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84th Congress 2d Session } SENATE { Report No. 1310

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

REPORT

OF THE

JOINT COMMITTEE ON THE ECONOMIC REPORT

TO THE

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January 5, 1956.—Ordered to be printed

Mr. Douglas, from the Joint Committee on the Economic Report, submitted the following

REPORT

[Pursuant to sec. 5 (a) of Public Law 304 (79th Cong.)]

The following report of the Joint Committee on the Economic Report was prepared by the Subcommittee on Tax Policy, composed of Representative Wilbur D. Mills, Chairman, Senators Paul H. Douglas, Joseph C. O'Mahoney, and Barry Goldwater, and Representative Thomas B. Curtis. The report from the subcommittee was approved for transmission to the Congress by the full committee on December 27, 1955, and will be given further consideration by the committee in connection with its report on the 1956 Economic Report of the President. The findings and recommendations presented in this report are based upon hearings and studies conducted by the subcommittee during 1955. Senator Joseph C. O'Mahoney, a member of the subcommittee, was unable to participate in these hearings, studies, and this report because of the pressure of other committee responsibilities.

Introduction

In today's complex world the Federal Government is spending billions of dollars for defense and domestic programs. Without passing judgment on the proper magnitude or the nature of Federal expenditure programs, this subcommittee recognizes that the Congress has been faced in years gone by, and will be faced in the years to come, with the necessity of levying substantial taxes to finance these expenditures. While the basic purpose of taxation is to raise revenue to finance expenditures authorized by the Congress, such taxes have an important economic impact; the higher the taxes the greater the impact. It is to these economic consequences of Federal taxation that the Subcommittee on Tax Policy has directed its study.

Thus, achievement of the objectives of the Employment Act of 1946 requires recognition of the implications of Federal tax policy. Constant endeavors must be made to improve the tax structure so as to minimize deterrents to economic growth consistent with the increase in the labor force and with advancing productivity. In making changes in the revenue system consideration must be given to stability of the general price level and to the full and best use of our economic resources. Improving the climate of competition is another important requisite of sound tax policy.

Pursuant to the directive of the full committee as set forth in its report to the Congress last March (S. Rept. No. 60, 84th Cong., 1st sess.), the subcommittee has focused its study on the relationship of tax policy to the attainment of the Employment Act objectives, with particular emphasis on maintaining a steady and sustainable rate of economic progress. The subcommittee recognized, of course, that other objectives of tax policy cannot be ignored in examining our revenue system.

The subcommittee has explored a wide range of tax issues in order (1) to formulate acceptable general criteria for evaluating tax policy from the standpoint of the growth and stability objectives of the Employment Act, and (2) to outline a general tax policy designed to conform to the Nation's economic requirements for the coming years.

In the course of its study, the subcommittee invited and received the assistance of 81 economists, accountants, lawyers, and other tax experts. These participants prepared papers on various aspects of the subcommittee's inquiry, which were printed and distributed to subcommittee members, participants, and the general public in mid-November in the joint committee print, Federal Tax Policy for Economic Growth and Stability. At hearings with these participants during the period December 5–16, the basic issues embraced by the study were explored and developed.

Economic Principles for Federal Tax Policy

The subcommittee has not attempted to spell out in detail specific recommendations for changes in our tax laws. This is the function of the Committee on Ways and Means in the House of Representatives and the Committee on Finance in the Senate. Rather, this report sets forth the basic standards in the light of which any and all tax recommendations should be evaluated if Federal tax policy, a major economic force, is to conform to the needs for steady economic growth. The tax policy recommendations offered herein, therefore, are necessarily broad in scope and character, and are intended to outline the course along which the Federal revenue system should develop to meet our basic standards, as well as revenue needs.

I. FEDERAL TAX POLICY SHOULD RECOGNIZE THAT THE LEVEL OF TAX REVENUES IN RELATION TO THE AMOUNT OF GOVERNMENT EXPENDITURES HAS AN IMPORTANT BEARING ON THE LEVEL OF ECONOMIC ACTIVITY. THIS WOULD TEND TO RESULT IN FEDERAL SURPLUSES AND DEBT RETIREMENT DURING PROSPEROUS AND BOOM PERIODS AND DEFICITS DURING RECESSIONS AND DEPRESSIONS

In recent years there has been increasing understanding of the fact that the Federal Government's tax and spending programs are important factors affecting levels of economic activity. It is now generally recognized that, given the amount of Government spending, Federal fiscal policies have a significant impact on the total demand for the goods and services which can be produced by maximum employment of our resources, and that, therefore, an important objective of these policies must be to minimize fluctuations in the level of total economic activity. Such fluctuations represent significant barriers to the attainment of any long-run growth objectives; recessionary movements interrupt the process of growth by leaving some of our growing resources idle, while inflationary changes in economic activity make continued growth more difficult to maintain.

