

GENERAL TAX REFORM

PANEL DISCUSSIONS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
NINETY-THIRD CONGRESS
FIRST SESSION
ON THE SUBJECT OF GENERAL
TAX REFORM

FEBRUARY 5, 6, 7, 8, 20, 22, 23, 26, 27, AND 28, 1973

Part 1 of 11
(February 5, 1973)

Objectives and Approaches to Tax Reform and Simplification

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TABLE 4.—ALTERNATIVE MARGINAL TAX RATE SCHEDULES BY TAXABLE INCOME CLASS

[Income classes in thousands]

| Taxable income | Present law ¹ | Alternative tax schedules under comprehensive income tax | | | | |
|-------------------|--------------------------|--|------|------|------|------|
| | | 1 | 2 | 3 | 4 | 5 |
| Under \$0.5 | 0.14 | 0.08 | 0.10 | 0.05 | 0.16 | 0.07 |
| \$0.5 to \$1.0 | .15 | .09 | .10 | .07 | .16 | .08 |
| \$1.0 to \$1.5 | .16 | .09 | .11 | .08 | .16 | .10 |
| \$1.5 to \$2.0 | .17 | .10 | .11 | .10 | .16 | .11 |
| \$2.0 to \$4.0 | .19 | .12 | .12 | .13 | .16 | .13 |
| \$4.0 to \$6.0 | .22 | .12 | .13 | .15 | .16 | .14 |
| \$6.0 to \$8.0 | .25 | .14 | .13 | .16 | .16 | .15 |
| \$8.0 to \$10.0 | .28 | .16 | .15 | .17 | .16 | .16 |
| \$10.0 to \$12.0 | .32 | .18 | .16 | .18 | .16 | .20 |
| \$12.0 to \$14.0 | .36 | .20 | .18 | .19 | .16 | .22 |
| \$14.0 to \$16.0 | .39 | .22 | .20 | .20 | .16 | .24 |
| \$16.0 to \$18.0 | .42 | .24 | .22 | .21 | .16 | .26 |
| \$18.0 to \$20.0 | .45 | .26 | .22 | .22 | .16 | .28 |
| \$20.0 to \$22.0 | .48 | .27 | .24 | .23 | .16 | .29 |
| \$22.0 to \$26.0 | .50 | .28 | .25 | .24 | .16 | .30 |
| \$26.0 to \$32.0 | .53 | .30 | .26 | .25 | .16 | .32 |
| \$32.0 to \$38.0 | .55 | .31 | .28 | .27 | .16 | .34 |
| \$38.0 to \$44.0 | .58 | .33 | .30 | .29 | .16 | .35 |
| \$44.0 to \$50.0 | .60 | .34 | .32 | .31 | .16 | .36 |
| \$50.0 to \$60.0 | .62 | .35 | .34 | .33 | .16 | .37 |
| \$60.0 to \$70.0 | .64 | .36 | .36 | .35 | .16 | .38 |
| \$70.0 to \$80.0 | .66 | .37 | .38 | .37 | .16 | .40 |
| \$80.0 to \$90.0 | .68 | .39 | .40 | .38 | .16 | .41 |
| \$90.0 to \$100.0 | .69 | .39 | .45 | .39 | .16 | .42 |
| \$100.0 and over | .70 | .40 | .50 | .40 | .16 | .44 |

¹ Revenue Act of 1971 rate schedule for married couples filing separate returns.

Note: Rate schedules 1 to 4 are applied with a \$1,300 low-income allowance; rate schedule 5 assumes a \$2,000 low-income allowance.

TABLE 5.—EFFECTIVE TAX RATES UNDER THE COMPREHENSIVE INCOME TAX AND ALTERNATIVE RATE SCHEDULES, BY INCOME CLASSES, 1972 INCOME LEVELS

[Income classes in thousands of dollars; effective rates in percent]

| Expanded AGI ¹ | Present law ² | Alternative tax schedules | | | | |
|---------------------------|--------------------------|---------------------------|------------|------------|------------|------------|
| | | Schedule 1 | Schedule 2 | Schedule 3 | Schedule 4 | Schedule 5 |
| Under \$3 | 0.5 | 0.9 | 1.1 | 0.6 | 1.8 | 0.1 |
| \$3 to \$5 | 1.7 | 3.2 | 3.6 | 2.6 | 5.6 | 1.7 |
| \$5 to \$10 | 5.3 | 5.8 | 6.2 | 5.9 | 8.7 | 5.0 |
| \$10 to \$15 | 8.7 | 8.1 | 8.3 | 8.7 | 10.7 | 7.8 |
| \$15 to \$20 | 10.7 | 10.1 | 9.9 | 10.6 | 11.8 | 9.9 |
| \$20 to \$25 | 12.1 | 11.9 | 11.4 | 11.9 | 12.4 | 11.9 |
| \$25 to \$50 | 14.5 | 15.1 | 14.1 | 14.3 | 13.1 | 15.6 |
| \$50 to \$100 | 23.5 | 23.4 | 21.8 | 21.4 | 14.0 | 24.9 |
| \$100 to \$500 | 29.5 | 30.8 | 33.7 | 29.8 | 14.3 | 33.8 |
| \$500 to \$1,000 | 30.4 | 34.4 | 41.9 | 34.2 | 14.2 | 37.7 |
| \$1,000 and over | 32.1 | 36.0 | 44.7 | 36.0 | 14.6 | 40.0 |
| All incomes | 11.3 | 11.3 | 11.3 | 11.3 | 11.3 | 11.3 |

¹ Expanded AGI is adjusted gross income as defined in the Internal Revenue Code modified to include the income items listed in table 2.² Revenue Act of 1971 applied to 1972 incomes.

TABLE 6.—REVENUE EFFECT OF VARIOUS STRUCTURAL REFORMS OF THE INDIVIDUAL INCOME TAX UNDER ALTERNATIVE PACKAGES, 1972

[Billions of dollars]

| Reform provision | Package 1 | Package 2 | Package 3 |
|--|-----------|-----------|-----------|
| Remove maximum tax on earned income | 0.1 | 0.1 | 0.1 |
| Include 60 percent of realized capital gains in adjusted gross income and remove alternative capital gains tax provision | 1.5 | 1.5 | 1.5 |
| Eliminate deduction of gasoline taxes | .5 | .5 | .5 |
| Eliminate deduction of real estate property taxes | | | 2.3 |
| Remove dividend exclusion | .4 | .4 | .4 |
| Eliminate 50 percent of excess depletion advantages | .2 | .2 | .2 |
| Place 3 percent floor on charitable contribution deductions | | 1.9 | 1.9 |
| Tax unrealized capital gains in excess of \$5,000 transferred by gift or bequest at capital gains rates | | | .6 |
| Remove \$25,000 exemption allowed for excess investment interest deduction | | | 1.2 |
| Revise preference income base ¹ | .5 | | |
| Revise preference income base ¹ and raise tax rate on revised base from 10 to 20 percent | | 1.1 | |
| Revise preference income tax ¹ and tax at 1/2 the regular income tax tax rates ² | | | 2.4 |
| Total revenue effect ³ | 3.1 | 5.6 | 10.2 |

¹ Include State-local bond interest as a preference item and remove deduction for current-year taxes paid.² That is, tax the revised base at 7 to 35 percent—1/2 the regular rates, which range from 14 to 70 percent.³ The total revenue effect of each package is not equal to the sum of the components because various provisions interact with one another.

TABLE 7.—COMPARISON OF EFFECTIVE INDIVIDUAL INCOME TAX RATES UNDER AN INDIVIDUAL INCOME TAX REFORM PROGRAM AND A VALUE ADDED TAX, 1972

[Income classes in thousands of dollars; effective rates in percent]

| Income class | Increase in effective rate from tax reform package 3 ¹ | Effective rate of tax under a value added tax with | |
|------------------|---|--|--|
| | | A narrow base ² | A broad base and a credit ³ |
| \$0 to \$5 | 0.3 | 1.8 | 0.1 |
| \$3 to \$5 | .1 | 1.5 | .6 |
| \$5 to \$10 | .2 | 1.4 | .8 |
| \$10 to \$15 | .4 | 1.4 | 1.1 |
| \$15 to \$20 | .6 | 1.4 | 1.7 |
| \$20 to \$25 | .7 | 1.3 | 1.9 |
| \$25 to \$50 | 1.2 | 1.2 | 1.7 |
| \$50 to \$100 | 3.0 | .7 | 1.1 |
| \$100 to \$500 | 8.4 | .5 | .8 |
| \$500 to \$1,000 | 16.3 | .2 | .4 |
| \$1,000 and over | 19.0 | .2 | .2 |
| All incomes | 1.1 | 1.3 | 1.3 |

¹ For details, see table 6.² Base excludes rent, food, and medical outlays; tax rate is 3 percent.³ Base excludes rent; full tax credit is given 4-person families with incomes up to \$5,000 and phased out at \$20,000; tax rate is 3.25 percent.

The CHAIRMAN. Thank you, Dr. Peelman.
Our next panelist is Dr. Norman B. Ture of Washington, D.C.
Dr. Ture, we are happy to have you with us. You are recognized.

STATEMENT OF DR. NORMAN B. TURE

Dr. TURE. Thank you, Mr. Chairman. I want to offer my commendations to the committee for making these panels possible. I do hope that they will be useful to you in examining the issues of tax reform on a broad basis before you get into the details of the reform agenda. I want to express my appreciation for being asked to participate in these hearings. I also want to assure the committee that in my testimony and

participation in this panel I am representing only my own views, not those of my clients, past, present, or prospective.

I should, of course, be delighted if any of them, my fellow panelists and the committee, were to agree with my analysis and conclusions.

The objectives of tax reform, I submit, should be to make the tax laws fairer, simpler, and less of an impediment to economic efficiency. In offering this suggestion I must wear two hats. As a tax economist, I can delineate, on the basis of analysis, provisions and features of existing tax law which interfere with efficient use of production capability and suggest changes in the law to moderate, if not eliminate, these obstructions. In my judgment these changes would also make the tax system fairer and simpler. But in offering that judgment, I profess no special expertness to command your attention.

Fairness, like beauty and so many other things, is in the eye of the beholder. No university, thank heavens, bestows an advanced degree in fairness or has an endowed chair as professor of fairness. Assertions about what is or is not fair, no matter who makes them, should be taken as expressions of preference and judgment, not as scientifically derived truths. I have my set of preferences which will be clear to the committee in the context of my testimony, but I do not warrant them as better or worse than anyone else's set.

Perhaps the best way to approach the question of tax reform objectives is by asking what we expect taxes to do. Taxes are imposed to raise revenues because the Government uses some of the economy's production capacity in carrying out its functions and operations. The production capacity used by the Government is not available to households, businesses, and institutions in the private sector of the economy. The basic purpose of the taxes levied by Government, therefore, is to reduce the private sector's claims on the economy's production capacity. Taxation is the means by which these claims are transferred from the private sector to the Government.

This transfer of claims is effectuated by raising the cost to households and businesses of their use of production capacity. If a tax is levied as an excise on a particular commodity or service, the cost to households and businesses for any given quantity of that commodity or service will, initially at any rate, go up and less of it will be sold to them. More of it then can be sold to the Government or, more generally, some of the production inputs—labor, machines, plant and so forth—used to produce it will be available for use by the Government.

Every tax has this effect of raising the cost of something or other to the private sector. No two taxes, of course, have the same initial effects on the costs facing the private sector. In choosing among taxes, then, the central questions are (1) what costs will each increase and by how much, (2) what will these respective increases in cost do to the amount and kind of claims exercised by the taxpayers, and (3) are these the results that are desired?

