TAX FOUNDATION

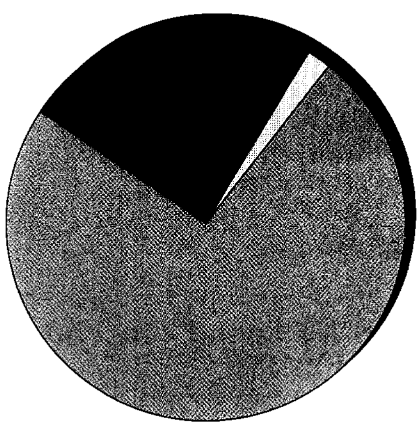
TAX FEATURES©

March 1997 Volume 41, Number 3

Common Persons' Definition of Income Leads to Tax Policy Confusion, Says Foundation Studies

Chart 1: How Consistent is the Common Man's Definition of "Income"?

When survey responses (see page 6) were judged on a standard of "near logical consistency" (3 or fewer inconsistent responses), the "gross yield" definition for income was overwhelmingly favored.



- Inconsistent Responses — 15.4%
- "Gross Yield" Definition — 74%
- "Yield Income" Definition — 1.9%
- "Accretion Income" Definition — 8.7%

Source: Tax Foundation.

What is "income"? Is it the cashflow at an individual's fingertips during a given accounting period? Is it the money earned but not saved, plus any growth in capital assets? Or is it the money earned but not saved, plus liquidated capital assets?

And why does it matter?

The definition of income matters, says Senior Economist Arthur P. Hall, Ph.D., because the present debate about overhauling the federal tax system is, at its most fundamental level, a debate about the proper tax base — in effect, the proper economic definition of income for tax purposes. In his new *Special Report*, titled "The Popular Definition of Income and Its Implications for Tax Policy," Dr. Hall observes that policymakers have long relied on a definition of income imputed to the "common man," a definition which the Supreme Court effectively ratified in the 1921 *Eisner v. Macomber* case. Yet this definition "is replete with internal inconsistencies," says Dr. Hall.

"To found our whole system of income taxation," Dr. Hall states, "on the common man's notions, so ... confused, uncertain, and vague is preposterous — just as preposterous as for physicists to found their theory of thermodynamics on what the common man thinks is 'heat.'"

To prove this point, the Tax Foundation undertook a survey of individuals in one way or another involved in federal tax policy, to determine the current popular definition of income. The results are reported in Dr. Hall's *Special Report*. (See Chart 1 for a picture of how consistent the common man is on the definition of income question.) Dr. Hall collected 104 completed copies of the survey, the questions and response rates of which are shown here on

Income Survey *continued on page 3*

FRONT & CENTER

Returning Capital to the American People

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Where Does Uncle Sam Plan to Spend Your Federal Tax Dollar in Fiscal Year 1988?

How does President Clinton propose to spend the average American's federal tax dollar in fiscal 1998? A lot differently than in fiscal 1988 or fiscal 1978, according to the Tax Foundation's annual comparison.

Assuming that Congress makes no dramatic changes in the President's FY 1988 budget, 58¢ out of every tax dollar will be spent on three areas — Social Security, health and medical, and net interest on the federal debt. (See Chart 2.) Each of these areas comprises mandatory programs, which means the federal government must provide them a legally determined amount of money.

