit, the attractiveness of foreign investment is enhanced. Considering the added risks of foreign investment, the additional after-tax yield on such investment has not, generally speaking, been sufficient to induce substantial increases in the outflow of American private capital. For example, an economic study prepared for the Chamber of Commerce of the United States estimated that the average, overall return to American corporations on domestic investment in 1951 was about 11 percent after all taxes. In the same year American corporations earned only an average overall return on direct foreign investment (i. e., after foreign taxes) of about 16 percent before United States corporate income taxes. If the amount of such United States taxes on the foreign income were determinable and included, the rate of return would be lower, thus narrowing or possibly even eliminating the gap between the return on domestic investment and the realized return on foreign investment. Relative rates of return (before United States corporate income taxes) differed significantly, of course, among industries. For public utilities (including transportation) the domestic rate of return was higher than the rate of return on equivalent foreign investments. For manufacturing the rate of return was about the same on both domestic and foreign investment. Thus, it has been generally true that the average returns on direct investment in foreign activities (other than extractive and, in 1951, distributive industries) have not been sufficiently great to attract large flows of private American capital abroad.

3. In the opinion of the United States Council, one of the biggest obstacles to the expansion of international trade and investments is double taxation, in other words, the taxation of the same business income or profits by more than one country

Testifying before the Senate Judiciary Committe in September 1955, the Deputy Assistant Secretary of Commerce for International Affairs reported on a Commerce Department survey of business opinion on obstacles to foreign investment. Of the investors interviewed the largest percentage of companies reported that the taxation policy of the Government was by far the most important impediment to foreign investment. The tax on foreign income was regarded by 34 percent as an impediment and 11 percent believed that the high level of domestic taxation was an impediment in that it prevents companies from accumulating capital for investment.

With respect to the establishment of criteria for determining an appropriate tax policy on foreign-earned income, the United States Council wishes to draw attention to the following points embodied in a resolution of the International Chamber of Commerce in February 1955:

(*a*) The claim of the country of residence to tax income derived from the country of origin rests largely on historical grounds which are out of keeping with existing conditions; at the most the country of residence is only entitled to a proportionate share of the total tax of the income which is commensurate with the contribution it makes to the production of the income. This, in the nature of things, must be small in relation to the contribution made by the country of origin.

(*b*) From the economic point of view, the claim of the country of residence to tax income of foreign origin is prejudicial to the interests of the country of origin, inasmuch as it checks the development of countries which are in need of capital, by discouraging new capital from being invested there and by taking away the portion of profits which might be available for reinvestment.

The claim to tax income of foreign origin is a form of protection to the home capital market of the country of residence which is contrary to the best interests of that country, because it is a bar to the free choice of money available for international investment to flow to the place where it is most needed or where it can be most usefully employed; such taxation is in fact an obstacle to greater productivity and the freeing of trade.

(*c*) From the technical point of view, the system of taxing foreign income and giving a credit for foreign taxes on it often fails to give adequate relief from double taxation owing to differences in the type of taxes levied in the country of residence and in the country of origin, in the bases of assessment to income taxes, and owing to the existence of subordinate taxing authorities in addition to the Central Government. In any case, the taxation of foreign income, even with deduction by the country of residence of taxes paid on it abroad, nullifies the advantages for private capital of moderate rates of tax in the country of origin.

For these reasons, the ICC concludes:

1. The country of origin—that is, the country from which the income is derived—has the sole right to tax the income. The problem of double taxation arises from the claim of the country of residence to tax income of foreign origin. The only sure method of avoiding double taxation is for the country of residence to exempt foreign income from any proportional or progressive tax.

2. In order to achieve this, internationally acceptable rules can be made to define the allocation of income to the country where it is deemed to arise for the purpose of taxation. Bilateral treaties, open to adherence by others, can be made to adopt such rules on a reciprocal basis and to exchange information so as to secure that income is allocable to one country only. Alternatively any country may apply such standard rules unilaterally or in relation to income derived from another country which has also adopted them.

The rates of tax charged by the country of origin should not favor its own residents and discriminate against nonresidents. In fixing the amount of the tax payable by a nonresident taxpayer, the country of origin should not take into account any income arising outside its jurisdiction, nor should its claim to tax be pressed any further than the first nonresident person who is entitled to the income, whether the tax is collected at source or by direct assessment.

Finally, the ICC recalls that even if all double taxation were eliminated by the method outlined above, since it is the country of origin which alone decides the rate of tax to be charged on the income arising within its jurisdiction, it will ultimately depend on the taxing authorities of that country to attract or repel capital from abroad.

III

While endorsing the foregoing as the ideally correct method of avoiding double taxation, the United States Council recognizes that intermediate steps may be necessary in achieving this goal. For

this reason attention is directed to the following intermediate principles regarding the taxation of income derived from foreign investment. It should be noted that these principles flow from the recognition that foreign investment is necessary to the growth and stability of the United States economy. It should be further noted that these principles are based on the premises:

(*a*) Primary reliance must be placed upon private enterprise and investment to cope adequately with the complexity and multiplicity of change and development in the economic world of today. Government lending, relying on public funds obtained through borrowing or taxation, can be reduced in the future if supplemented by substantial movements of private capital.