Thus, increasing taxes to maintain Federal revenue in balance with expenditures during a recession is a force toward deepening the recession. By the same token, maintaining a budget balance by reducing tax rates when a budget surplus emerges from inflationary expansion of income could serve to reinforce inflationary pressures.

Tax policy which recognizes the need for minimizing fluctuations in prices and employment is in line with a major recommendaton of the Douglas subcommittee of the Joint Economic Committee on Monetary, Credit, and Fiscal Policies in the 81st Congress:

> * * * that Federal fiscal policies be such as not only to avoid aggravating economic instability but also to make a positive and important contribution to stabilization, * * * (Monetary, Credit and Fiscal Policies, S. Doc. No. 129, 81st Cong., 2d sess., p. 1).

At the outbreak of the Korean war in 1950, following a unanimous recommendation of the joint economic committee, the Congress changed a tax-reduction bill into a tax increase bill to counteract inflationary pressures.

This view of the contribution which tax policy can make toward stabilizing the economy was reaffirmed by the joint economic committee under the chairmanship of Representative Wolcott in its unanimous report to the Congress in February 1954. The substantial tax reductions in that year were major factors in stemming and reversing recessionary trends.

On the basis of present information, the Federal administrative budget probably will be balanced and the consolidated cash budget, including trust fund accumulations, likely will show a surplus for the current fiscal year 1956. The relative stability of defense and defense-related expenditures with moderate increases in other spending programs are expected to result in total expenditures for the year of about $64 billion. Rising personal and corporate incomes, reflecting the current marked expansion of economic activity, are expected to increase total revenues to the level of anticipated spending as shown in the administrative budget, resulting, therefore, in a cash budget surplus of about $2 billion.

The prospect of a balanced administrative budget and a surplus in the consolidated cash budget raises the question of possible tax reductions early in 1956. Such action, however, should not be taken without due consideration of its effects on the economy as a whole.

It is generally agreed that the currently emerging Federal cash budget surplus is the result of the significant expansion of economic activity since the last quarter of 1954. As such, this surplus represents a check on the pace of this economic advance. Were it not for this increase in tax receipts relative to expenditures, we should probably now be witnessing a more rapid increase in the general price level.

Prices of industrial products have been rising in recent months; only the continuing decline in farm prices prevents an overall rise in the wholesale price index. So long, therefore, as the present expansionary movement continues with upward pressure on prices of nonagricultural commodities, using the developing cash budget surplus as the occasion for tax reduction would be to forego utilizing a force for maintaining a stable rate of economic growth. A tax rate reduction next year in the face of a booming economy might well be inflationary. Rather, tax policy aimed at stabilizing the Nation's economy would call for applying the surplus to reducing the bank-held Federal debt. Only in highly prosperous times such as the present are we likely to find it economically possible to reduce the level of the Federal debt. We should reduce the Federal debt during periods of boom to offset the deficits resulting during periods of recession and depression.

Of course, it must be recognized that the economic outlook may change rapidly in the coming months. It may become apparent that expansion of economic activity is slowing, and that a higher rate of increase in total demand is required to make full use of our growing productive capacity and to provide the impetus for further growth. In this event, we would be in a position to reduce taxes more advisedly than by taking the action prior to evidence of economic need. In any event, improvements in the revenue structure are always timely; the revenue effects of such revisions, of course, should be carefully weighed in the light of prevailing economic conditions.

It should be emphasized that if Federal tax policy reflects the need for avoiding both inflation and recession, the long-run possibilities for Federal tax reductions will be greatly enhanced. If we succeed in moderating short-run fluctuations in economic activity, we can count on a steady growth over the next decade which will make possible within that decade substantial reductions in effective Federal tax rates—perhaps by as much as one-third. Indeed, barring increases in Government spending programs, general reductions of tax rates will probably be necessary to assist in providing a level of total demand adequate for full utilization of all our resources. The key factor, of course, is the international situation. If, however, the world political situation does not worsen and if we have steady economic growth and price stability, prospects for substantial reductions in Federal tax rates are excellent.