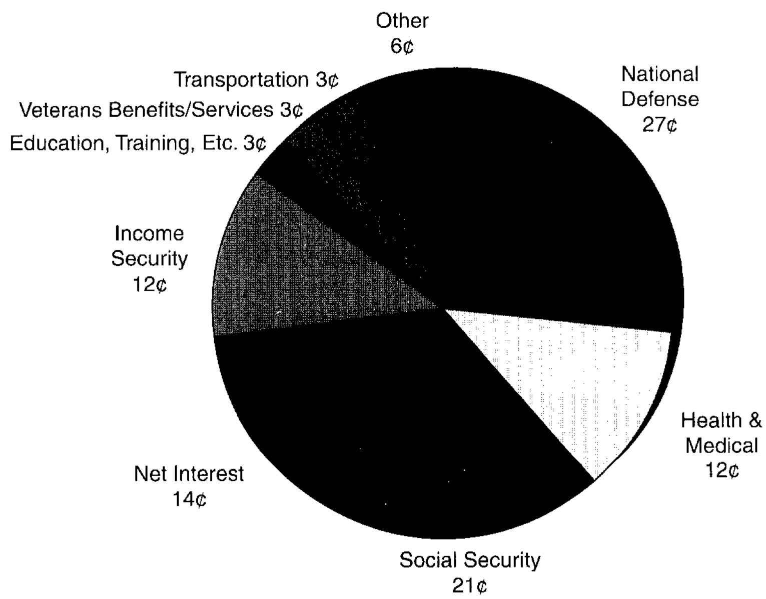
The biggest changes in the last two decades can be found in how much Uncle Sam spends on health-related programs and defense, as seen in a comparison of Charts 1 and 2. In FY 1978, the federal government spent 9¢ out of every tax dollar on health care. That total jumped to 12¢ in FY 1988, but has since soared to a projected 20¢ in FY 1998. On the other hand, defense spending in FY 1978 claimed 23¢ out of each tax dollar. That figure rose to 27¢ in FY 1988, but has since fallen to a projected 15¢ out of every tax dollar in FY 1998 .

Net interest payments on the federal debt, as a portion of the total tax dollar, have almost doubled since FY 1978 — from 8¢ to 15¢.

The categories are based on Office of Management and Budget definitions of government functions. "Income security" includes, among other things, federal employee retirement and disability; unemployment compensation; and housing, food and nutrition assistance. "Health and medical" includes, among other things, Medicare and Medicaid. "Education, training, etc." includes, among other things, spending on education at all levels, employment training, and social services.

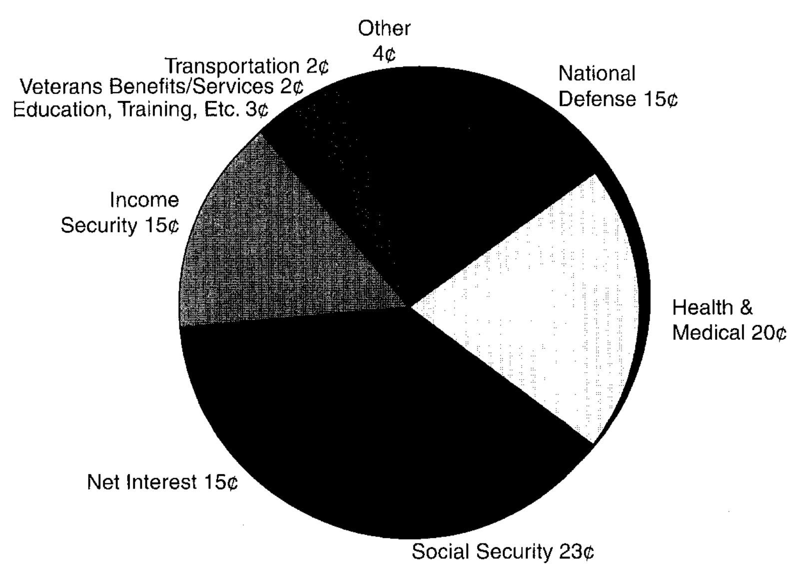
The category "other," which has shriveled from 13¢ to 4¢ out of every tax dollar, includes such federal subfunctions as agriculture; natural resources; general science, space, and technology; energy; and administration of justice. •

Chart 1: Where Uncle Sam Spent Your Federal Tax Dollar, FY 1978



Source: Tax Foundation based on OMB data.

Chart 2: Where Uncle Sam Will Spend Your Federal Tax Dollar, FY 1998



Source: Tax Foundation based on OMB projections.