For many years past a general proposition in answer to these questions has been that those taxes are best which least change the relative costs determined in the marketplace and which, therefore, least alter household and business decisions about how to use the resources at their disposal.

As a corollary, those taxes are best which increase all costs to the private sector in the same proportion. There have, of course, always been important exceptions; at various times and in pursuit of various objectives of public policy, specific tax devices have been used to encourage or discourage particular kinds of private sector activity and use of production capacity. But on the whole, there has been widespread agreement that taxes should have the least possible effect in changing the composition of supply and demand in the private sector.

This is essentially what all of us mean when we talk about neutrality in taxation. This, I submit, is still the correct guide for tax policy. It suggests, moreover, an approach which would be highly useful in evaluating reform proposals and in designing constructive revisions of the existing taxes. That approach is to ask, "What do the present tax provisions do to relative costs? Are these changes in relative costs in line with broad public policy objectives? If not, what tax changes will bring them closer in line? Would the various reform proposals move us closer to or farther away from attaining these objectives?"

One of the basic features of the present income tax is that, with few exceptions, both the amount that people and businesses save out of their current income and the future returns on that saving are included in their taxable incomes. One of the effects of this tax treatment of saving and the returns thereto is to increase the cost of private saving relative to the cost of consumption. If there were no income tax, for example, a person might be able to buy some given quantity of consumption goods for \$1,000 or he might use the same \$1,000 to buy a bond paying \$50 a year for 10 years, when the market rate of interest is 5 percent. He decides about how to allocate his income between consumption and saving, that is, buying future income, on the basis of many factors, an important one of which is the relative cost of each.

Now suppose an income tax like the present one is levied. For ease of illustration, suppose the tax rate is 50 percent. With the tax the cost of the same amount of consumption goods goes up 100 percent in the sense that it now takes \$2,000 of pretax income to buy the same \$1,000 of consumption goods. But the cost of saving goes up much more.

To have \$50 per year of additional income, one has to receive \$100 of pretax income. But with no change in the market rate of interest one must now buy a \$2,000 bond to get \$100 per year. And to have \$2,000 with which to buy the bond \$4,000 of pretax income is needed. The 50-percent income tax, thus, has doubled the cost of consumption, but it has quadrupled the cost of savings. Thus the tax has doubled the cost of saving relative to the cost of consumption.

Suppose that instead of the bond, the person prefers to buy a machine tool lasting 13 years, requiring a 12-percent-discount function in order to warrant its purchase. With a 48-percent income tax rate and with straight-line depreciation, to buy either a thousand-dollar machine tool or a thousand dollars' worth of consumption goods, the taxpayer is going to have to have \$1,923 of pretax income.

But before the tax, that machine tool would have provided him \$156 per year net income, the amount required to justify that investment. After the tax the machine tool does not provide him \$156; it gives him \$118. If he still insists on having a 12-percent rate of return in order

to allocate a thousand dollars from consumption to the purchase of that machine tool, he still has to have \$156 after-tax cash flow, and the amount of the required pretax earnings goes up to \$228.

Provisions such as the 7-percent job development credit, double declining balance depreciation, the reduced writeoff period under ADR, taken all together somewhat abate, but do not eliminate the extra cost of saving compared with consumption. They afford no subsidy to business. They afford a modest abatement of the enormous tax bias against saving and investment which is inherent in the basic structure of our income tax.

An additional element that compounds that bias is the graduation of income tax rates. It impairs economic efficiency by making it more costly to increase one's productivity. I hardly think that is a worthwhile social objective. In addition, graduation augments the fundamental income tax bias against saving of capital accumulation deriving from inclusion of both savings and the future income it affords in the tax base.

The tax bias is less if the applicable tax rate is 20 percent than if it is 50, 60, or 70 percent. Rate graduation differentiates the basic anti-saving bias on the basis of the amount of the taxpayer's income, not on the amount or proportion of income allocated to the savings.

This is far from the whole story of the antisaving bias of the present tax structure. Supposing in our example above the individual's saving takes the form of the purchase of shares of common stock in a corporation which uses the machine tools in its production.

In the absence of any income tax, the person would be willing to forgo a thousand dollars of current consumption and buy the stock in a corporation if the machine tool that is to be purchased with those funds would earn \$156 a year.

Suppose now that an individual income tax and corporation income tax are imposed. Again for ease of illustration assume the marginal rate applicable under both taxes is the same, 48 percent. In order to buy a thousand dollars of consumption goods or a thousand dollars of the company's stock, the individual will have to have \$1,923 of pretax income, but he will no longer get \$156 as a net return per year on his stock, on his savings.

The corporate income tax itself reduces the after-tax cash flow of the machine, as before, from \$156 to \$118. If the shareholder is willing to leave the earnings per share in the corporation, but still requires the same 12-percent rate of return, net of tax on his investment, the corporate after-tax flow on the machine tool will have to go up from \$118 to \$156 annually. In order to obtain \$156 after-tax cash flow, the pretax earnings of the machine tool will have to go up to \$228.

If this shareholder were so foolish as to want to withdraw the full amount of his share of the company's net cash flow each year and if he still insists on a 12-percent rate of return on his investment in order to forgo that \$1,000 of current consumption, he will need to receive a dividend of \$300 in order to net \$156 after-tax. If the after-tax cash flow of the machine tool has to go up to \$300, its pretax earnings have to increase to \$506. In other words, imposition of either one of these taxes requires a 46-percent increase in the pretax earnings of the machine tool to warrant the individual's forgoing \$1,000 of current con-

sumption. With both taxes fully imposed the required increase in pretax earnings is a staggering 224 percent.

Is there some broad goal of public policy which is served by these enormous tax-imposed increases in the cost of saving? Is there some system of ethics which says this is a fair way to impose taxes? In what sense is the proposal for reducing the corporation income tax rate properly characterized as a "tax break for business?"

We are not done yet. Suppose the corporation in our example retained the after-tax cash flow instead of paying any of it out as a dividend to the shareholder and in the seventh year after the initial investment by the shareholder the company had accumulated enough to buy another machine tool at a thousand dollars.

Suppose the same machine tool is the same as the initial one. It will last for 13 years. Suppose it will produce \$156 per year in after-tax cash flow. Now if the stock market is aware of this, the value of the shareholder's stock will go up from \$1,000 to \$2,000. This increase in the value of that share of stock is, of course, exactly equal to the present or discounted value of the additional \$156 per year of after-tax earnings discounted at 12 percent as before.

Recall that every single dollar of the corporation's earnings on the original machine tool out of which the \$1,000 to buy the new tool was accumulated was taxed as it was earned. Every dollar of the earnings on the new machine tool will also be taxed as it is earned. If the shareholder decides to sell his share of stock in the corporation, he will realize a gain of a thousand dollars on which he will pay an additional tax of at least \$240 under present law. This additional tax is a surcharge on the tax already paid on the prior year's earnings on his initial investment or equivalently it is a surcharge on the tax that will be paid over the succeeding years on the new machine tool's earnings.

In either case the future earnings stream will be taxed twice, once at the 48 percent rate as the earnings are realized each year and again at 24 percent in our example on the capitalized value of that future income stream.

To be sure that is not a really realistic example because that tax is going to be imposed only when the gain is realized.

The occasion for the tax is not merely the accrual of the gain; it is the transfer of the asset as well. Taxing capital gains not only increases the relative cost of saving, but it also increases the cost of changing the composition of one's wealth. It therefore must have the effect of reducing the frequency of transfers and impeding the ready shift in the allocation of savings. It must impair the efficiency with which savings are allocated among alternative uses.

What worthy social objective is sought by increasing the cost of transferring property? In what sense is it fair to increase that cost?

Moreover, what intellectual gymnastics must one go through to convert the additional tax penalty on savings imposed by taxing capital gains into a tax "loophole"? How can the difference between imposing that additional penalty at 24 percent instead of 48 percent in our example be regarded as a tax preference? How can taxing the gains on property transferred by gift or at death be seen as closing a "loophole"?

And we are not done yet.

If our corporation and shareholder live in a State that levies income taxes, the effects of Federal taxes in increasing the cost of saving relative to the cost of consumption are compounded. And irrespective of the State in which the corporation's production facilities are located, there are local government property taxes, which correctly analyzed, must be seen as additional, heavy levies on the earnings produced by the taxed properties, and which therefore must also be regarded as further increasing the cost of saving relative to consumption. And let us not forget death and gift taxes which take additional bites out of the capitalized value of the future income on accumulated saving.

Add these taxes up and include the myriad additional levies—for example, license fees, franchise taxes, excises, and so forth—and the tax-imposed increase in the relative cost of saving is enormous.

Are these effects of the existing tax system in line with the broad objectives of public policy? What goals are effectively pursued by making it relatively more costly for every household and every business to save than to consume?

I think I have exhausted my time, Mr. Chairman, but I would like briefly to refer to a couple of the loopholes that are at the top of most of the lists of loopholes that are sought to be closed by any reform agenda, just to examine them for illustrative purposes for their substantive content.

Let me first point out that to a very large extent, it seems apparent to me, most of the drive for closing loopholes has a very strong element of an effort to redistribute income, to make the distribution of income more nearly equal than it is. I would like to point out to the committee that this has been the cast of Federal fiscal policy throughout the entire postwar period.

It has been highly redistributive. Yet if one will examine the data that pertain to the distribution of income prepared by the Bureau of Economic Analysis in the Department of Commerce and its predecessor organization, the Office of Business Economics, one will find throughout the entire postwar period that the changes in the measure of the inequality in the distribution of income have been extremely small and they have been random.

They have seemed to me to be primarily statistical noise. Income redistribution efforts through the fisc have not been successful. There is good and sufficient reason for that. The reason is that since most of those efforts involve imposing increasingly heavy taxes on those who save and invest, we wind up with less capital in our economy than we otherwise would. By virtue of that fact the productivity of labor and, therefore, its real wage rate is lower than it otherwise would be. Even if we attempt to redistribute income through the fisc by lowering the tax rates applicable to labor income, in effect what we are doing is taking away with the one hand what we are trying to give back with the other. Demonstrably it has not been an effective approach to public policy.

It seems to me the priority in tax reform with which this committee really ought to be fundamentally concerned is the elimination or at least the moderation of the existing tax bias against saving, against capital accumulation. I think that can be done by providing very sub-

stantial deductions in the individual tax base and in the business tax base for current saving.

I think it is readily demonstrable that in order to treat tax-wise saving on the same basis as consumption it is necessary either to allow for a current deduction of saving or exemption of the future income on that saving. In that context it is interesting to me to find that our existing tax treatment of tax-exempt municipals conforms much more closely with the criterion for neutral tax treatment as between saving and consumption than virtually any other saving outlet in existence in the country today.

Yet as you all know, tax-exempts appear very high on the list of so-called loopholes.

It seems to me the tax rates ought to be grossly moderated. Graduation ought to be, if not completely eliminated, at least very substantially reduced. It seems to me there is very little occasion for the Government to be a senior partner in the economic efforts of any household and any business. Certainly no tax rate ought to exceed 50 percent, not in the income tax, not in the estate tax, not in the gift tax. I think those tax rates above 50 percent are highly counterproductive and induce people to make inefficient use of the resources at their disposal.

No tax ought to be applied to capital gains. As an interim measure toward elimination of the taxation of capital gains, I would suggest, very strongly recommend, the extension to all capital gains of the existing rollover treatment applicable to residences.