II. TAX POLICY SHOULD IMPROVE THE AUTOMATIC STABILIZATION POTENTIAL BUILT INTO THE FEDERAL REVENUE SYSTEM

The responsibility of the Congress, under the Employment Act of 1946, to minimize fluctuations in the level of economic activity is a heavy one. While the Congress has in recent years shown a willingness to act promptly to meet changing fiscal requirements, there may nevertheless remain a delay between the time when the need for action first develops and when legislative action is completed. Fortunately, the revenue structure contains built-in features which tend automatically to offset inflationary and deflationary tendencies in the economy. It is recognized that these automatic stabilization features cannot fully counteract fluctuations in economic activity. Nevertheless, to the extent that these features can be strengthened, the difficulties involved in congressional action to repress these fluctuations through amendment of the Revenue Code will be reduced. Accordingly, increasing the capacity of the Federal revenue system to provide automatic stabilization is an important factor in Federal tax policy.

The principal components of the Federal revenue system which automatically afford the desired compensating changes in revenues are the individual and corporation income taxes. Excise and sales taxes respond much more sluggishly to changes in national income, while estate and gift taxes respond only over time to such changes as affect property values. Employment taxes evidence only moderate sensitivity, and are necessarily hinged on the character of social-security programs, thereby restricting the scope of the adjustments which might be made. Accordingly, enhancing the built-in flexibility of the revenue system requires strengthening the individual and corporate income taxes.

The stabilizing capacity of income taxes depends primarily on (1) the size of the tax base relative to the actual income of individual and corporate taxpayers, (2) the responsiveness of the items of income which comprise the tax bases to changes in levels of economic activity, and (3) the degree of effective progression in the rate structure applied to the tax base. If we are to produce more built-in flexibility, proposals for amendment of our income taxes should be weighed in the light of their impact on these factors. Under the present individual income-tax laws, for example, only about 40 percent of what the Department of Commerce describes as personal income enters the tax base. Moreover, some of the most cyclically responsive types of income are not fully subject to the graduated rate schedule. Thus, the actual or effective progression of rates is considerably less than that indicated by the statutory rate schedule. The result is that much of the built-in flexibility of the tax has been lost. Much the same criticism may be directed against the corporate income tax. To a considerable extent this loss may be accounted for by inadequate recognition of the importance of built-in flexibility in the revenue system in evaluating proposals which may very well have been quite desirable on other grounds. For the future, the cost of any proposed revision of the income taxes in terms of possible loss of responsiveness to changes in the level of economic activity should be carefully weighed.

Strengthening the countercyclical sensitivity of these taxes involves no necessary implications with respect to the level of rates. The basic area in which this must be sought, rather, is in increasing the responsiveness of the tax bases to changes in levels of economic activity. In general, this may be accomplished by directing tax policy toward broadening the bases of the income taxes relative to the economic concepts of personal and corporate income. We call particular attention to those income items which are highly responsive to changes in levels of economic activity and which now escape ordinary income-tax treatment. Similarly, we call attention to deductions which do not contribute to accurate measurement of net income but which serve to offset fluctuations in income. At the very least, proposals which would result in further constriction of the tax base should be avoided whenever possible.

Adjustments of the tax-rate schedules to increase the responsiveness of the income taxes should also be sought. In the corporation income tax, the $25,000 surtax exemption provides a limited graduation in effective tax rates ranging from 30 percent on corporations with taxable income of $25,000 or less, to a top rate just under 52 percent. An increase in the spread between the bottom and top combined rates would contribute at least modestly to greater sensitivity of the corporate income tax.

In the individual income tax, nearly 80 percent of taxable individual returns in recent years has been subject to tax only at the first-bracket rate. For most individual taxpayers, therefore, graduation in the statutory rates is largely of academic interest only. While considerable graduation in effective rates is provided for these taxpayers by the personal exemption system, a substantial improvement in the built-in flexibility of the individual income tax might be afforded by providing additional marginal rate graduation at the bottom of the taxable income scale. Built-in flexibility would also be greatly enhanced by narrowing the taxable income brackets applicable to joint returns of married persons.

The importance of strengthening the built-in flexibility of the Federal revenue system is accentuated by the prospects for a changing relationship in Government finances in the years ahead. Barring the necessity for a significant increase in defense buildup, the Federal Government's spending programs and revenue system may well decline in importance relative to the level of total demand. At the same time, State and local government responsibilities may be expected to grow as an increasing population requires higher and higher levels of public services. We may anticipate a shift in the relative importance of Federal and State and local government fiscal operations in the coming years. Such a shift, however, necessarily entails an increasingly important role for the relatively regressive and, therefore, insensitive revenue systems of State and local governments. Despite continuing efforts at these levels of government to improve their revenue structures in line with contemporary standards of adequacy, it is recognized that the barriers to attainment of these standards permit only very slow progress. Thus, we face the possibility of an increasingly unresponsive overall fiscal system, unless determined efforts are made to strengthen the built-in flexibility of the Federal revenue structure.