Income Survey: Policymakers, Public Show Inconsistencies in Defining "Income"

Continued from page 1

page 6. Most of the survey questions were taken from a similar survey published in a 1942 book by Irving and Herbert W. Fisher, titled *Constructive Income Taxation: A Proposal for Reform,* in order to assess the continuity of the "common man's" definition of income over time. The results of the 1942 survey and the Tax Foundation survey were virtually identical.

In his *Special Report,* Dr. Hall states that only two definitions of income have logical consistency:

• "Accretion income," which also goes by the name of Haig-Simons income (in tribute to the writings of economists Robert M. Haig and Henry C. Simons). Accretion income is defined as "money earned over a given period but not saved" plus "net capital accumulation (whether through new saving or changes in the market value of existing savings)." In other words, any money that one earns this year, plus any increase in the value of previous savings or investments, would be considered income.

• "Yield income," which represented economists' common interpretation of the term "income" before the income tax was introduced. Yield income is defined as "money earned over a given period but not saved" plus "dissaving from existing savings." In other words, any money that one earns and spends this year, plus any previous savings or investments that one liquidates and spends, would be deemed income.

The essential difference in the two definitions is whether or not you count capital accumulation (savings) as part of income. Throughout most of this century, the accretion-income definition has prevailed in this country for purposes of tax policy. Yet the yield definition is used for money earmarked for retirement (for example, pensions, 401(k)s, and IRAs).

However, as the income survey shows, the popular understanding of income generally does not split along such lines. Rather, says Dr. Hall, the common man thinks of the term "income" more literally as new cashflow — which corresponds with the notion of "gross yield," that is, total money inflow without regard for money saved or money reinvested.

This idea of gross yield remains consistent throughout the survey. Answers that correspond to the "yield" definition tend to be chosen when they correspond with the idea of gross yield. Similarly, answers that correspond to the "accretion" definition are chosen when they correspond with the gross yield concept.

Few survey respondents were completely consistent with regard to their own responses, notes Dr. Hall. Despite the general tendency to favor gross yield, only 15.4 percent favored "gross yield" consistently throughout. No surveys favored "yield income" so consistently, and only 3.8 percent favored "accretion income" consistently throughout. As viewed in Chart 1, three-quarters of the surveys showed a "near logical consistency" — i.e., three or fewer inconsistencies — in defining income as gross yield. Yet some 15 percent of the surveys were inconsistent, with four or more inconsistent responses.

Chart 2 dissects the popular concept of gross yield by comparing it to the responses that favored an accretion-income definition. Dr. Hall points out that the accretion responses are lumped into three discernible groups, which are separated out in the chart. The top five responses all are similar in that they involve an accumulation of capital that results from the acquisition of cash — and thus correspond to the gross yield concept.

Meanwhile, in the bottom two groups (with the exception of the stock sale questions, which correspond to gross yield), the increase or decrease in capital accumulation results from appraisals, not the acquisition of cash. In essence, most respondents who favor the accretion-income definition regard depreciation in capital value as "negative" income, but they do not regard appreciation in capital value as positive income.

Income Survey *continued on page 8*

Chart 2: Accretion Response Sorted by Frequency

Question Number	Question Description	Accretion Responses	Share
3	Savings made out of gross yield	100	96.2%
7	Accrued interest withdrawn but reinvested	97	93.3
6	Part of accrued interest withdrawn	96	92.3
8	Sudden profit partly spent, partly reinvested	96	92.3
12	Dividends paid out but reinvested	91	87.5
5	Interest accrued but not paid out	91	87.5
13	Property reduced in value by fire	38	36.5
14	Depreciation in value of life annuity	26	25.0
9	Depreciation of investment	25	24.0
10	Capital gain on stock sale reinvested	18	17.3
11	Capital gain on stock sale not reinvested	16	15.4
4	Appreciation of investment	12	11.5
15	Appreciation of property	10	9.6
2	Whether yield or earnings of stock is income	10	9.6
16	Appreciation of property	9	8.7

Source: Tax Foundation.

Returning Capital to the American People

By Rep. Jennifer Dunn (R-Wash.)