Very high on everybody's list of loopholes is the existing tax treatment of extractive industries. The major culprit here is percentage depletion, though the more sophisticated among us also assert that intangible drilling expenses are also "loopholes." It seems to me when you examine the existing tax provisions pertaining to the mineral industries against the criterion which I urge for your consideration that the question you must ask in order to determine whether the present arrangements constitute a loophole is the following:

Does the deductibility, the initial deductibility of investment outlays by mineral companies plus the present value of all of their subsequent depletion allowances equal, fall short of, or exceed the total amount of their investment in that property? If that sum falls short of their investment in mineral properties, they are not receiving a tax break, they are not beneficiaries of a loophole. In fact, they are paying some additional penalty tax on the saving and investment in those properties.

Only if that sum exceeds the amount of their investment is the loophole to be found.

Let me conclude with the following:

This inspection of "loopholes" against the criterion of equal taxation of saving and consumption could be greatly extended, but the examples offered above should suffice to illustrate a central point of my testimony: Many of the principal "loopholes" are deemed to be such only because they are evaluated against a standard calling for punitive taxation of saving as compared with consumption.

Against the standard of equal taxation of saving and consumption, many of these so-called loopholes are not preferences, tax breaks,

shelters, tax expenditures, or what-have-you, but modest abatements of the tax bias against saving. Still others, notably the tax on capital gains, are correctly seen as heavy additional tax burdens on saving.

Closing these loopholes along the lines widely proposed would mean further increasing the cost of saving relative to the cost of consumption. The consequences of doing so would be to reduce the rate of private sector saving and capital formation. In turn, this would not only reduce the rate of expansion of real output, but it would also retard the growth in the productivity and in the real wage rate of labor.

This analysis is developed at length in a study which I have just completed for the National Association of Manufacturers. The study, "Tax Policy, Capital Formation and the Growth of Productivity," will be available shortly.

Tax revisions to reduce the existing tax bias against saving would contribute significantly to simplifying the tax law. It would afford a much more nearly neutral tax climate for the private sector of the economy and enhance the efficiency of its operations. It would contribute over time to accelerating the economy's rate of expansion of real production capacity, real income, and employment opportunities. And unless the case can be made that penalizing the saving of rich and poor alike is fairer than equally taxing the saving and consumption of everyone, it would make the tax system fairer.

Thank you.

(Dr. Ture's prepared statement and additional material follows:)

STATEMENT OF DR. NORMAN B. TURE, WASHINGTON, D.C.

I am Norman B. Ture, President of Norman B. Ture, Inc., an economic consulting company with offices at 1100 Connecticut Avenue, N.W., Washington, D.C.

The Ways and Means Committee is to be highly commended for initiating its hearings on tax reform with these panel discussions. It is my understanding that the Committee hopes to obtain from these panels a broad perspective on the issues of tax policy and to have the opportunity to examine the basic facts and analyses upon which these issues rest before dealing with specific proposals for tax reform. If these panels do their job well, the Committee will have at its disposal a set of practicable and operational criteria against which to evaluate the many suggestions which will be made for changing the tax laws. I wish to express my appreciation to the Committee for its invitation to participate in this effort. I also want to assure the Committee that in my testimony and participation on this panel, I shall be representing only my own views and not those of my clients, past, present, or prospective. Of course, I should be delighted if they, my fellow panelists, and the Committee were to agree with my analysis and conclusions.

This first panel has been asked to consider objectives and approaches to tax reform and simplification. The objectives of tax reform, I submit, should be to make the tax laws fairer, simpler, and less of an impediment to economic efficiency. In offering this suggestion, I must wear two hats. As a tax economist, I can delineate, on the basis of objective analysis, provisions and features of existing tax law which interfere with efficient use of production capability and suggest changes in the law to moderate, if not eliminate, these obstructions. In my judgment, these changes would also make the tax system fairer and simpler. But in offering that judgment, I profess no special expertness to command your attention. Fairness, like beauty and so many other things, is in the eye of the beholder. No university, thank heavens, bestows an advanced degree in Fairness or has an endowed chair as Professor of Fairness. Assertions about what is or is not fair, no matter who makes them, should be taken as expressions of preference and judgment, not as scientifically derived truths. I have my set of preferences which will be clear to the Committee in the context of my testimony, but I do not warrant them as better or worse than anyone else's set.

THE FUNCTION OF TAXES

Perhaps the best way to approach the question of tax reform objectives is by asking what we expect taxes to do. Taxes are imposed to raise revenues because the government uses some of the economy's production capacity in carrying out its functions and operations. The production capacity used by the government is not available to households, businesses, and institutions in the private sector of the economy. The basic purpose of the taxes levied by government, therefore, is to reduce the private sector's claims on the economy's production capacity. Taxation is the means by which these claims are transferred from the private sector to the government.

This transfer of claims is effectuated by raising the cost to households and businesses of their use of production capacity. If a tax is levied as an excise on a particular commodity or service, the cost to households and businesses for any given quantity of that commodity or service will, initially at any rate, go up and less of it will be sold to them. More of it, then, can be sold to the government or, more generally, some of the production inputs—labor, machines, plant, etc.—used to produce it will be available for use by the government.

Every tax has this effect of raising the cost of something or other to the private sector. The effectiveness of any tax, in terms of its basic purpose of transferring claims on production capability to the government, depends on how responsive households and businesses are to these increases in costs. Clearly, if the excise tax results in no reduction in the sales and production of the taxed item, it is not efficient in transferring to the government the production inputs used for producing that item.

No two taxes, of course, have the same initial effects on the costs facing the private sector. In choosing among taxes, then, the central questions are (1) what costs will each increase and by how much, (2) what will these respective increases in cost do to the amount and kind of claims exercised by the taxpayers, and (3) are these the results that are desired?

For many years past, a general proposition in answer to these questions has been that those taxes are best which least change the relative costs determined in the market place and which, therefore, least alter household and business decisions about how to use the resources at their disposal. As a corollary, those taxes are best which increase all costs to the private sector in the same proportion. There have, of course, always been important exceptions, predicated on the conviction that some of the results of the operation of the market place are undesirable, or do not adequately conform with the priorities of public policy. So at various times and in pursuit of various objectives of public policy, specific tax devices have been used to encourage or discourage particular kinds of private sector activity and use of production capacity. But on the whole, there has been widespread agreement that taxes should have the least possible effect in changing the composition of supply and demand in the private sector.¹

This, I submit, is still the correct guide for tax policy. It suggests, moreover, an approach which would be highly useful in evaluating reform proposals and in designing constructive revisions of the existing taxes. That approach is to ask "What do the present tax provisions do to relative costs? Are these changes in relative costs in line with broad public policy objectives? If not, what tax changes will bring them closer in line? Would the various reform proposals move us closer to or farther away from attaining these objectives?"

Permit me to illustrate.

THE ANTI-SAVING BIAS OF THE EXISTING TAX SYSTEM

One of the basic features of the present income tax is that, with few exceptions, both the amount that people and businesses save out of their current income and the future returns on that saving are included in their taxable incomes. One of the effects of this tax treatment of saving and the returns thereto is to increase the cost of private saving relative to the cost of consumption. If there were no income tax, for example, a person might be able to buy some given quantity of consumption goods for \$1,000 or he might use the same \$1,000 instead to buy a bond paying \$50 a year for 10 years, when the market rate of interest

¹ This is essentially what is meant by neutrality in taxation and why neutrality in taxation is deemed to be important for efficiency of the economy.

is 5 percent. He decides about how to allocate his income between consumption and saving, i.e., buying future income, on the basis of many factors, an important one of which is the relative cost of each.

Now suppose an income tax like the present one is levied. For ease of illustration, suppose the tax rate is 50 percent. With the tax, the cost of the same amount of consumption goods goes up 100 percent in the sense that it now takes \$2,000 of pretax income to buy the same \$1,000 of consumption goods. But the cost of saving goes up much more. To have \$50 per year of additional income, one has to receive \$100 of pretax income. But with no change in the market rate of interest, one must now buy a \$2,000 bond to get \$100 per year. And to have \$2,000 with which to buy the bond, \$4,000 of pretax income is needed. The 50 percent income tax, thus, has doubled the cost of consumption, but it has quadrupled the cost of saving. Thus, the tax has doubled the cost of saving relative to the cost of consumption.

To take the example further, suppose that instead of buying a 5-percent, 10-year bond, the person prefers to acquire future income by buying, say, a machine tool, or equivalently, by supplying funds to a machine tool user for the purchase of the machine. Suppose the machine is expected to remain in use for, say, 13 years, and because of the greater risk in this type of investment than in the purchase of a bond, the funds necessary for its purchase will be supplied only if the machine's future income provides a 12 percent rate of return. If the machine's price is \$1,000, it will have to produce \$156 per year.² Now suppose an income tax at 48 percent is imposed, with straight-line depreciation allowed as deductions for tax purposes from the income produced by the machine. The after-tax cash flow from the machine will be reduced to \$118. To buy either the \$1,000 of consumption or the \$1,000 machine, the taxpayer will have to have \$1,923 of pretax current income, but the machine now affords him a future income of only \$118 per year instead of \$156. If before the tax was imposed he required \$156 per year to induce him to give up \$1,000 of current consumption, he'll hardly be likely to settle for \$118 per year. Instead, he and others like him will cut back on their saving-investing until the amount of machines and all other capital has been sufficiently reduced, relative to labor services in production, to provide an increase in pretax earnings on the machine which after tax will again afford a cash flow of \$156. The amount of the required pretax earnings in this example is \$228.

Tax provisions such as the investment credit, accelerated depreciation, shortening of useful lives for tax depreciation purposes, etc., somewhat reduce, but do not eliminate the extra cost of saving compared with consumption imposed by the tax. Suppose in the example the taxpayer had been able to claim the 7 percent Job Development Credit, had used the double-declining balance method of depreciation, and had used a 10-year write-off period, under the ADR's 20 percent range provision. With these assumptions, the machine would still have to produce pretax earnings of \$188 to provide \$156 of after-tax cash flow.

These provisions certainly afford no subsidy for saving and investment. Their effect, rather, is to reduce somewhat the income tax bias against saving and capital formation. In this respect, to be sure, they contribute to a higher rate of saving and capital formation than would occur if the tax-bias were more severe. But even with these provisions, the income tax significantly increases the cost of saving relative to the cost of consumption.

The fundamental income tax bias against saving and capital accumulation, deriving from the inclusion of both saving and the future income it affords in the tax base, is compounded by graduation of income tax rates. Clearly, the weight of the anti-saving tax bias is less when the applicable income tax is, say, 20 percent than when it is, say, 50 percent. Rate graduation, therefore, differentiates the basic anti-saving bias on the basis of the amount of taxpayers' incomes, not on the amount or proportion of their incomes allocated to saving.

It is quite widely assumed that the proportion of one's income that is saved increases as one's income increases. To the extent that there is, indeed, a systematic relationship of this sort, tax rate graduation obviously increases the weight of the basic income tax bias against saving. The inference to be drawn is not that the differentially heavier tax on saving than on consumption eliminates saving but rather that it reduces the amount of saving out of any given

² \$156 per year for 13 years, discounted at a rate of 12 percent, is \$1,000.

income compared to what it would be under a neutral tax. The evidence of high living by the affluent does not call for increasing their income taxes. Instead, it calls for revision of the income tax to reduce the relative cost of saving.