III. FEDERAL TAX POLICY SHOULD ENCOURAGE THE BALANCED GROWTH OF THE ECONOMY AND THE MOST EFFICIENT USE OF OUR ECONOMIC RESOURCES

The record of the American economy since the end of World War II is an impressive testimonial to the vigor of the basic growth-generating forces in the economy. The advance of technology and the efforts of business to implement these advances, and the growth in population and the labor force with the attendant increase in consumer demand and the ability to meet this demand, have resulted in an increase of almost 40 percent in our national production at constant prices from 1946 through the 3d quarter of 1955.

This is an impressive record. In large part, it is attributable to the fact that the economy has maintained, at least approximately, the appropriate balance between the two major components of private demand, namely, consumer expenditures and capital outlays. Failure to maintain this balance makes it extremely difficult to achieve steady economic growth. Where the rate of growth in consumer demand outstrips that of investment expenditures, the rise in living standards will soon grind to a halt by reason of the failure of our productive capacity to keep up with the expansion of our consumption needs. By the same token, an excessive rate of capital formation involves not only some current sacrifice of rising standards of living, but also threatens idle capacity and disorganization and interruption of growth in productive capacity.

The Federal tax system has made an important contribution toward balanced economic growth as between consumption and investment. Some exceptions may be noted within the investment category. Several important industries have been unduly burdened and their growth repressed by discriminatory selective taxation, while others have been able to outstrip competitors because of preferential tax treatment. Lack of uniformity in the application of our tax laws has also resulted in a highly differential tax impact on various types of economic activity, often closely related in terms of basic economic characteristics. While noting exceptions of this sort, it may nevertheless be concluded that on the whole the Federal revenue system has not been significantly biased in favor of or against either consumption or investment.

No discussion of the balance between consumption and investment would be complete without recognizing the growth in recent years of public investment, particularly at the Federal level. This is not to pass judgment on the merits or the economic impact of such investment, but merely to call attention to the fact that investment may be made either through traditional private channels or through Government. In the present context, we refer to the impact of the Federal tax system on private investment.

Maintaining the proper balance in the impact of tax burdens on the growth of consumption and investment outlays, therefore, is a prime criterion of tax policy for steady economic growth. Adhering to this standard does not, however, necessarily preclude shifts in the relative emphasis placed on various components of the revenue system from time to time as the occasion warrants. Slackening in the rate of growth of the economy associated with lagging consumer demand and idle plant and equipment, for example, would suggest the need for a reduction in taxes bearing on consumption relative to other major elements of the revenue system. By the same token, should rising levels of consumption prove inadequate to induce the desired rate of growth in productive capacity, easing the relative burden of taxes falling primarily on capital accumulation would be called for.

Since such shifts in tax emphasis necessarily involve relatively heavier burdens on one or the other of the major components of private demand, the economic situation should be very carefully appraised before the shift is undertaken. Decisions in this regard must be based on careful economic analysis, rather than on the popular catch phrases which are frequently and indiscriminately attached to legislative proposals.

Moreover, balanced economic growth as an objective of Federal tax policy requires that the burden of taxes fall as neutrally as possible among all taxpayers. It has been repeatedly observed that the present Federal revenue system contains a host of special provisions, some of very restricted applicability, which provide preferential treatment with respect to certain types of economic activity. A distinction must be made in this connection between "differential" and "preferential" tax treatment. Differences in actual economic circumstances may require differential tax treatment if the tax base in each set of circumstances is to be accurately and fairly measured and, therefore, the correct tax rate is to be applied. A preferential tax provision, on the other hand, refers to treatment which involves a lighter tax burden on some taxpayers than their circumstances warrant from an economic point of view.

A common characteristic of most preferential provisions is that they tend to induce use of resources in such a way as to produce lower returns before tax and higher returns after tax than would result in the absence of the preferential treatment. In other words, these preferential provisions tend to result in resource use different from that which would result if the tax system were more nearly neutral and resource allocation were determined to a greater extent by the impersonal mechanism of the price system. But since it is commonly assumed that the operation of the price system in free markets will result in the best direction of our resources, tax provisions which interfere with such allocations must necessarily involve a cost in terms of a lower total real value for the product of the economy. This cost is reflected in restriction of the growth in productive capacity which might be attained with minimum sacrifice of current living standards.

Of primary significance in light of the objective of balanced economic growth are those special provisions in the tax laws which are aimed at stimulating the growth of some particular industry or industries. It should be recognized that use of the Federal tax system as a means of stimulating the growth of any particular industry necessarily means willingness to deter the growth of others not equally favored. The more preferential the tax treatment afforded industry A to stimulate its growth, the less can be afforded industries B through Z. Possibly some, if not all, of the latter may even have to assume greater tax burdens than formerly and therefore may encounter more substantial barriers to their growth.