In mid-March, I introduced the "Return Capital to the American People Act" (ReCAP Act), which would provide a capital gains reduction for both individuals and corporations and would do more to boost our nation's economy, more to create jobs, more to enhance U.S. competitiveness worldwide, and more to increase savings and investment than any other single legislative change Congress can enact.

For established, successful businesses, for struggling entrepreneurs, and for middle-class families across the country, this measure represents the most serious effort to unlock billions of dollars in investment, providing for expanded growth and job creation.

While there are many reasons to support a reduction in the capital gains rate, I would like to highlight what I believe to be the most compelling case for enactment of the ReCAP Act.

> ***A low capital gains rate is important for our future and our nation's ability to save and invest. Americans do not save enough. If you look at our tax laws, you will see why. Instead of encouraging people to save, the tax code often punishes people who save and invest.***

A low capital gains rate benefits all Americans. This bill is fair to all income groups and sectors of our economy. Many of the so-called "rich" who would benefit from a cut in capital gains taxes are only "rich" for one year. A family that sells its house, an owner who sells a small business, a worker selling stock received through an employee stock option, and a retiree selling an asset and planning to live off the proceeds would all be considered wealthy on current "tax distribution" tables. For example, a review by the Joint Committee on Taxation on capital gains realizations for the period 1979-1983 shows that nearly 44 percent of tax returns claiming a capital gain during that five-year period claimed only one capital gain. Most of these people aren't rich, regardless of what statistics say. They merely have one year of inflated income because they realized a big capital gain.

Furthermore, an analysis of 1993 tax returns found that nearly 50 percent of the tax returns reporting capital gains were filed by taxpayers with less than $40,000 in adjusted gross income. Of tax returns claiming a capital gain, nearly 60 percent of those returns are filed by taxpayers with less than $50,000 in adjusted gross income.

A low capital gains rate is important for our future and our nation's ability to save and invest. Americans do not save enough. If you look at our tax laws, you will see why. Instead of encouraging people to save, the tax code often punishes people who save and invest. This is primarily due to the fact that the income tax hits savings more than once — first when income is earned and again when interest and dividends on the investment supported by the original savings are received. This system is inherently unfair because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no savings took place. We need to change this. Without savings, a person cannot buy a house, a business cannot purchase new equipment, and our economy cannot create jobs. Unless we can raise our national savings rate, our standard of living, and our children's and grandchildren's standards of living will not grow.

Lowering the capital gains rate unlocks investment and America's true economic potential. High capital gains taxes can prevent someone from selling an asset and paying the tax. This is the "lock-in effect": When a person will not sell an investment and reinvest the proceeds in a higher-paying alternative if the capital gains taxes he or she would owe exceed the expected higher return on the original investment.

This lock-in effect limits economic growth and job creation. Capital stays locked in an investment instead of being free to go to a person who wants to hire new employees in her consulting business. Lower capital gains taxes will reduce the lock-in effect and free up capital for small businesses, first-time home buyers, and entrepreneurs.

Lower capital gains taxes will increase federal revenues and thus help

The Return Capital to the American People Act (ReCAP Act) contains several capital gains incentives:
- *a 50 percent capital gains deduction,*
- *indexation of the basis of capital assets to eliminate inflationary gains,*
- *incentives to direct capital to small businesses, and*
- *a provision to allow homeowners who sell their homes at a loss to deduct that capital loss.*

The 50 percent capital gains deduction and the home sale capital loss provision would apply to sales on or after January 1, 1997. The capital assets indexation would apply to inflation (and sales of assets) occurring after December 31, 1996.

reach the goal of a balanced budget. History indicates that lower capital gains taxes have a positive impact on federal revenues. During the period of 1978 to 1985, the marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent — but total individual capital gains tax receipts increased from $9.1 billion to $26.5 billion. After surging to $326 billion in 1986 (the year before the 1986 rate increase took effect), capital gains realizations have gone down and stayed under $130 billion per year in the 1990s.