Graduation of income tax rates has a further effect in impairing economic efficiency. It is correct, I believe, that the amount of one's income is in general, a good measure of one's contribution to the total income of the economy. In very large part, that contribution depends on one's productivity and the efficiency with which one uses the production resources at one's disposal. With a graduated tax on income, the more efficient and productive an individual is (as evaluated in the market place), the greater is the tax bite on the rewards he receives for his contribution to total output. Graduation, thus, imposes an increasing cost on improving one's efficiency and productivity. It is difficult to perceive any worthwhile social objective to be achieved by making it more and more costly to be more productive. And whether it is fair to tax one person's income at an effective rate of, say, 20 percent and another's at a rate of, say, 30 percent, it seems to me, is purely a matter of taste, good or bad, depending on one's viewpoint.

The examples above tell far less than the whole story of the anti-saving bias in the present tax structure. Suppose in the example above that the individual's saving takes the form of the purchase of shares of common stock in a corporation which uses machine tools in its production. In the absence of any income tax, the person would forego \$1,000 of current consumption and buy the stock if the machine tool purchased with those funds would earn \$156 per year. Now suppose that an individual income tax and a corporation income tax are imposed and that the marginal tax rate applicable to both the individual and the corporation is 48 percent. In order to buy either \$1,000 of consumption goods or \$1,000 of the company's stock, the individual will have to have \$1,923 of pretax income. But he will no longer obtain \$156 per year on his saving. The corporation income tax itself reduces the after-tax cash flow of the machine tool from \$156 per year to \$118 per year. And if the corporation were to distribute the after-tax cash flow to the individual shareholder as a dividend, he would net only \$61.36.

Suppose the shareholder is willing to leave the earnings in the corporation, but requires the same 12 percent rate of return, net of tax, on his investment. Then the corporation's after-tax cash flow on the machine tool must go up from \$118 to \$156 annually, and to obtain a \$156 after-tax cash flow, the pretax earnings of the machine tool will have to go up to \$228.

If the stockholder is so foolish as to want to withdraw his share of the company's earnings each year, the \$156 after-tax cash flow distributed to him as a dividend shrinks to \$81.12 after he pays his personal income tax. If he still insists on a 12-percent rate of return to forego \$1,000 of current consumption and to make that amount available to the corporation, he'll need to receive a dividend of \$300 to net \$156 after tax. But if the after-tax cash flow of the machine tool is to go up to \$300, its pretax earnings must increase to \$506.

In other words, imposition of either one of the taxes requires a 46 percent increase in the pretax earnings of the machine tool to warrant the individual's foregoing \$1,000 of current consumption: the full imposition of both taxes increases the required pretax earnings by a staggering 224 percent.

Another way of looking at this effect of the taxes on the cost of saving is that in the absence of the tax, the cost of foregoing \$1,000 of current consumption, i.e., of saving \$1,000, was \$156 per year, representing an earnings rate of 12 percent. With one or the other tax imposed, the cost of saving \$1,000 goes up to \$228 per year, an earnings rate of 21 percent. With both taxes fully imposed, the cost of saving increases to \$506 per year, i.e., requires an earnings rate of over 50 percent.

Is there some broad goal of public policy which is served by these enormous, tax-imposed increases in the cost of saving? Is there some system of ethics which says that this is a fair way to impose taxes? In what sense is a proposal for reducing the corporation income tax rate properly characterized as a "tax break for business"?

But we've not done yet.

Suppose the corporation in our example retained the after-tax cash flow instead of paying any of it out as a dividend to the shareholder, and in the seventh year after the initial investment by the shareholder, the company buys another machine tool for \$1,000, the amount of the accumulated retained earnings. Suppose the new machine will also last 13 years and produce \$156 per year in after-

tax cash flow. If the market is aware of this, the value of our shareholder's stock will go up from \$1,000 to \$2,000. This increase is, of course, exactly equal to the present or discounted value of the additional future \$156 per year of after-tax earnings, discounted at 12 percent as before. Recall that every dollar of the corporation's earnings on the original machine tool out of which the \$1,000 to buy the new machine was accumulated was taxed as it was earned. And every dollar of the earnings of the new machine will also be taxed as it is earned.

If, never mind why, the shareholder decides to sell his share of stock in the corporation, he will realize a capital gain of \$1,000. Under present law he'll pay an additional tax of \$240 or more on this realized capital gain. This additional tax is properly viewed as a surcharge on the tax already paid on the prior years' earnings on his initial investment or equivalently as a surcharge on the tax that will be paid over the succeeding years on the new machine tool's earnings. In either case, the same future earnings stream will be taxed twice, once at the 48 percent rate as the earnings are realized each year, and again at 24 percent (in our example) on the capitalized value of that future stream of earnings.

What standard of fairness dictates imposing this additional tax cost on saving? What broad goal of public policy is served by levying, over and above the initial individual tax cost and the additional corporation tax cost, a further tax cost on saving?

To be sure, the example is not completely realistic, since the market value of the shareholder's stock will probably increase year by year as the corporation retains its after-tax earnings. The capital gains tax is not imposed as the gain accrues but only when it is realized. The occasion for the tax, then, is not merely the accrual of the gain itself, but the transfer of the asset as well. Taxing capital gains not only increases the relative cost of saving but also increases the cost of changing the composition of one's wealth. It therefore must reduce the frequency of transfers and impede the ready shift in the allocation of saving. Accordingly, it must impair the efficiency with which savings are allocated among alternative uses.

What worthy objective of social policy is sought by increasing the cost of transferring property? In what sense is it fair to increase that cost?

Moreover, what intellectual gymnastics must one go through to convert the additional tax penalty on saving imposed by taxing capital gains into a tax "loophole"? How can the difference between imposing that additional penalty at 24 percent instead of 48 percent (in our example) be regarded as a tax preference? And how can taxing the gains on property transferred by gift or at death be seen as closing a "loophole"?

We have not done yet.

If our corporation and shareholder live in a state that levies income taxes, the effects of Federal taxes in increasing the cost of saving relative to the cost of consumption are compounded. And irrespective of the State in which the corporation's production facilities are located, there are local government property taxes, which correctly analyzed, must be seen as additional, heavy levies on the earnings produced by the taxed properties, and which therefore must also be regarded as further increasing the cost of saving relative to consumption. And let us not forget death and gift taxes which take additional bites out of the capitalized value of the future income on accumulated saving.

Add these taxes up and include the myriad additional levies (e.g., license fees, franchise taxes, excises, etc.) and the tax-imposed increase in the relative cost of saving is enormous.

Are these effects of the existing tax system in line with the broad objectives of public policy? What goals are effectively pursued by making it relatively more costly for every household and every business to save than to consume? It seems to me that a tax system with this basic bias against saving would be appropriate, if at all, only in a country which enjoyed capital superabundance in the sense that adding to the existing stock of capital would add nothing at all to total output. These are certainly not the circumstances of the United States. Barring capital superabundance, the tax system should certainly not increase the cost of saving and of capital accumulation in greater proportion than it increases the cost of consumption. A tax system which does so is unfair, and it erects a barrier to efficient use of the economy's production capability, in this case by distorting household and business choices between current consumption and future income.

The lower rate of private saving resulting from the anti-saving bias of the income tax also means a lower rate of private investment in both human and non-human capital. Among the principal consequences of this smaller stock of capital are (1) less total output for the economy as a whole and (2) a lower real wage rate for labor.³ Surely neither of these results conforms with any broad public policy objective.

The question, then, is why the tax system is structured to impose this bias against saving and investment. The answer surely cannot be that Congresses and/or administrations, past or present, have consciously sought to restrict private saving and the expansion of production capability. Rather, I suspect, this antisaving bias of taxation is in part the consequence of an accumulation of *ad hoc* provisions over a long period of years, largely uninformed by even elementary economic analysis as their likely effects on the relative cost of saving and consumption.

In larger part, the existing tax system reflects doctrinal persuasions, embodied in slogans and phrases, such as "ability to pay", "equal taxation of equals", etc., which however superficially appealing, are devoid of practicable, operational substance. It is not that taxes should be deliberately levied disproportionately to ability to pay nor that equally situated persons should pay different amounts of tax. It is, rather that an operational concept, let alone measurement, of ability to pay has proved to be highly elusive and an inadequate guide to taxation. And the mere bulk of the Internal Revenue Code is eloquent testimony to the problems encountered in delineating the relevant characteristics for determining whether any two or more persons are "equal" or "unequal" for tax purposes. The pursuit of these concepts in tax policy, I submit, has blinded policy makers to the effects of their decisions on economic factors, which are far more readily and precisely identifiable and measureable. Thus, in orienting the tax system to provide some sort of equality of tax liability on "equally" situated taxpayers and suitably different tax liabilities on "unequally" situated taxpayers, tax policy has tended to burden unfairly those with a relatively strong saving preference and to favor those with relatively high consumption propensities.

In very large part, moreover, the doctrinal notions expressed by "ability to pay" have been addressed to using the tax system, in conjunction with government spending programs, to redistribute income and wealth from the affluent to the needy. Economists have long past given up the conviction that such redistribution, to the extent it were effective, would increase the total utility or efficiency of the society. Insofar as they urge such redistribution, they do so without the support of their professional expertise, and are indeed merely expressing their personal preferences. Discriminating among these preferences is purely arbitrary, and in fact many of us are highly ambivalent on the subject. Thus, some of us believe it is desirable for a person whose annual contribution to the economy's total product is valued at, say, \$20,000 to give up, in various taxes, a third, more or less, of his income to help finance government payments to some other person whose contribution to total product, for whatever reason, is valued at zero or some very small amount. Others of us may find this tax-transfer redistribution is grossly unfair, particularly if the taxpayer is hard working while the transferee is indolent. But apart from our judgment as to the fairness or unfairness of imposing taxes so as to redistribute income or wealth, the questions that are almost universally ignored are whether the system works and what side effects it has.

As to the first of these, the highly redistributive tax-transfer system of the postwar era has not in fact changed the shape of the distribution of income. The following table presents measures of the degree of inequality in the distribution of income for the years 1947-1968.⁴

³In a study recently completed for the National Association of Manufacturers, I have attempted to measure the contribution of the postwar growth of business capital to real total business output and to the increase in the real wage rate. Growth in capital inputs accounts for 32 percent of the increase in real total business output and the increase in the amount of capital relative to labor increased the real wage rate by 2.2 percent per year, on the average. Cf. Norman B. Ture, *Taxes, Capital Formation, and the Growth of Productivity*, forthcoming by the National Association of Manufacturers, Section III—A.

⁴Edward C. Budd, "Postwar Changes in the Size Distribution of Income in the United States", *American Economic Review*, May 1970, pp. 247-60. The basic data are from the U.S. Bureau of the Census, *Current Population Reports*, Series P-60. Income is defined as total money income.

| Year | Gini ratio † | Year | Gini ratio † |
|------|--------------|------|--------------|
| 1947 | 0.430 | 1959 | 0.422 |
| 1948 | .424 | 1960 | .423 |
| 1949 | .428 | 1961 | .432 |
| 1950 | .431 | 1962 | .421 |
| 1951 | .416 | 1963 | .418 |
| 1952 | .416 | 1964 | .419 |
| 1953 | .429 | 1965 | .417 |
| 1954 | .429 | 1966 | .413 |
| 1955 | .420 | 1967 | .416 |
| 1956 | .415 | 1968 | .406 |
| 1957 | .418 | | |
| 1958 | .416 | | |

† The Gini ratio is a measure of income inequality. The lower the ratio, the more nearly equal the distribution of income.

While one may argue as to whether the income concept embodied in these measures is appropriate, there is no reason to believe that use of any alternative concept would materially alter the results; the measures of inequality would still be closely bunched and would evidence no trend.