(*b*) Because of the opportunities for domestic investment with its more easily calculable risks and relatively good yield, private capital is not easily attracted abroad. Nevertheless, under proper conditions substantial amounts of foreign investment might reasonably be expected—not only in the extractive industries but also in the manufacturing industries.

(*c*) Consequently, foreign investment should not, among other things, be subject to additional handicaps under a system of taxation.

With the foregoing premises in mind, attention is directed to the intermediate principles discussed below:

1. The use of bilateral treaties

If all countries followed the practice of limiting their taxes to income arising within their jurisdiction and exempting income arising to their residents from foreign sources, double taxation would disappear except in cases where definition of sources differed. Bilateral treaties, even under such an ideally correct system of avoiding double taxation, would serve the useful function of binding the signatories to the same definitions and providing for exchange of information to insure compliance by their respective residents.

However, as suggested above, it may not be feasible for any one country to adopt unilaterally the principle of taxing income only in the source country. Under these circumstances bilateral treaties afford a useful mechanism for mutual agreement and concessions which may gradually lead to the removal of various barriers. Among the advantages of the treaty approach are: (*a*) The approach can be flexible—the provisions of the treaty can be governed by circumstances in the respective countries since the same risks and obstacles are not necessarily barriers to United States investment in all countries; (*b*) a treaty can be put in force for long periods, thus avoiding problems of vacillating political policies in the signatory countries.

A further discussion of the uses of bilateral treaties is contained in an appendix to this report.

2. The use of credits for foreign taxes paid

The system of taxing foreign income and giving a credit for foreign taxes falls short of the above ideal method of avoiding double taxation in two respects—there arise inequities resulting from different definitions and, of much greater importanec in its effect on the outflow of capital, it nullifies the advantages of attractive tax rates in the country of origin.

However, the United States Council believes that a proper system of tax credits may be an intermediate step in the direction of the more ideal system. For this reason the most liberal system feasible of tax credits is urged—a system which affords maximum flexibility with respect to "per country" limitations, and permits the maximum number of foreign taxes to be eligible as tax credits.

3. Taxation of foreign income of individuals

The tax laws relating to foreign income should be sufficiently flexible to permit individual investors to obtain benefits comparable to those available to corporate investors. For example, rate reductions, foreign tax credits, or other devices now or which may become available to corporations should also be accorded to individuals. Comparable treatment of individual tax credit for dividend income from domestic corporations and from foreign corporations is also desirable.

4. The timing of taxation

In the opinion of the United States Council, income earned in a foreign country, at the option of the taxpayer, should not be subject to United States taxes until "brought home."

5. The form of foreign organization

In the opinion of the United States Council, the tax law relating to foreign earned income should not penalize investors with respect to establishing the form of foreign organization deemed most appropriate under local business conditions abroad.

IV

In summary, the United States Council would like to express the belief that private foreign investment can make an important contribution to the long-run growth and stability of the United States economy. The substantial and necessary flow of private capital is not likely to be forthcoming unless certain major deterrents to private foreign investment are removed. Among these are tax deterrents affecting foreign-earned income. In view of the difficulties in immediately adopting the most desirable policy of taxing income only in the country of source, the United States Council recommends the adoption of intermediate policies which will permit the gradual movement toward the complete elimination of repressive taxation, particularly double taxation.

APPENDIX

Bilateral Investment Treaties

Elimination of double taxation—by whatever method—will not be enough, by itself, to remove all of the barriers to the investment of private funds abroad. The International Chamber of Commerce has therefore suggested the use of bilateral treaties to remove not only tax obstacles but also other barriers to private investment. Its proposal is contained in the following resolution which it adopted at its last congress, held in Tokyo in May 1955:

> The International Chamber of Commerce is encouraged by the widespread acceptance of the basic principles of its Code of Fair Treatment for Foreign Investments (brochure 129) to believe that many governments are prepared to protect foreign investors against risks of expropriation, nonconvertibility of assets and earnings, excessive or multiple taxation, and discriminatory regulations.
>
> The ICC therefore recommends the capital-importing and capital-exporting countries to negotiate bilateral treaties which accord with the principles of its code of fair treatment and which, wherever appropriate, modify tax treatment by both countries so as to make any removal of tax barriers by the capital-importing country really effective. In this way, substantial progress can be made in creating a favorable climate for private foreign investments.

The recommendation contained in this resolution is not limited to tax treaties. It is in support of a program of "investment treaties" to encourage and assist foreign countries, if they desire, to create and maintain a favorable investment "climate" and to remove not only tax roadblocks but other investment roadblocks as well.

The investment treaty approach is flexible. It should be used only if the foreign country wants private investment from abroad and if the capital exporting country wishes to assist. The willingness of a foreign country to negotiate by treaty the removal of its own barriers to investment will be a good measure of that country's desire for private capital. The provisions of investment treaties will vary with the varying circumstances of the countries with whom negotiations are conducted.