Given the increase in the stock market, inflation, and growth of the economy since the late 1980s, realizations and taxes paid are certainly being depressed by the current high capital gains rates.

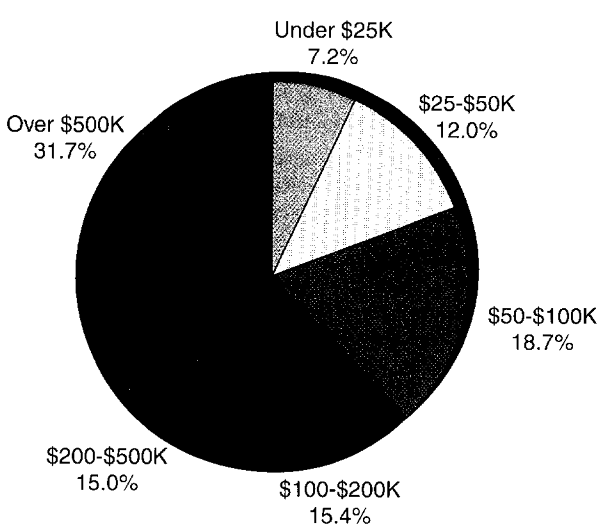
Lower capital gains taxes leave more vital capital in the hands of women-owned businesses, and female investors and entrepreneurs. A 1995 survey of women-owned businesses found that the most common source of start-up funds was personal savings: 84 percent used personal savings as one source of start-up funds, and 50 percent used personal savings as the sole source of start-up funds.

Here is another example: After a divorce, where the woman is the custodial parent she is often left with only one major asset, the family home. A 50 percent reduction in tax on that asset is very significant to her. This legislation will help her make ends meet during a tough time.

Conclusion. Rather than discouraging American workers and businesses, the federal government ought to simply get out of the way. Lower capital gains taxes — as embodied in my bill — leave more vital capital in the hands of businesses, investors, and entrepreneurs. They know a lot more than the federal government ever can or will about creating jobs and products in a competitive marketplace.

History proves that capital gains tax reduction is the right course to take. In the past, reductions always have boosted the nation's economy and increased tax revenues to the federal government. If a goal of this Congress is to pass legislation promoting economic opportunity and growth in America, then common sense suggests that we enact the ReCAP Act. •

Income Groups' Shares of Total Taxable Capital Gains, 1942–1992



Source: Tax Foundation.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

Survey Results: The Popular Definition of Income

Between September 1996 and January 1997, the Tax Foundation collected survey responses to gauge the popular definition of income. The survey questions and their results follow. For Questions 2 through 9 and Questions 12 through 16, responses to "A" equate to a definition of "yield income," while responses to "B" equate to a definition of "accretion income." For Questions 10 and 11, a response to "A" equates to a definition of "yield income," a response to "B" equates to a definition of "realization income," and a response to "C" equates to a definition of "accretion income."

1. Please mark the answer that best describes you career experience:

A. Accounting (34.6%)
B. Finance (3.8%)
C. Lawyer (13.5%)
E. Legislator/Policymaker (0%)
F. Student (13.5%)
G. Other (34.6%)

2. Suppose a certain stock earns $3 a share during a certain year, but the company pays out in dividends $2 per share, the other $1 being undivided profits on the books of the company. You own 1,000 shares, so that you receive in that year $2,000 in dividends. What would you ordinarily consider your income from that stock?

A. $2,000 (89.4%)
B. $3,000 (9.6%)
C. $0 (0%)
D. Undecided (1%)

3. Suppose your wages to be $40,000, and, out of this, you save $10,000 (by depositing it in a savings bank, buying a bond, putting it into your business, or otherwise). Would you think of your total income as

A. $30,000 (3.8%)
B. $40,000 (96.2%)
C. Undecided (0%)

4. Suppose you have stock worth $100,000 on the market January 1, 1996. On December 31, 1996 (12 months later), this stock has increased in value to $107,000. No dividends are paid by the company for that year, and you neither buy nor sell any of the stock during 1995. Do you regard this $7,000 increase in stock value as income?