The side effects of redistributive fiscal policy, almost entirely disregarded, explain in considerable part the lack of change in the distribution of income. To a substantial degree, the tax part of the tax-transfer system has consisted of taxes which heavily penalize saving compared with consumption. The consequence has been, as pointed out earlier, a slower rate of increase in the stock of capital and in the input of capital services relative to labor services than would otherwise have occurred. And the consequence of this retardation of the growth of capital has been that the pretax return per unit of capital has been higher than otherwise, while the pretax wage rate of labor has been lower than otherwise. Thus, what workers may have gained by way of lower taxes on their wages and salaries they have lost, at least in part, by way of lower wages and salaries because of their lower productivity. And insofar as the transfer payments have gone to the nonworking poor, labor has sustained the loss from lower productivity without reduction in taxes as an offset. At the same time, employment opportunities for the nonworking poor have also been curtailed. And in any event, the total output of the economy has been less than it would otherwise have been.

This has assuredly been an inefficient tax-transfer system. To whom has it been fair?

PRIORITIES IN TAX REFORM

This has assuredly been an inefficient tax-transfer system. To whom has it been constructive tax reform should be on reducing, if not completely eliminating, the tax bias against saving. The long-run consequence of recasting Federal taxation in this way would be a higher rate of private saving, faster accumulation of capital, more rapid expansion of total output, expansion of employment opportunities, and a more rapid increase in labor's productivity and real wage rate. If the tax changes required to moderate the existing anti-saving bias are deemed to be unfair, it must be that the existing heavy penalties on saving are in some sense fair, though it is mystifying to me to see what criteria of fairness could produce that assessment. Surely the required tax changes would tend to simplify the tax system.

1. The treatment of saving in the income tax base

A tax that increases the cost of saving and consumption in equal proportion, hence doesn't change their relative cost, must either allow a deduction of current saving from current income, or exclude the future income produced by that saving from the future tax base. Let us go back to the first example above, in which a person decides between \$1,000 of consumption goods and a \$1,000 bond, paying \$50 per year for 10 years. Again assume a 50 percent income tax is levied. If the saving were deductible, then \$50 after-tax income per year for the next 10 years will still require \$100 pretax income each year, which will in turn require \$2,000 of current saving. But with saving deductible, only \$2,000 of current pretax income will be needed to buy the bond; with current deductibility of saving, therefore, the 50 percent tax doubles the cost of acquiring the future income stream,

just as it doubles the cost of current consumption.⁵ Equivalently, the cost of the future income will be just doubled by the 50 percent tax if the current saving is included in the tax base but the future income from the saving is deductible. In this case, \$50 per year of after-tax income will require only \$50 per year of quire \$2,000 of pretax current income. Again the tax doubles the cost of the future income, just as it doubles the cost of current consumption; accordingly, it leaves the relative cost of consumption and saving the same as before the tax was imposed.

A neutral tax on income, to repeat, requires either a deduction for saving from current income or for the future income on the saving. To be neutral, the tax cannot be imposed on both, even if it is imposed at a reduced or "preferential" rate on one or the other; any such treatment increases the relative cost of saving. By the same token, the tax must be fully imposed on one or the other; failure to do so reduces the relative cost of saving.

It is interesting to examine some of the popularly identified "loopholes" against this criterion of equal taxation of saving and consumption. The purchase of a municipal bond, for example, comes out of taxed income, i.e., the saving is taxed, but the returns on the bond are tax exempt. This tax treatment is much more nearly in line with the requirements of equal taxation of saving and consumption than is that of most other saving. As another example, the fact that the imputed rent on owner occupied residences is not subject to tax is regarded by some economists as a "loophole". But unless the purchase of the residence is financed from tax exempt sources, the present tax exemption of imputed rent is precisely what equal taxation of saving and consumption demands.

To achieve full tax equality between saving and consumption, all private sector saving should be deductible from the income tax base, whether that saving takes the form of a savings account, education of one's children, the purchase of machine tools, or the building of a shopping center. So far as business saving is concerned, this could be accomplished in the main by providing for 100 percent write-off of the cost of production facilities in the year in which they are acquired, thereby eliminating depreciation and other capital recovery allowances.⁶ An intermediate measure toward achieving that equal tax treatment would be additional liberalization of existing capital recovery allowances, although even the most accelerated depreciation allowances, short of full first-year write off, fall short of equality. For household saving, adoption of the Administration's 1972 proposal to allow all employed persons a deduction for limited amounts of income saved for retirement would be a constructive initial step.

2. Tax rates

For the long run, a major objective of constructive tax revision should be to eliminate or at least moderate the graduation of income tax rates. This would afford an important contribution to abating the income tax bias against saving. In itself, this revision would not eliminate the basic bias, but it would reduce it; at the least, it would moderate the accentuation of the bias at those income levels where supposedly the greatest potential for saving exists.

A first step would be to initiate a program of periodic reduction of income tax rates above the first four brackets. This program should begin with extending the present 50 percent effective rate limitation on "earned" income to all individual income.

3. The corporation income tax

To eliminate the incremental tax bias against saving imposed by the corporation income tax clearly would require complete elimination of the tax itself. Although the corporation might still act as a tax collecting agent, its earnings should be attributed to its shareholders and taxed to them only under the individual income tax. Moreover, the attributable corporate earnings for tax purposes should be reduced by the amount of the corporation's saving.

With the advance of computer technology, this treatment of corporate income is quite feasible. Indeed, much the same provision is made under existing law in

⁵ The future income on the bond consists of 10 annual interest payments of \$50 plus the repayment of the \$1,000 principal at the end of the 10th year, which would be taxed as well under this approach.

⁶ Any proceeds from the sale or other dispositions of assets would be fully taxed. However, if an equal amount were newly saved, the deduction of the saving would offset the inclusion of the sales proceeds in taxable income. In effect, the deductibility of saving provides automatic "roll over" tax treatment.

the case of Subchapter S corporations, companies with a limited number of shareholders who are taxed as partners.

Partial integration could be accomplished by revising the tax treatment of dividends under the so-called "gross-up" approach. Individual shareholders under this approach would attribute corporation income tax deemed to have been paid to the dividends they receive, compute their tax on their total taxable income including the grossed-up dividends, and claim a tax credit equal to the amount of the corporation income tax included in the grossed-up dividends.

4. Capital gains

One important revision to reduce the existing income tax bias against saving would be to eliminate capital gains and losses entirely from the tax base. This revision should be a companion measure to the complete integration of corporate earnings in the individual stockholder's income.

As an intermediate measure, the existing tax treatment of capital gains and losses should be amended by extending the present "rollover" treatment on residences to all capital assets. Under this approach, tax on gains would be deferred so long as the gains were fully reinvested. Tax would be paid on any portion of such gains not reinvested but allocated to consumption.

5. Taxation of extractive industries

High on almost everyone's "loophole" list is percentage depletion. Combined with the deduction allowed for mine development and exploration expenses for minerals other than oil and gas and for intangible drilling costs in the case of oil and gas, percentage depletion is widely alleged to afford businesses in natural resource industries unconscionable tax breaks.

The tax equality conditions discussed above suggest that the appropriate way of looking at these tax provisions is to determine whether the sum of the exploration and development deductions, or the intangible drilling deductions, plus the percentage depletion deductions equals, falls short of, or exceeds the investment in the property. To the extent that the sum is less than the investment, the existing tax provisions are not properly regarded as "loopholes" or "preferences"; indeed, they involve a heavier tax burden on the saving invested in such properties than would be imposed on an equal amount of consumption by the persons supplying the savings invested in the property. If the sum is just equal to the investment, the existing tax arrangements should be deemed to conform with the requirements for equal taxation of saving and consumption. Only if and to the extent that the sum exceeds the investment are the present tax provisions properly characterized as "preferences."

If the suggestion above for full first-year write-off of business capital outlays were included along with the other proposals for eliminating the existing tax bias against saving, the question of percentage depletion would, clearly, become irrelevant. All outlays to find, develop, and bring a mineral property into production would be deductible as they were incurred, and no depletion deductions would be appropriate. Lacking full first-year write-off, however, the characterization of percentage depletion, just as the characterization of accelerated depreciation, as a "loophole" is name calling rather than analysis.

6. Real Estate

The so-called "tax-shelters" for real estate investment are popular items on many "loophole" closing lists. The culprits are generally depicted as upper bracket individuals, often professionals, whose investments in real property cast off tax deductions in excess of the income from the real estate and which act, therefore, to "shelter" their other income from tax. The offending provisions of the law are generally identified as excessive depreciation allowances.

The Tax Reform Act of 1969, on the basis of this line of reasoning, severely restricted the availability of accelerated depreciation methods for real property, subjected the excess of any such accelerated allowances over straight line allowances to the minimum tax and increased the severity of the Section 1250 recapture rules. All of these provisions significantly increased the tax cost of saving invested in real property. Moreover, these additional tax costs were not abated in 1971 by the Job Development Credit and ADR, for which real property is not eligible.

Under the revisions I have proposed, saving invested in real property, just as that in any other form, would be deductible at the outset. No depreciation allowances would be claimed, and all rental income on the property in excess of oper-

ating costs and interest on indebtedness would be fully subject to tax. And the full amount of any proceeds from the subsequent sale or other disposition of the property would similarly be fully included in income in the year of the sale or disposition. Real property income would be taxed in the same way as income from other property, eliminating most of the complexity under existing law. And all such saving would be taxed equally with income allocated to consumption.

CONCLUSION

This inspection of "loopholes" against the criterion of equal taxation of saving and consumption could be greatly extended, but the examples offered above should suffice to illustrate a central point of my testimony: Many of the principal "loopholes" are deemed to be such only because they are evaluated against a standard calling for punitive taxation of saving as compared with consumption. Against the standard of equal taxation of saving and consumption, many of these so-called "loopholes" are not "preferences", tax breaks", "shelters", "tax expenditures", or what have you, but modest abatements of the tax bias against saving. Still others, notably the tax on capital gains, are correctly seen as heavy additional tax burdens on saving.

Closing these "loopholes" along the lines widely proposed would mean further increasing the cost of saving relative to the cost of consumption. The consequences of doing so would be to reduce the rate of private sector saving and capital formation. In turn, this would not only reduce the rate of expansion of real output, but it would also retard the growth in the productivity and in the real wage rate of labor. If I may take the liberty of citing my favorite author, this analysis is developed at length in a study which I have just completed for the National Association of Manufacturers. The study, "Tax Policy, Capital Formation, and the Growth of Productivity", will be available shortly.

Tax revisions to reduce the existing tax bias against saving would contribute significantly to simplifying the tax law. It would afford a much more nearly neutral tax climate for the private sector of the economy and enhance the efficiency of its operations. It would contribute over time to accelerating the economy's rate of expansion of real production capacity, real income, and employment opportunities. And unless the case can be made that penalizing the saving of rich and poor alike is fairer than equally taxing the saving and consumption of everyone, it would make the tax system fairer.

TAX AIDS IN THE FEDERAL BUDGET

(By Norman B. Ture)

In recent years, a number of proposals have been advanced for including in the budget of the Federal Government estimates of the amounts of each of a large number of so-called "tax expenditures" or "tax aids".¹ Simply stated, the proposition upon which these proposals are founded is that there is merely a formal accounting distinction between a government expenditure and the revenue foregone as a consequence of a tax provision which affords differential treatment for some taxpayers, in some situations, engaging in some types of transactions. There is, of course, some basis for this proposition in the literature of public finance, e.g., in some economic analyses, government transfer payments are treated as negative taxes.²

¹ Cf. former Assistant Secretary of the Treasury Stanley S. Surrey, Remarks before the Money Marketeers on "The U.S. Income Tax System—The Need for a Full Accounting," in the 1968 Report of the Secretary of the Treasury, pp. 322-340; Stanley S. Surrey, and William F. Hellmuth, "The Tax Expenditure Budget—Response to Professor Bittker," *National Tax Journal*, Volume XXII, No. 4, December 1969, pp. 528-537; Assistant Secretary of the Treasury Murray L. Weidenbaum, "How to Make Decisions on Priorities," Statement before the Subcommittee on Economy in Government of the Joint Economic Committee, June 2, 1970; former Secretary of the Treasury Joseph W. Barr, "Tax Expenditures: Government Expenditures Made Through The Income Tax System," Supplemental Statement before the Joint Economic Committee, January 17, 1969. These terms are shown in quotation marks here to indicate that they are phrases of art rather than of solid analytical content. Hereafter, the quotation marks are omitted in the interests of facilitating typing and reproduction. The reader should supply them whenever these terms are encountered.