If preferential tax treatment is afforded any group in the economy, it necessarily implies a value judgment with respect to the type of economic activity most essential to the process of economic growth. We must be keenly sensitive to the weight of responsibility we assume if such decisions, which traditionally we are inclined to leave to the mechanism of the price system in the market, are made. Errors in making these value judgments may prove very costly in terms of the efficiency with which scarce economic resources are used and therefore in terms of the growth in living standards and productive capacity of which the economy is capable.

Moreover, experience has shown that preferential tax provisions tend to produce chain reactions; each such provision leads to claims for similarly preferential treatment from taxpayers who do not quite qualify for the initially provided benefits. The cumulative effect of such a process is to constrict the tax base and to reduce the extent to which economic growth may be taken advantage of for purposes of reducing tax rates.

Adjustments in the revenue system to conform with growth considerations should take the form of general revisions rather than special provisions of narrow applicability. General revisions hold far greater promise for removing the deterrents to balanced economic growth than those which attempt to obtain neutrality in the impact of taxes by providing equally preferential treatment for one narrow group of taxpayers after another.

A prime objective of Federal tax policy should be to strive for neutrality in the application of our revenue laws. This neutrality in impact will be closely approximated by providing uniform tax treatment for all taxpayers with equal taxpaying ability, without reference to the particular circumstances out of which the taxpaying ability arises.

Elimination of growth-distorting features from the tax system would entail a thoroughgoing revision of the Internal Revenue Code. While the magnitude of such an undertaking is recognized as formidable, the rewards in terms of a more dynamic and better balanced economy warrant that a start be made. Although all of the principal components of the Federal revenue system contain such distortions, attention should be focused at the outset on the individual and corporate income taxes and on excises, since these account for all but a small fraction of total Federal revenue.

Considerations of fairness as among similarly situated taxpayers as well as among different groups in the economy cannot be ignored in formulating tax policy for economic growth and stability. Fortunately, these considerations almost invariably tend to reinforce the criteria and broad recommendations for future tax policy discussed above. The inequities in the present tax system are to be found primarily in those provisions of the tax law which afford some taxpayers preferential treatment as compared with others in fact similarly situated and which serve to reduce, very markedly, progression in tax burdens. Both the need for greater built-in flexibility and for balanced economic growth and most efficient use of our economic resources suggest a tax policy which would greatly reduce these inequities. Achieving greater equity in the distribution of tax burdens and a Federal tax system which will offer the greatest encouragement to steady, sustainable economic growth, therefore, go hand in hand as objectives of Federal tax policy.

IV. FEDERAL TAX POLICY SHOULD PROTECT AND PROMOTE AN ATMOSPHERE FAVORABLE FOR SMALL AND NEW BUSINESSES

The importance of small and new businesses in preserving and strengthening a competitive market economy has long been recognized. A large number of small-business units is required to insure that control over the use of resources and therefore over output and prices is widely diffused. A high entrance rate of new businesses is required to insure the continuing challenge of established firms so essential to the development of new products and new and more economical production processes and methods.

It is obvious at the outset that every effort should be made to write simpler tax laws. The more complex the tax code, the greater the burden on small business relative to the position of larger businesses.

Recognition of the importance of small and new businesses implies a tax policy which prevents tax discrimination against such business units. In general, the principal requirement in this connection is to avoid imposing tax disadvantages on the relatively high degree of risk and venturesomeness which characterize new enterprise in particular. This criterion, however, should not be construed as calling for preferential treatment on the basis of the type of venture undertaken. The criterion, rather, should be regarded as generally applicable, suggesting the need for adequate provision for risks in the tax laws without preferentially offsetting such risks on the basis of type of business activity. This criterion also suggests the need for gearing the tax burdens of small and new businesses to any problems peculiar to such businesses in obtaining the financial resources required for their survival and growth.

A distinction should be drawn between "preferential" and "differential" tax treatment in gearing tax policy to protecting and strengthening the competitive position of new and small businesses. The needs of such businesses, and the reflection of these needs in public policy, do not call for a preferentially lighter real impact of the revenue system on such taxpayers as compared with larger, established companies. Differential tax treatment, however, may be required in order to offset a disproportionately heavy impact on small, new firms resulting from application of tax laws geared to the taxpaying ability of large, established business units.

Accordingly, this criterion calls for careful examination of tax proposals in the light of their real impact on the relative position of new and small businesses in the national economy. We should be sure that such businesses can participate equally with large, established firms in the benefits of proposed tax adjustments. Similarly, it should be recognized that, whatever its merits may be, a proposal which weakens the competitive position of small and new businesses may involve a significant cost in the effectiveness with which other public policies can achieve the free competition and atmosphere of economic challenge so essential in our economy.