A. No (87.5%)
B. Yes (11.5%)
C. Undecided (1%)

5. Suppose you have $1,000 in a savings bank. The bank allows 5% interest on this and so increases your account by $50 during a period of one year. Would you consider this $50 as part of your income?

A. No (11.5%)
B. Yes (87.5%)
C. Undecided (1%)

6. You have $1,500 in a savings bank. The bank allows you 5% interest and so increases your account by $75 during a period of one year. On December 31 you withdraw $60 of this accrued interest to pay bills. What would be your income from this savings account?

A. $60 (7.7%)
B. $75 (92.3%)
C. Undecided (0%)

7. On January 1, 1995, you have a savings account of $500. The bank paid 5% interest. On December 31, 1995, 12 months later, your accrued interest amounted to $25, and you withdrew it. Later, during the same day, you changed your mind and deposited the same $25 in the same account. What was your income from that account for the year?

A. $0.00 (6.7%)
B. $25.00 (93.3%)
C. Undecided (0%)

8. For many years your income has been $50,000 a year. Last year in your spare time you diligently worked a small mining claim, which suddenly brought you an additional $500,000. Of this $500,000, you spent $50,000 on a new boat and invested $450,000 in bonds. What was your income for that year?

A. $100,000 (3.8%)
B. $550,000 (92.3%)
C. Undecided (3.8%)

9. Suppose your investments were worth $100,000. This year you received and spent $5,000 from those investments, but your investments shrank in value to $99,000. Which of the following items would be your "income" for this year?

A. $5,000 (69.2%)
B. $4,000 (24%)
C. Undecided (6.7%)

10. On January 1, 1995, you own 2,000 shares of stock worth $20,000. On December 31, 1995, these shares are worth $30,000 and you sell 1000 shares, reinvesting the $15,000 proceeds in other shares. You earn $50,000 in salary over the year, all of which is spent on living expenses. What is your income for the year?

A. $50,000 (21.2%)
B. $55,000 (51%)
C. $60,000 (17.3%)
D. Undecided (10.6%)

11. In the example above (Question No. 10), suppose you reinvested $10,000 from the proceeds of the sale of stock, using the other $5,000 to buy a computer. What is your income for the year?

A. $50,000 (5.8%)
B. $55,000 (67.3%)
C. $60,000 (15.4%)
D. Undecided (11.5%)

12. You own shares of stock that pay a dividend of $5,000 over the course of the year. Upon receipt of the dividend you reinvest it in shares of another company. Your salary for the year is $50,000, all of which is used for living expenses. What is your income for the year?

A. $50,000 (12.5%)
B. $55,000 (87.5%)
C. Undecided (0%)

13. You own a strip mall worth $800,000. From January 1, 1995, to December 31, 1995, this mall paid you $40,000, which you used for living expenses. During this period of 12 months the mall was damaged by fire to the extent of $200,000. Which of the following figures represents your income for that period of time?

A. $40,000 (52.9%)
B. $-160,000 (36.5%)
C. Undecided (10.6%)

14. You have purchased from an insurance company a $6,000 a year life annuity, and on the basis of your age it costs you $50,000. The same policy, if taken out one year later, would have cost you only $49,000. During the year you spent the whole $6,000 to pay bills. Your annuity meanwhile decreased in value (as was stated) by $1,000. What do you consider as your income for that year?

A. $6,000 (55.8%)
B. $5,000 (25%)
C. Undecided (19.2%)

15. Several years ago you purchased an orange grove. The trees were very young and had not yet reached their period of peak production; lack of sufficient water had also prevented the trees from attaining their best growth and productivity. But during the 12-month period of time, January 1, 1995, to December 31, 1995, there was more than sufficient rainfall, and your trees reached a high level of productivity. Real estate experts informed you that your orange grove had increased in value during this 12-month period, and that, whereas it had been worth only $130,000 on January 1, 1995, it was now worth $170,000 on December 31, 1995. This represented an increase of $40,000. During this period of 12 months your salary was $50,000, all of which you used for living expenses. Which of the following figures do you regard as your income for the specified 12-month period?