² In the Keynesian analysis of the impact of changes in fiscal magnitudes on gross national product, the multiplier effect of a given amount of change in income tax liabilities is treated as the same as the multiplier effect of an equal amount of government transfer payments, i.e., nonexhaustive expenditures.

It is, nevertheless, the conclusion of this discussion that there are fundamental differences between government expenditures and so-called tax aids, that the conceptual and practical problems of measuring these tax aids are, in the present state of knowledge, insurmountable, and that the measurements which are offered by advocates of the proposal are grossly misleading, and if relied upon to serve any of the objectives for which the proposal is advanced would in all like likelihood produce bad results.

EVALUATION OF TAX AIDS IN THE FEDERAL BUDGET

Whatever one's view as to the appropriateness of the objectives which might be served by including measures of tax aids in the Federal budget, two major sets of problems confront the endeavor to do so. The most immediate involves the method of measurement itself. The second set of problems is more fundamental and concerns the very concept of a tax aid and of its identification.

A. Measurement Problems

1. Conceptual

Assistant Treasury Secretary Weidenbaum, former Treasury Secretary Barr, former Assistant Treasury Secretary Surrey, and many others have produced and made public estimates of tax expenditures, tax aids, tax loopholes, tax differentials, or what have you. In virtually every case, these estimates are what Surrey and Hellmuth termed "... 'first level' figures, ... i.e., they involve the revenue that would be obtained from a change in the tax provision involved without anything else being changed." This is, of course, the standard procedure used by the U.S. Treasury and others, in and out of Government, in estimating the revenue effects of a proposed tax change or the revenue cost of an existing tax provision. There are some exceptions. For some purposes, Treasury estimates sometimes reflect the impact on the revenue effect of a tax aid of projected changes in some economic aggregate over time, e.g., gross national product, corporate profits, personal income, etc., but these growth factors are assumed to be independent of and unaffected by the particular tax provision(s) under consideration. For example, the Treasury Report on Depreciation Policy recently submitted by Secretary Kennedy to Senator Jacob Javits⁴ estimates the impact of alternative depreciation liberalization methods on Federal revenues under the assumption of a fixed rate of increase in investment and in depreciable facilities, but specifically disregards the effects of liberalizing depreciation on the rate of investment, hence on total output and on the tax base.⁵ On rare occasions, a Treasury estimate is based on an effort to quantify the induced secondary effects of a proposed tax change, but such estimates are invariably confined to a single, specific tax change employing highly simplifying assumptions about the scope of the secondary effects and ignoring tertiary consequences. For example, the estimate of the revenue gain from the proposed tax on leaded gasoline presumably reflects (1) the effect of the consequent price increase on the volume of gasoline sales and (2) the increase in depreciation deductions which would follow from the increased capital outlays of petroleum refiners. Even estimates of this character, however, are likely to fall short of the "real" revenue effect.

The basic question so far as the measurement problem is concerned is whether "first level" estimates of tax aids are meaningful or misleading. The "first level" estimate, to repeat, is "... the difference between the tax actually paid and the tax that would otherwise be paid in the absence of the tax aid provision No induced or indirect effects are taken into account" In other words, these estimates assume that the composition and level of economic activity, hence the composition and level of the tax base are unaffected by the presence or absence of the tax aid. In turn, this implies that *all* price elasticities, of demand for and supply of final products and factors of production, are precisely zero, surely the *least* plausible assumption to make. Were there no other occasion for disputing the utility of measuring tax aids in the Federal budget, the inherent implausibility of the present type of measurement would suffice since the invalidity of the underlying assumptions upon which these estimates are based results in misleading measurements.

³ Op cit., p. 535. Italics added.

⁴ Cf. *Congressional Record*, July 23, 1970, pp. E6963-E6975.

⁵ *Ibid.*, p. E6971.

⁶ Weidenbaum, op. cit., p. 14.

The correct measurement of the revenue effect of a tax aid is the difference between (1) the amount of actual tax liability and (2) the tax liability which would arise *with respect to the composition and level of economic activity which would prevail in the absence of the tax aid*. Despite the apparent simplicity of this concept of the real measure of the tax aid, enormous complexities are involved.

The most immediate question that arises concerns the appropriate time frame for the measurement as just defined. As an example, suppose the Internal Revenue Code were amended to permit more liberal write-off of depreciable facilities and that it were agreed that this amendment constituted a tax aid. Presumably taxpayers would take advantage of the change in the law in the first taxable year in which it was effective, i.e., would immediately claim the more liberal depreciation allowances, but it can hardly be presumed that their investment in depreciable facilities, their labor-capital mix, the volume of their output, the prices of their products, the impact of these changes on other industries, consumers, etc., in that initial taxable year would fully reflect their response and that of others to the tax aid. That is to say, the effects on Federal revenues in that first taxable year (even if measurable at all) would reflect only an initial impact of the tax aid on the tax base.⁷ The more realistic assumption is that the response throughout the economy to the tax aid will extend over a substantial number of years and that full adjustment thereto will be achieved only in some "long run".⁸ The meaning of the first, second, third, etc., year revenue effect of the tax aid, even were it measurable, is, therefore, ambiguous or at least subject to widespread misinterpretation.

Properly interpreted, the revenue effect in the years before full adjustment is achieved should be regarded as a measure of one of the results of the tax shifting process in the particular year or as the amount by which revenues would have differed had the shifting process not been initiated by the tax aid. Only when it might be confidently concluded that the shifting process had been completed could one unambiguously take the difference between actual revenues and the revenues which would have been received with the total tax base that would have existed had the tax aid not been enacted as the complete measure of the revenue effect of the tax aid. Without a complete quantitative analysis of the shifting and incidence of the particular tax aid, of course, there is no unambiguous basis for an a priori view as to whether that revenue effect is positive or negative.

To recapitulate, the measure currently employed which completely ignores both immediate and long-term adjustments to the enactment of the tax aid expresses the initial impact of the tax provision; its relevance is only for that period of time in which there is no response to the tax aid. In the case of a tax aid which has long been in effect, the initial impact measurement is obviously absurd. Between the time of initial impact and the time in which the adjustments throughout the economy to the tax aid are substantially complete, the difference between actual revenues and the revenues that would have been obtained from the tax base that would have existed at that latter time in the absence of the tax aid may be taken as the revenue effect of the tax shifting process. The complete measure of the revenue effect of the tax aid is the difference between actual revenues at the time when the adjustment to the tax aid is complete and the revenues that would have been obtained at that time from the tax base that would have existed at that time in the absence of the tax aid.

2. Applied

The discussion in the preceding section urges that the measurement of the revenue effect of a tax aid requires measurement of all the changes in the tax base that occur in response to the provision of the tax aid. In a dynamic eco-

⁷ Even were such a first-year measure of the effect of the tax aid on the tax base, hence on revenues, deemed to be acceptable, it is clear that this measure is *not* simply the product of the change in depreciation allowances times some average tax rate unless it were true that *no change* in economic activity in response to the tax aid had occurred in that first year.

⁸ In this example, it may be hypothesized that the effect of the depreciation liberalization is to raise the whole time path of *net* new investment in depreciable facilities. Quite apart from the effects of this higher investment path on output and income throughout the economy, it would also involve larger annual amounts of replacement investment, not only because of the larger stock of facilities at any future point in time but also because of a possible shortening of the replacement cycle. The point in future time at which the new equilibrium growth path of gross investment would be reached would depend in part on this last factor.

nomie environment, this requires in turn a means for identifying those changes in the composition and volume of economic activity which are impelled directly and indirectly by the tax aid and distinguishing them from the changes which would otherwise have occurred. Otherwise stated, the requirement is for a full-blown, quantifiable model of the shifting and incidence of taxation and of particular features and elements of particular taxes, if anything other than the misleading initial impact measure of the tax aid is to be provided.

The problems in this connection are obvious. In the first place, there is no effective consensus regarding tax shifting and incidence, even in abstract terms. One need only consider the wide divergence of views concerning the shifting and incidence of the corporation income tax. In the second place, even were there such a consensus so that a model could be rigorously stated in abstract terms, its quantification surely lies beyond the present capacity of econometrics. As a practical matter, therefore, measurement of the real revenue effect of tax aids is not presently feasible, and questions of the validity of the objectives which might be served by including such measures in the Federal budget are not yet relevant.

B. Conceptual Problems

1. Identification of Tax Aids

The discussion of measurement problems above implies that the tax aid whose revenue effect is to be measured can in fact be identified. That is to say, it implies that the concept of a tax aid is so clear as to permit an unambiguous segregation of those provisions of the code which may be properly labeled tax aids. But the definition of a tax aid and criteria for their identification pose problems substantially more severe than those discussed in connection with measurement.

Indeed, not even the principal proponents of including tax aids in the budget have provided an unambiguous definition; they have, moreover, conceded the difficulties in doing so and have characterized their own listings of the present inventory of tax aids as nondefinitive. Assistant Treasury Secretary Weidenbaum's characterization of a tax aid is very much the same as that used by Surrey and Barr, i.e., "... those provisions which represent departures from a proper measure of net income . . ." Surrey explicitly recognized the ambiguity of this characterization: "... just which tax measures can be said to fall in this category—in other words, which tax rules are integral to a tax system in order to provide a balanced tax structure and a proper measurement of net income, and which tax rules represent departures from that net income concept and balanced structure . . . ?" It is not surprising, therefore, that the specific listings of tax aids by Surrey, Barr, and Weidenbaum are prefaced by the caution that the list is not exhaustive, that "... some items were excluded where there is no available indication of the precise magnitude of the implicit subsidy . . . [or] where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments [or] because of their relatively small quantitative importance." This implies that the items which are listed do not run afoul of these constraints. This inference, of course, is highly debatable, as the discussion below reveals.

The view that a tax aid is a provision of the tax rules which affords an exception to the correct concept of the tax base is a good starting point. Examination of the ramifications of this view demonstrates just how difficult, ambiguous, and arbitrary the identification of tax aids is.

The correct concept of the tax base, of course, is the major hurdle which must be overcome. Most of the literature of public finance addressed to this question concerns the income tax, and the lists of tax aids which have been offered to date consist exclusively of provisions in the income tax rules. But the Federal revenue system consists of several taxes other than the income tax. Indeed, payroll taxes have replaced the corporation income tax as the second largest Federal revenue producer and excises are expected to produce about half as much revenue in fiscal 1971 as the corporation income tax. Non-income taxes, in other words, are important components of the Federal tax system and if the proposal to include tax aids in the budget is to be adopted, there is, as Boris

⁹ Weidenbaum, op. cit., p. 14.

¹⁰ Surrey, op. cit., pp. 323-324. Surrey does not help to clarify matters by reference to "balanced structure."

¹¹ E.g., Surrey, *ibid.*, p. 329.