In recent months, increasing attention has been focused on the rise in mergers and consolidations of corporate enterprise. While this development does not uniquely involve small businesses, their position is weakened by any tendency toward concentration of enterprise in fewer and fewer hands.

Tax considerations have been identified as playing an important role in this movement. Present law provisions with respect to loss carryovers, corporate reorganizations, and nontaxability under the income tax of gains on property transferred by gift or at death appear to be of major significance in this connection. Accordingly, the tax laws should be carefully examined and appraised in terms of their impact on the ability of small- and medium-size companies to resist inducement for absorption into larger business units.

In addition, it is a widely held view that small and new businesses have limited access to credit and equity capital from external sources, as compared with larger, better-established firms. The growth requirements of small and new companies frequently involve more extensive reliance on internal resources, particularly retained earnings, than in the case of other companies. A corporation income tax rate structure which does not unduly limit the financial resources required to finance the growth of large, established companies, therefore, may prove extremely burdensome in this respect for small and new companies. A greater differential in effective rates applicable to small and large corporate taxpayers should be given careful consideration.

Conclusion

The needs of the American economy for increasing capacity to provide higher living standards for all the population must be reflected in all the economic policies of the Federal Government. To be of greatest effectiveness in this respect, Federal tax policy in the future should:

(1) Be related to levels of Government expenditures by the need for full utilization of growing productive resources and stability in the general price level;

(2) Enhance the built-in stabilizing capacity of the Federal tax system by strengthening the individual and corporation income taxes;

(3) Encourage the balanced growth of the economy and most efficient use of our economic resources by maintaining a careful balance between those elements of the tax system which rest most heavily on consumption and on investment and by seeking greater neutrality among taxpayers; and

(4) Protect the competitive position of small and new businesses by providing adequate tax offsets to business risks and by gearing the structure of tax rates to any differential barriers to acquiring the financial resources required for their growth and development.

Finally, in light of the experience and benefits derived by this subcommittee through use of statistics in the course of its study, we commend to the committees of the Congress the desirability of obtaining additional data and other information bearing on the economic effects of existing tax provisions and other factors influencing balanced economic growth and stability.

SUPPLEMENTAL VIEWS OF SENATOR DOUGLAS

The report of the subcommittee is excellent on the points which it covers and it is to be commended to the Congress and the public. The chairman, Mr. Mills, stated when he assumed his duties that in his judgment the subcommittee should concern itself with the economic effects of taxation but that it should leave the formulation of specific changes in tax provisions to the Ways and Means Committee of the House and the Finance Committee of the Senate. He has held strictly and honorably to that pledge.

Although it may be quite proper for the subcommittee as a whole to refrain from recommending specific tax changes, this does not preclude individual members from offering their views. In fact, I think recommendations on the next steps in tax policy as well as specific illustrations of the very excellent general principles in the report may increase the benefits from our inquiries. I am, therefore, taking this opportunity of adding these supplementary views which are based, to a great extent, on the testimony presented before the subcommittee.

1. State and local taxation which raises about $28 billion a year, or almost 30 percent of all revenues, is significantly regressive in character. The paper by Dr. Musgrave, and the testimony by one of the ablest tax administrators of the country, Eugene A. Shaw, of North Carolina, clearly show [1] that property taxes from which seven-eighths of local revenue is obtained are imposed at higher effective rates upon the homes of the lower-income groups than upon the mansions of the wealthy or upon industrial and commercial property. Similarly, State governments derive about two-thirds of their revenue from some form of sales taxation, whether this be general sales taxes or specific excises such as a gasoline tax, a liquor or cigarette tax, or a motor-vehicle tax. These taxes are quite markedly regressive. Since expenditures for services, such as servants, health, education, etc., and savings are exempt, and since the proportion of income devoted to these purposes increases with income, this means that, as income increases, the percentage absorbed by such sales taxes and excises decreases.

2. It is therefore necessary to have a considerable degree of progression in the Federal tax structure if we are to have even a proportional distribution of tax burdens in the total tax system. But it should be remembered that we collect about $10 billion a year, or about 16 percent of the total Federal revenues from excises on liquor, tobacco, gasoline, communications, transportation, etc. These excises are regressive in nature, i. e., they bear more heavily on the poor than they do on the rich, and add to the disproportionate burden of taxation on low-income groups occasioned by State and local systems. Progression in the Federal tax structure is provided by the individual income

[1] See Federal Tax Policy for Economic Growth and Stability, pp. 96–113, 799–807.

tax—which gives only one-sixth of State but 48 percent of Federal revenues—and the corporation income tax.