A. $50,000 (89.4%)
B. $90,000 (9.6%)
C. Undecided (1%)

16. You own a vacant lot which is tax free. On January 1, 1996, the lot was evaluated by a real estate expert at $20,000. On December 31, 1996, 12 months later, the same real estate expert informed you that your lot was now worth $30,000. He also stated that the reason for the $10,000 increase in value was due to the fact that a big corporation was going to build a large factory in the vicinity. During this 12-month period your income from all other sources amounted to $50,000, all of which you used for living expenses. Which of the following figures represented your income for the 12-month period.

A. $50,000 (90.4%)
B. $60,000 (8.7%)
C. Undecided (1%)

FOUNDATION MESSAGE

To Tax Expenditures, Or Not to Tax Expenditures

J.D. Foster
Executive Director
& Chief Economist

It's fashionable for writers with regular columns to have a subject they return to annually, triggered by some periodic event. This month I inaugurate my annual plea to the Treasury Department and the Joint Committee on Taxation to excise the concept of "tax expenditure" from their respective lexicons and to desist from reporting tax expenditure budgets — at least until they get it right.

A tax expenditure, as the concept is employed by these agencies, is a negative deviation from the agency's model of a normal income tax. A more common definition might be "tax loophole."

Some people object to the very concept of a tax expenditure because it implies the government has some natural right to a taxpayer's money and that the taxpayer should be grateful, and maybe even a little ashamed, that he or she can take advantage of some provision of the tax code to keep more of his or her own money.

Such is not my objection, however. Governments must raise money from taxpayers and it is important that the means be as fair as possible. As long as revenues are scarce, one group's special tax relief probably comes at somebody else's expense. We can all agree with the proposition that taxes should be as low as possible, and still allow that "tax loopholes" are bad.

Further, it will be a fact of life as long as we are subject to an income tax through which policymakers can provide special tax provisions in lieu of explicit spending programs.

We can even agree that tax loopholes are problematic in that they create special benefits bestowed on special groups. The more groups receiving special benefits, the greater the share of the population vested in the system. Obviously, if everyone gets a special tax break, then, on average, no one is getting a break, except the politicians who play the system.

No, my problem with the tax expenditure concept is that the "normal" income tax which is used as the benchmark bears little relation to a neutral tax system as even the Treasury Department interprets these terms.

For example, the largest "tax expenditure" on the individual side is the home mortgage interest deduction. This deduction is essential both to tax neutrality and to achieving a proper accounting according to accretion income. Mortgage interest income is taxable to the lender, so mortgage interest expense should be deductible to the payor. A more sophisticated analysis might try to discern what fraction of the national home mortgage market is supplied by tax-exempt and tax-deferred entities like foreign governments and pensions. Such an analysis would define that fraction of mortgage interest claimed as a tax expenditure, but no such analysis is put forward.

Imagine you rented your home from yourself. As a taxable landlord, you would then be expected to pay income tax on your net rental income. It is sometimes argued that the home mortgage interest deduction is a tax loophole because this implicit income is not subject to tax. This isn't an argument about the interest deduction, however, but the failure to tax the implicit income. Further, if the implicit income were to be taxed, then the tax code would need to allow for depreciation and other deductions consistent with rental income. In short, this argument doesn't wash.

On the business side, the biggest tax expenditure error is also the biggest tax expenditure — accelerated depreciation of plant and equipment. (The term "accelerated" means the taxpayer can take larger deductions in the early years of an asset's life than would be the case using straightline depreciation. The total amount of deductions remains equal to the asset's original purchase price.) Curiously, when the current system was devised during the reform debate in 1996, the Treasury Department argued that the resulting system of accelerated capital consumption allowances achieved or nearly achieved tax neutrality for most assets. Many economists disagreed with Treasury on this matter. But the point is that Treasury includes accelerated depreciation in the tax expenditure budget, on the one hand, while arguing the need for accelerated depreciation for tax neutrality on the other. Obviously, the "normal" income tax it uses as a benchmark has nothing to do with tax neutrality as Treasury defines the term.