Bittker has pointed out,¹² no reason in logic to confine the list to the income tax. On the contrary, the objectives ostensibly to be served by the measurement of tax aids require a complete listing. As a single illustration, if obtaining a better measure of the impact of fiscal operations on the allocation of the economy's resources is a valid objective of the proposal, surely the differential excise on gasoline should not be ignored. The measurement of the tax aid embodied in this excise—presumably a negative tax aid, in this instance—must wait, however, until someone develops the concept of the correct excise tax base so that identification of exceptions to that base can be made.

There is little prospect for resolving these conceptual problems with respect to excises, payroll taxes, estate and gift taxes. Indeed, the conceptual problems in formulating the correct base for the income tax have to date been highly resistant to solution. It is no wonder that nowhere in the Internal Revenue Code is the concept of income spelled out nor that little if any of the legislative effort on the Tax Reform Act of 1969 was constrained explicitly by a rigorously delineated concept of the correct income tax base.

Clearly, no acceptable designation of tax aids can be forthcoming without a consensus regarding the concept of the correct tax base. But the correctness of a tax base depends very largely on the priorities assigned to the various criteria of taxation, i.e., neutrality, equity, simplicity, adequacy, etc. Since consensus is not to be found regarding the concepts of these criteria, still less regarding their relative importance, there are numerous obstacles to be overcome before any listing of tax aids may be safely interpreted as anything more than an expression of the lister's tastes and preferences.

Consider, for example, the impact of the neutrality criterion on the delineation of the income tax base and rates. A tax may be properly characterized as neutral only if its imposition does not alter relative prices. Any income tax, therefore, is likely to violate the neutrality criterion since the tax necessarily increases the price of activities generating income included in the tax base relative to the price of all other activities. Even if one accepts this fundamental unneutrality, one should at least require of an income tax in the interests of neutrality that the tax be imposed at the same effective rate on the net returns per unit of every factor of production, irrespective of its use, the circumstances of its owner, etc. But then, clearly, the entire corporation income tax would have to be treated as a *negative* tax aid, since by this concept of neutrality the corporation income tax represents an *incremental* levy on the net returns per unit of capital used by corporations compared with the tax on the net returns per unit of capital used in other organizational forms. By the same token, any tax on capital gains and any tax on saving violates the neutrality criterion.¹³ The present income tax differential on realized capital gains should therefore be included in the list as a *negative* tax aid, rather than as a positive one as in the Surrey list and partially in the Barr and Weidenbaum lists. These lists, moreover, should add the tax liability on saving as negative tax aids. By the same reasoning, accelerated depreciation, the investment credit, or any similar device should be viewed not as a tax but as a partial abatement of the additional tax imposed on saving embodied in physical production facilities. And the failure to allow a deduction for investment in education or even the amortization of this investment represents a negative tax aid of vastly larger proportions than the tax aids on behalf of education in the Surrey, Barr, and Weidenbaum lists. In brief, a neutral income tax would have to exclude all saving, irrespective of its allocation, from tax; the inclusion of most saving in the tax base represents a negative tax aid of much larger amount than the so-called tax aids pertaining to the treatment of capital in the existing lists.

The neutrality criterion would lead to a concept of the "correct" income tax base materially different from that now in the law and would cast up an entirely different list of tax aids, most of them negative, from those now offered. In addition, adherence to the neutrality criterion would require treating any graduation of effective tax rates as a tax aid for the benefit of those persons whose effective tax rates are below the overall average and as a negative tax aid for those whose effective tax rates exceed the average.

¹² Boris I. Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," *National Tax Journal*, Volume XXII, No. 2, June 1969, pp. 244-261.

¹³ An income tax which includes saving in the tax base, as the present tax largely does, impose a tax on the capitalized value of a future income stream, i.e., the saving, and on that income stream as it materializes, i.e., twice. A tax on capital gains is a tax on the capitalized value of an expected increase in an income stream, which will be taxed as it materializes.

Quite different conclusions may emerge if some other tax criterion is given priority. The Haig-Simons definition of income (the algebraic sum of consumption and the change in net worth between two points in time), for example, is more closely oriented to an equity criterion than to neutrality. In the introduction to his treatise on the subject, Simons dealt at length with varying bodies of argument about the basis for income taxation, and clearly indicated that his focus was on the measurement of equality or inequality of status. Elsewhere in his essay, he repeatedly implied that the appropriateness of any given income concept depends on the use to which it is to be put. And Simons quite explicitly recognized the conflict between his concept of income and its income tax treatment and considerations of economic efficiency and economic growth.

If equalizing economic status (or more realistically, reducing disparities therein) is regarded as the principal criterion of taxation and if consumption plus change in net worth is accepted as the best measure of economic status, then the correct income concept to use for the identification of tax aids would be pretty much the Simons concept. The listing would probably be substantially more extensive than those of Surrey, Barr, or Weidenbaum, but would include almost all of the items on those lists.

The evidence is unmistakable, however, that the proponents of including tax aids in the budget do not feel constrained by the rigorous application of the Simons definition in identifying tax aids. Thus, Surrey and Hellmuth, responding to Bittker's challenge of the utility of the Simon's definition for this purpose, observed that ". . . while offering a large measure of guidance, such an economic definition is not the criterion solely used in the Treasury classification. The latter tempers the economic analysis by utilizing 'widely accepted definitions of income' and the 'generally accepted structure of an income tax' as the governing guideline . . . The development of the boundaries of an income tax structure will at many points be an evolutionary matter . . ." ¹⁴ The ambiguities of concept conveyed in this response reveals how much the classification of any tax provision as a tax aid reflects the viewpoints of the classifier rather than some objectively determinable exception to the correct concept of income. Having eschewed the Simon's definition, nothing now remains as the guide to classification except the unspecified "widely accepted definition of income" and the "generally accepted structure of an income tax."

2. Comparability of Direct Expenditures and Tax Aids

One of the principal arguments for including tax aids in the budget is that they are substantially the same as direct government expenditures in terms of their effect on the budget deficit or surplus, impact on the allocation of resources, and amounts of resources devoted by government to various programs. Quite apart from the reservations expressed in the preceding discussion, the utility of including tax aids in the budget must also depend on the comparability of tax aids and direct expenditures. If, for example, a tax aid of a given amount affects resources allocation through different channels from that of a direct expenditure of equal amount, presenting the two as equal budget magnitudes will misinform rather than enlighten the budget policy maker.

One obvious difference between some tax aids and direct expenditures which casts serious doubt as to their comparability was noted by Barr and Surrey, though not with the reservation just expressed. Thus Barr observed that "Some of the special tax provisions cause revenue to be lost to the Government forever . . . Such tax expenditures correspond closely to direct expenditures. Other special tax provisions . . . defer the time when the taxes will be paid . . . special tax provisions, which serve to defer but not forgive tax payments, might be compared to net lending in budget terminology." ¹⁵

Barr's statement illustrates the ambiguity of the comparison. Certainly there is a major distinction between net lending and direct expenditures in every relevant sense, i.e., direct impact on resource allocation, on composition of demand for and supply of funds in the financial markets, on future revenues and expenditures, etc. This distinction suggests that tax aids should be sub-classified into categories comparable to direct expenditures and net lending in the Federal budget.

This distinction, moreover, has important implications for the measurement of tax aids. Thus, some tax aids should be measured as suggested above, i.e., as the difference between actual revenues and the revenues that would have been

¹⁴ Surrey and Hellmuth, op. cit., p. 532.

¹⁵ Op. cit., pp. 3-4.

obtained from the tax base that would have been generated by the level and composition of activity that would have prevailed in the absence of the tax aid (incidentally, in numerous cases this measure would require amending the Barr statement to read "Some of the special tax provisions cause revenue to be *gained* to the Government forever . . . Such tax expenditures correspond closely to *tax revenues*"). But those that correspond, as Barr put it, to net lending require a different measurement. In this case, the direct expenditure counterpart of the tax provision is the present value of the foregone interest on the deferred tax payments less the present value of the *net* increase, if any, in future revenues. As in the former case, it is not evident, a priori, whether this would result in a positive or negative expenditure measurement. If the special tax provision, for example, were to result in a larger expansion of the tax base than would otherwise be the case, the present value of the increase in revenues therefrom would have to be subtracted from the present value of the interest on the tax payments deferred by the special provision.

Accelerated depreciation illustrates this case. The government loses the interest it might have earned—or equivalently, pays more interest on a larger volume of borrowing—on the taxes it does not collect on the difference between the accelerated and nonaccelerated depreciation deductions. But suppose that the volume of capital formation increases by virtue of the accelerated depreciation provision and the resulting increase in production capability expands the future tax base in equal proportion. Then the Government gains the additional revenue attributable to that incremental tax base. In effect, it is repaid more than the principal amount of the "loans" it extended taxpayers by permitting larger depreciation deductions. Its net gain or loss is the difference between the stream of foregone interest receipts—or higher interest payments—and the stream of higher revenues. To express that net gain or loss for the current year, it is necessary to discount both streams by some appropriate discount rate. The difference between the present value of the two streams would be the correct figure to include in the budget for the current year.

Other problems of comparability are even more severe. A direct expenditure involves a direct impact on resource use; \$X billion of military aircraft procurement expenditures represents \$X billion of capital, labor, raw materials, fuel supplies, etc., committed to the specific activity. But tax aids do not involve any such direct impact; they operate on resource use by changing relative prices or equivalently the actual or expected after-tax income flows from the benefited activity, circumstance, etc., relative to the income flows in other activities, circumstances, or what have you. The magnitude of the change in the use of resources cannot be inferred merely from the amount of tax dollars involved; the determination of that response also requires knowing the degree of responsiveness of taxpayers to the tax aid, i.e., the price elasticity of the affected activity. Accordingly, \$X billion of tax aids, properly measured, may involve substantially larger or smaller resource allocation effects than the same amount of direct expenditures.

Such differences in effects reflect substantially more than the question of first-level impact vs. ultimate incidence discussed above (Surrey and Hellmuth are, of course, quite correct in observing that direct expenditures are also measured in the budget at their first-level impact values ¹⁶). Rather, to repeat, the difference is that direct expenditures constitute a direct claim on resources (granting that the exercise of these claims involves secondary effects) while tax aids do not.

A rigorous quantitative comparison of direct expenditures and tax aids would require measurement of the full effect of each on budget magnitudes in the context of a full-blown, dynamic model of fiscal incidence. A comparison otherwise derived should be regarded as highly suspect and as more likely to obscure than to elucidate the budget.

SUMMARY AND CONCLUSIONS

The preceding discussion of the problems of concept and measurement strongly urge that the inclusion of tax aids in the Federal budget would not achieve the objectives ostensibly sought by proposals to this effect. Given the present state of knowledge and of the art of econometric analysis, the identification of tax provisions as tax aids is necessarily arbitrary and dependent on the views of

¹⁶ Op. cit., p. 536.

the classifier as to what constitutes the correct tax base, and the measurement of the revenue effect of the provisions identified as tax aids is necessarily inaccurate and misleading. Including tax aids in the budget would not afford a fuller accounting of public financial resources allocated to public programs; at most, one might be able to say, lacking knowledge of the response to the tax aid, that more public financial resources are devoted to the various programs than is indicated by the direct expenditure measures. Including tax aids in the budget would not afford a more accurate measure of the effect of the identified tax provisions on the budget surplus or deficit, unless the provisions are deemed to have no effect on economic activity. Without solving the measurement problems, tax aids in the budget cannot be expected to improve decision-making about budget allocations nor do they afford the basis for evaluation of alternative fiscal devices in achieving program objectives in a cost-effectiveness analysis. Their inclusion in the budget would, in all likelihood, increase their public exposure, but unless the conceptual problems of identification and the practical problems of measurement can be overcome, the Congress and the public are likely to be entrapped in doctrine rather than informed by hard facts and rigorous analysis.