The combined Federal, State, and local tax systems, therefore, impose an overall burden which, according to Dr. Musgrave,[2] is approximately proportional at income levels up to $10,000 a year and mildly progressive at higher income levels. Therefore, if taxes at all three levels of government are taken into account the overall results are quite different from the burden imposed by the Federal income tax alone.

3. At the very least, the degree of progression in the present overall Federal tax structure should not be reduced. To do so would make the combined burden of the Federal, State, and local tax structure regressive. Only somewhat cruel people can advocate such a system. It follows therefore that attempts to substitute in the Federal tax structure a general manufacturers' sales tax for a part of the income tax should be resisted. Judging from the experience of Canada, initially low excise and sales taxes are later readily increased. We should not permit the thin edge of the wedge to be inserted in our tax structure for the opening would soon be widened and deepened.

4. The highly progressive nature of the Federal income tax based on statutory rates which range from 20 to 91 percent is in fact more apparent than real. Steady erosion of the income tax base has resulted in effective tax rates far less progressive in practice than those shown in the tax schedules.[3]

There have been steady erosions of the tax base, whereby actual income has either been removed from taxation or taxed at a much lower rate. Among these erosions I would mention the following:

(*a*) The provision of split income for husband and wife produces sizable reductions in the amount of income tax which would otherwise be paid by persons with large incomes, for under this provision tax savings increase with increases in income.[4] The provision is of virtually no benefit to over three-quarters of all individual income-tax payers since their taxable income falls within the first rate bracket. The effect of this provision is a yearly revenue loss in the magnitude of $3 to $3.5 billion at the present time.

(*b*) The fact that the basic tax rate is not deducted at the source for corporate interest and dividends although it is for wages and salaries, leaves a considerable degree of tax avoidance and evasion amounting probably to between $200 and $300 million per year.

(*c*) The capital-gains tax which takes into account only one-half of the gain and subjects the gain to a maximum rate of 25 percent,

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[2] Ibid., table 2, p. 98.

[3] In 1951, for example, there were 1,697 returns by single persons and married persons filing separately which showed adjusted gross income between $100,000 and $150,000. On a dozen of these returns income subject to tax was less than $50,000. On 831 returns, or almost half, taxable income was between $50,000 and $100,000. One return showed taxable income less than $2,000. When one realizes that adjusted gross income represents income after deductions for 50 percent of long-term (6 months) capital gains and for percentage depletion, it is seen that effective rates of tax on the actual income of high income groups are far less than those indicated by the statutory rate schedule. See Internal Revenue Service, Statistics of Income, pt. I, 1951.

[4] For example, a married man with $100,000 of taxable income saves $13,680 and pays taxes of $53,640, instead of taxes at $67,320, or a savings of over 20 percent. A married man with $4,000 in taxable income saves only $40 and pays taxes of $800 instead of $840, or a savings of less than 5 percent. Thus the gains of high-income groups from the split-income provision are greater in both absolute and proportionate amounts than for low-income groups.

has resulted in the classification of a great deal of actual income as capital gains and hence, a great loss of revenue. As compared with provisions which would restrict capital gains to the sale or exchange of a capital asset rigorously defined, the revenue loss may very well be in the magnitude of $500 million.

(*d*) The depletion allowances for the extractive industries have the effect of exempting a large amount of income from taxation and lead to a less efficient utilization of the resources of labor and capital than would be true in the absence of such a tax.[5] This is particularly true of the oil industry. But it has also been extended to such extractive industries as sand and gravel, oystershells, and clamshells. The latest verifiable figures indicate that the depletion allowances amount to a little over $2 billion a year.

(*e*) Something of the same kind can be said about the preferential rates granted to incomes derived from investments in the Western Hemisphere which would otherwise be paid by foreign incorporated subsidiaries of domestic corporations.

(*f*) There is still some abuse in the field of family partnerships when income is shared with minor family members who make no real contribution to the earnings of the partnership. Tightening the law with regard to family partnerships could provide additional revenues in the magnitude of about $100 million a year.

5. The Federal estate tax has gone through a similar process of erosion. Some of the ways in which this has been done are:

(*a*) By exempting from the estate tax gifts made more than 3 years prior to death.

(*b*) By using the device of life estates to avoid payment of the estate tax on successive transfers of estates from one generation to another.

(*c*) By eliminating the premium payment test for determining whether insurance proceeds are included in the gross estate.

A conservative estimate of the revenue losses by these and other generous provisions of estate and gift taxes is in the magnitude of $500 million.