To be sure, there are tax provisions that would be deemed loopholes under any reasonable definition of economic income. The special personal deduction for the elderly, the exclusion of Credit Union income, and the exclusion of employer-provided benefits come to mind.

However, until the benchmark "normal" income tax is given a sound theoretical footing, tax expenditure estimates can only mislead. Worse, the tax expenditure concept is a one way street. Just as some taxpayers receive special benefits, others get to pay especially burdensome taxes. If there is to be a tax expenditure analysis, there must also be a tax surcharge analysis. It would show, for example, that income collected under the personal and corporate Alternative Minimum Tax is a special levy or surcharge. The limitation on capital losses would also qualify as a surcharge, as might the taxation of capital gains due to inflation. A comprehensive analysis might find hundreds of surcharges adding up to a few hundred billion dollars in punitive tax policy. And that's without even getting into federal excise taxes.

Correcting the tax expenditure report requires at least two changes. First, the "normal" income tax used as a benchmark must be made explicit and consistent with tax neutrality. Second, the report must indicate the tax surcharges beyond the taxes paid if a "normal" income tax were applied to economic income. Until these changes are made, Treasury and the JCT should cease and desist from putting out false information.

Income Survey: Income Definition Makes for Confused Tax Policy

TAX FEATURES©

Tax Features© (ISSN 0883-1335) is published monthly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are $15.

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Why the Definition of Income Matters

Dr. Hall observes that the key difference between accretion and yield for purposes of tax policy has to do with the double taxation of money used for saving. The use of accretion income results in double taxation, while the use of yield income does not. "The double taxation inherent in the use of accretion income is a manifestation of the difference between the unique goals of accounting practice and economic reality."

Dr. Hall notes that the accretion income definition has its roots in bookkeeping practices which hold fixed over an accounting period the item called "capital." The utility of this convention is that it allows businesses to measure the overall growth or decline in their capital stock. "This centuries-old bookkeeping convention helps explain why the accretion income concept, as practiced by accountants, is so entrenched in the minds of many as the proper definition of income."

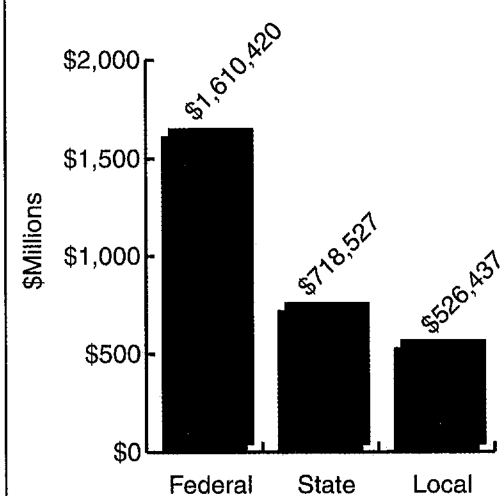
But from an economic perspective, this convention fails to measure actual income properly. It has two major drawback: First, it fails to distinguish between capital and income, two economic concepts which are reciprocally related but mutually exclusive categories. Second, counting capital accumulation as income results in the double counting of actual economic income — and, therefore, double taxation.

The reason for this, says Dr. Hall, is that capital, by definition, is the present value of expected future income. The value that people place on the money they invest or save incorporates the future cash flows that will be derived from the savings or investment. Current tax policy taxes this money twice: once when the money is first earned and saved, and a second time when the expected future returns (cash flows) materialize.

Thus, because the popular definition of income and the current tax system both fail to distinguish between capital and income, they are inherently biased against saving. They double count some actual income and, therefore, double tax capital accumulation. The institutionalization of the common man's definition of income, concludes Dr. Hall, has resulted in destructive fiscal policy.

TAX BITE

Revenue Collections by Level of Government 1996e



Source: Tax Foundation, Census Bureau.

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