The same problems of measurement and concept militate against the utility of quantitative statements of tax aids in the budget as a means of achieving tax policy objectives. Nor would economic policy formulation or the achievement of economic policy objectives be enhanced by measuring the initial revenue impact of designated tax provisions in the budget. Vastly more work has to be done before these proposals would result in the data required for better and more complete analysis of fiscal impact on the distribution of income and wealth or on the allocation of resources in the economy.

In this last connection, a further brief word is called for. Tax aids, loopholes, tax shelters and differential provisions are frequently criticized as contributing to resource misallocation and to a consequent loss of efficiency in the economy. The proposition is that a tax aid reduces the effective rate of tax on a particular type of activity which, as a consequence, will increase to a level that is greater than optimum. The conditions of optimum are delineated, with few exceptions, under the assumptions of a "best world", i.e., under the assumptions that except for the tax aids, the resource allocating mechanism operates perfectly. But the real world is hardly a best world in this context; on the contrary, it is a world of severe institutional limitations on free and perfect markets. In this real world, the effect of a tax aid in moving toward or away from a higher level of efficiency cannot be characterized on a priori grounds.

For example, a strong argument may be made that the general outline of the Federal tax system involve an extremely heavy bias against private capital. A tax aid which reduces this bias with respect to some given activity will indeed result in a different mix of capital formation from that which would otherwise prevail. A priori, however, there is no basis for determining which mix is "better". The investment tax credit was available with respect to specific types of depreciable property; by virtue of its restrictions, it surely must have had some effect on the composition of private investment. What would one have to know to be able to assert confidently that the actual investment mix was inferior to that which would have prevailed in the absence of the credit? Had the credit been introduced into an otherwise perfectly neutral tax and institutional setting, the a priori answer would be clearly that it misallocated capital. In the actual setting in which it was introduced, no such assertion should be unqualifiedly accepted.

There is an important implication for the measurement problem in this recognition of a far from best world state of affairs. How should the revenue effect of any given tax aid be measured—against the tax base that would in fact exist in its absence or against a tax base that would be generated by a perfectly neutral tax regime? No one has yet proposed the latter, but what is the meaning of the former measurement except as a quantitative statement of a difference in the state of tax affairs? The present income tax has been frequently and widely characterized as a collection of selective excise taxes. Assuming the correctness of this characterization, how is one to measure the tax aid in a provision of the law which results in one excise being imposed at a lower effective rate than some others? Should one characterize as a tax aid the difference between an excise on a car and a truck if the excise for the car is 7 percent and the excise for the truck is 10 percent?

The listing and measurement of tax aids in the budget would tend to undermine their effectiveness. Not even the principal advocates of the proposal assert that no tax aid is justified or useful in effectuating government policy. The possible wholesale undermining of taxpayer confidence in tax aids, those that are deemed by the classifier to be "good" along with those regarded as "bad", would unnecessarily circumscribe the government's use of an effective fiscal device. This device—the tax aid—has already been made less powerful by the demonstration in the Tax Reform Act of 1969 of the vulnerability of any such tax provision.¹⁷ Its further weakening could significantly constrain government's options in the selection of instruments to achieve policy objectives.¹⁸

A collateral point is that many tax aids have a built-in control on their budgetary impact, while this is the exception in the case of direct expenditure. There are relatively few tax aids with respect to which some substantial part of the effect on government revenues does not depend directly on taxpayers' response to the tax aid. In other words, the amount of the tax aid and therefore the revenue effect depends significantly on the extent to which taxpayers do—or do more of—the specific things which the tax aid seeks to encourage.¹⁹ On the other hand, numerous direct expenditure programs go on their merry way irrespective of their accomplishments; indeed, some increase more rapidly the more pronounced their failure.

If the point of the immediately preceding discussion is well taken, attention on tax aids should be refocused from futile or misleading efforts at their quantification to increasing their effectiveness as tools for achieving public policy objectives. Tax aids which do not vary in amount with accomplishment should be examined for the possibilities of revising them to build in such an automatic regulator. In other words, the emphasis in this far from "best" world should be placed on increasing the efficiency of fiscal tools rather than on discarding them because they might not be appropriate in a best world.

ADDITIONAL INFORMATION SUPPLIED FOR THE RECORD BY NORMAN B. TURE

On page [168] of my prepared statement, discussing the percentage depletion and intangible drilling or exploration and development deductions, I stated: "The tax equality conditions discussed above suggest that the appropriate way of looking at these tax provisions is to determine whether the sum of (the present value of) the . . . deductions equals, falls short of, or exceeds the investment in the property. To the extent that the sum is less than the investment, the existing tax provisions are not properly regarded as "loopholes" or "preferences;" indeed, they involve a heavier tax burden on the saving invested in such properties than would be imposed on an equal amount of consumption by the persons supplying the savings invested in the property. If the sum is just equal to the investment, the existing tax arrangements should be deemed to conform with the requirements for equal taxation of saving and consumption. Only if and to the extent that the sum exceeds the investment are the present tax provisions properly characterized as "preferences."

The view apparently held by those urging the elimination or reduction of deductions for intangible drilling costs and percentage depletion is that these deductions vastly exceed the gross investment in the property. There is little Treasury Department information available for confirming or refuting this view. Material from a recent study by Seymour Flekowsky,²⁰ however, is highly illuminating. Dr. Flekowsky estimated the average deductions claimed by oil and gas

¹⁷ Unless one disagrees with this conclusion, the Tax Reform Act of 1969 offers convincing evidence of the error in the familiar proposition cited earlier in this report, that direct expenditures are continuously subject to the hazard of being reduced or eliminated, while tax aids rest serenely and securely behind a budgetary veil. Indeed, the TRA was not required to demonstrate the validity of the contrary position, viz., most expenditure programs have an almost unlimited life expectancy with splendid growth prospects while many tax aids require constant vigilance and diligent support by their beneficiaries to survive.

¹⁸ A separate essay would be required to explore the relative efficiency of fiscal alternatives. There appears to be no basis for the a priori judgment that direct expenditures are superior to tax aids.

¹⁹ There are signal exceptions, of course. What is the specific thing intended to be accomplished by the additional personal exemption for blindness (identified on all lists as a tax aid)?

²⁰ Seymour Flekowsky, "The Impact of Taxation on Mineral Capital: The Case of Oil and Gas," in *Economics of the Mineral Industries* (NY: American Institute of Mining, Metallurgical, and Petroleum Engineers), 1973.

companies, based on annual surveys of costs reported by firms to the American Petroleum Institute. He found that for each dollar spent on domestic exploration and development, the average deductions were:

| | |
|--|-----------|
| Depreciation ----- | \$0.12 |
| Intangible drilling costs and dry holes ----- | .70 |
| Depletion ----- | 0.60-.70 |
| Total ----- | 1.42-1.52 |
| Discounted at 15 percent, the present value of these deductions are: | |
| Depreciation ----- | \$0.06 |
| Intangible drilling costs and dry holes ----- | .70 |
| Depletion ----- | 0.27-.31 |
| Total ----- | 1.03-1.07 |

These data strongly suggest that on the average, the present-law deductions provide very nearly correct treatment of saving invested in oil and gas properties. The tax preference is so small that it should be disregarded in assessing the adequacy of the existing tax provisions.

The CHAIRMAN. Thank you, Dr. Ture.

At this point if there are any additional statements any of the panelists wish to make, I would appreciate your raising your hand or if you wish to interrogate.

Mr. Surrey.

Professor SURREY. Just a few observations. I did not, in my opening statement, go into detail on the present escape from taxation. Accurate figures, with respect to individuals, are very hard to obtain. We know that roughly 100-odd individuals with incomes of over \$200,000 did not pay tax, any tax, in 1970. The Treasury has tried to explain away those figures by talking about adjusted gross income, which happens to exclude all of the tax escapes, and to use aggregate debts rather than detailed figures in individual cases.

We also have some information on corporations, but not accurate detailed information as to particular corporations. My guess is if the committee and the public were given the actual facts with respect to tax escapes by individuals and by corporations, the outcry in this country would be deafening. But that information has been withheld, as far as I know.

Second, with respect to Mr. Ture's statement, if he wants to use the example of tax-exempt municipal bonds as an outstanding way to run the tax system, then he is welcome to use the example, for I think it indicates how ridiculous the whole mechanism is. Today we pay out about \$3 billion to high-income individuals and banks so that they, in turn, will pay out in effect \$2 billion to State and local governments in lower bond interest rates. In other words, local government saves \$2 billion, but the Treasury loses \$3 billion to the upper bracket individuals and the banks. That is a commission for a 70-percent taxpayer of 170 percent.

Now, I don't know how we can justify commissions of 170 percent in carrying out sound objectives. If Mr. Ture also wants to say that we should, in effect, not tax the savings on investment, the dividends on stock, and we should not tax any appreciation on stock, I would like to see him explain that to a wage earner in Johnson City, which is Mr. Bittker's test.

The CHAIRMAN. I will let Dr. Ture respond, and then we will go to Professor Bittker.

Dr. TURE. Thank you, Mr. Chairman.

I am perfectly willing, if necessary, for the saving invested in a corporate stock, in a municipal bond, in anything you can think of, to be taxed and be taxed at the same rates as any other income, once. I can see no justification in any aspect of public policy for taxing it twice, three times, four times, five times ad nauseum.

The observation has been made by those who have done a good deal more close mathematical work on it than I have that the amount of tax accumulated in a dollar of saving and dollar of capital is enormously greater than the amount of tax that is imposed at all levels of government on this cigarette, which strongly suggests if the respective amounts of taxes are to be taken as an index that this society prizes capital and addition to our stock of it than it does smoking. It seems to me that what Professor Surrey has done is to identify indeed one of the principal sources of difficulties, I think, with which members of this committee are continuously faced.

They are definitional questions. What, in fact, is income? What is the appropriate way to tax it in order to make sure you do not increase the cost of one kind of activity relative to another? That, it seems to me, to repeat my testimony, should be your acid test. Is there some social objective that says to you that it really is desirable to increase the cost of saving relative to the cost of consumption? Perhaps there is.

If a case can't be made for that and it is recognized, then I think we ought to be able to design an improved tax system which attempts to implement that decision. As matters stand now, it seems to me you are proceeding on the assumption that, indeed, the present arrangement taxes equally when indeed it does not.

The CHAIRMAN. Professor Bittker.

Professor BITTKER. I have an observation on Mr. Ture's remarks, coupled with a question for him. The observation is that if existing law taxes savings 4 or 5 times or "ad nauseum," as he asserted, I am surprised in looking around that the country does not look more like Bangladesh. My question is: Does not the logic of your position lead to an ideal income tax consisting of a tax on wages, salaries, and other earned income plus a tax on capital gains, but with no tax at all on interest, rents, and dividends—in order that those items will not be taxed, as you define it, a second time?

Dr. TURE. No, sir; it does not. It suggests that household income be taxed on the current flow of whatever it happens to be, wages, salaries or any other income source less the amount the household commits to its own capital, its current saving. It certainly does not involve any tax on capital gains at all, since whatever it is that capital gain has capitalized is going to be taxed as it comes along.

In the case that I have presented in testimony, in fact, that capital gain is simply the market valuation of the retained earnings of the corporation which have already been taxed.

The CHAIRMAN. Dr. Smith.

Professor SMITH. I have two or three comments on those of the panelists, Mr. Chairman.