6. The effect of all these erosions is not only to lead to tax avoidance and loss of revenues but also to great injustices as between individuals and families in the same income group. One set of people who do not or cannot take advantage of these loopholes are in fact taxed at a higher rate than those in the same income class who can and do profit from these exemptions and privileges. This disparity produces a smarting sense of injustice, leads to a constant widening of the existing loopholes and the opening up of new ones, and weakens the morale of those who do continue to pay taxes. Any widening of those loopholes should therefore be resisted and we should try to gain back some of the ground which has been lost.

7. A reduction of the total tax take is always welcome, but it needs to be carefully considered in the present situation. We need to remember that communism is still a threat, that the total military strength of the Communist bloc is increasing, and that they have made diplomatic and propaganda gains during the last few months. We need also to remember the acute needs for education, public health, highways, and housing. I believe some increase in the expenditures for

[5] Federal Tax Policy for Economic Growth and Stability: See particularly the papers by Messrs. Paul, pp. 297–313, Gray, pp. 430–439, and Harberger, pp. 439–449.

these purposes would be constructive and, in the finest sense of the term, productive.

Furthermore, we should realize that there will probably be no surplus in the administrative budget in 1955–56, although there may be a surplus in the consolidated cash budget as indeed there was in every fiscal year but one from 1947–52.[6] Any surplus in the administrative budget for 1956–57, provided general prosperity continues, can more properly be devoted to a reduction of debt. If indeed we do not reduce the debt in a period of what is termed "high prosperity" when will we in fact do so?

Specific action must await economic events and business conditions. Nonetheless the best interests of the economy are served if receipts exceed expenditures in times of prosperity and if expenditures exceed receipts in times of depression or sharp recession.

8. Nevertheless, it would be wise to effect some readjustment within the general Federal tax structure whereby some loopholes would be plugged and some inequities corrected.

I would suggest as a minimum program that (*a*) the direct credit against taxes of 4 percent of dividends be repealed; (*b*) that income from corporate dividends and interest should have the basic rate collected at the source, as is now the case with wages and salaries; (*c*) that abuses in family partnerships be checked; (*d*) that certain types of capital gains be more rigidly defined; (*e*) that while preserving the present depletion allowance on oil and gas for small operators who are not able to distribute drilling risks within their own enterprise, that an equal allowance is not needed in the case of large operators who can distribute risk through numerous drillings;[7] (*f*) that there should also be a tightening of the estate tax in reducing the amount by which the tax can be avoided by gifts in anticipation of death by trusteeship, etc.

9. The extra revenue obtained by plugging or reducing these loopholes should, in my judgment, be devoted to three sets of purposes:[8]

(*a*) Reducing or eliminating certain excises such as those on communications, transportation of persons and property, admissions, and most of those except liquor, tobacco, and gasoline excises.

(*b*) Making some reduction in the income tax paid by those in the lower brackets. In this connection I would like to suggest that the first $1,000 of taxable income be taxed at the rate of 15 percent rather than 20 percent as at present. The present 20-percent rate would then be applied to the second $1,000 of income. For those with taxable income at the top of the first bracket or above, this would give a maximum tax reduction of $50 for the single person and $100 for a married man.[9]

(*c*) As we plug the loopholes in the tax structure, we can also somewhat reduce the scheduled rates in the upper brackets of Federal income and inheritance taxes. This would produce greater fairness

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[6] In this period the cash budget showed a net surplus of $22 billion and showed a deficit only in the Korean war year of 1950. The administrative budget was in balance in 3 of the 6 years and showed a net surplus of $3.8 billion in the same period. Both the cash and administrative budgets have shown deficits in the fiscal years 1953, 1954, and 1955.

[7] For a specific recommendation see my amendment and remarks in the Congressional Record for June 30, 1954, pp. 8861–8865.

[8] Depending on the nature of the provisions and whether or not they were backdated to the first of the calendar year, approximately $2.5 to $2.75 billion could be recaptured. If in addition, or in lieu of these, the split-income provision were removed, it, of itself, would provide revenues in the magnitude of $3 to $3.5 billion.

[9] The revenue losses involved are in the magnitude of $2.5 to $3 billion.

as between individuals in the same income bracket. I must repeat, however, that we should not make the Federal tax system less progressive. On the contrary, I believe we should make it somewhat more so. The American public properly believes in taxation according to the relative ability of individuals and families to pay. While a detailed discussion of this issue would involve elaborate treatment which present space does not permit, the sense of justice of the people favors a progressive tax structure. This should be carried out in practice. But even without any such marked change, a real improvement can be effected. In my judgment, we should not delay action.

Paul H. Douglas.

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