one bracket to the next higher, the rates in the law do apply. Each actually does burden taxpayers. And each, especially those which are marginal for the leaders of the economy, influences personal and business decisions.

6. Inequities among Taxpayers in Essentially Similar Circumstances

Because of "special provisions," some of which are touched upon elsewhere in this study, the Federal tax system fails to impose equal burdens on all taxpayers in apparently similar situations. This inequality is frequently said to be unfair. Not all taxpayers have equal opportunity in practice to take advantage of the special provisions. Though the most familiar cases involve income taxes, other taxes, especially those on gifts and estates, produce significant differentials.

A few of these tax differentials are benefits or hardships which Congress never intended. Most result from provisions that were designed to produce certain effects. In cases of the latter type an important question must be raised from time to time. Do the non-revenue purposes which are actually produced justify the differentials in tax burdens?

The inequalities do not usually arise out of different classifications of persons — no specified groups of persons are exempt from tax, nor, except as the result of income splitting, are specified groups of persons subject to special rates. Moreover, unlike some countries, the United States does not rest its income tax on the principle of differentiation by source of income. Thus investment, business, and labor income in the United States are all taxed at the same statutory rates. However, numerous provisions governing capital gains, deductions, exclusions, etc., do create situations in which taxpayers in much the same economic circumstances get significantly different tax treatment. The great increase in tax rates has altered profoundly the practical significance of specific features of the tax structure.

7. Summary

Space limits do not permit discussion of other characteristics of the Federal tax system. For most purposes, however, those just described are of greatest importance. (1) The system imposes heavy burdens. (2) The laws and regulations, especially those taxing incomes, estates, and gifts, have become increasingly complex. (3) Yields are unstable over the cycle and rise automatically with, but at a more rapid rate than, national income. (4) The revenue system exerts a stabilizing effect on the economy but one which slows down economic expansion before full employment is reached. The major taxes, those on income, bear relatively heavily upon income which would be saved and thereby become available for investment. The tax system favors some types of investment over others, with results which may well hurt, rather than benefit, the national interest. (5) The total Federal tax burden is progressive, sharply so in the income ranges over about $10,000; the highest rates do actually apply. (6) Special provisions have unequal effects on taxpayers in about the same circumstances. Some of the results are sometimes unfair.
II. CRITERIA FOR TAX REVISION

Most complaints about the tax system could be removed to a large degree by reduction in tax rates. A rate cut would reduce total burdens. It would also make the "special provisions," the so-called "loopholes," of less practical importance. The most effective tax "reform" possible would be achieved by reducing tax rates.

While recognizing this fact, a clearer understanding is needed of principles by which proposals for tax change can be judged. What principles should guide efforts to revise the tax system? What are the goals to seek?

A. REVENUE ADEQUACY

The Federal tax system must raise huge amounts of revenue. To p-y for an adequate national defense, for other services needed or to which the nation is committed, and for still others which the public will approve even though the need is debatable — for all these, the revenue required will inevitably be large. Failure to raise enough could jeopardize the public welfare by leading to the curtailment of truly valuable programs or by inviting deficit financing at times when a deficit would tend to be inflationary. Moreover, if the national debt is to be reduced, revenue must exceed spending, on the average, over the years. Nevertheless, in the post-war period — one marked by a more than doubling of the dollar amount of net national product — the budget has had a deficit in two out of every three years. Despite the fact that budget receipts are now more than $50 billion a year higher than in 1947, Federal debt has grown by over $40 billion since 1947.

The Federal tax system, though perhaps not adequate for meeting expenses in many years may still, in a sense, raise too much revenue. Whenever money seems likely to be available, more spending will probably be authorized. The benefits from the expenditure may be worth less than what the taxpayers could get with the money if they were free to spend it themselves. In such cases the plentitude of revenue leads to waste — perhaps not so much in the form of inefficient execution of a program as in the decision to do something of only slight value for the general welfare. Waste of this type seems hard to identify with enough clarity to convince the public. And when a spending program has been established or expanded, abandoning or curtailing it proves difficult to the point of impossibility. Federal domestic spending, including social security and highways but not defense and foreign aid, rose from $26 billion in 1947 to an estimated $62 billion in 1963.

The tax system may yield too much revenue in another sense. The amount drawn off from the private income stream may be so large as to act as a depressant on business in general when the economy is suffering from the waste of idle productive capacity. The "right" amount of revenue, therefore, is not easily determined. The long-run goal for tax revenues should be to balance the budget. Deficits in periods of recession, and surpluses in periods of prosperity may not necessarily balance. But as a policy objective such offsetting is desirable. The tax structure, and the total load made necessary by expenditures, must then be adapted to prevent the tax system from acting as a depressant on the economy.

B. FAIRNESS AND EQUITY IN THE DISTRIBUTION OF TAX BURDENS

All taxes eventually fall upon people, and some must pay more than others. What guides or principles, then, shall be used to decide upon the unequal sharing? If there is one criterion which will appear in any answer to this question, it is "fairness." Here, beyond dispute, is a goal of cardinal importance where the distribution of taxes is concerned. Difficulty arises, however, in trying to define "equity," "justice," and "fairness" as they apply to the sharing of the costs of government.11

1. On one aspect of equity there will be a consensus. Every taxpayer shall be treated according to legal rules which apply equally to all taxpayers in the same class. Fairness requires that there be no prejudice, whether by accident or design, in the application or administration of the law.

2. "Equal treatment of equals" — horizontal equity — is also a principle which will be generally accepted for evaluating taxes and tax systems. Attempts to define "equal treatment" and "equals" lead to debate which ranges from quibbling about details to serious discussion of just what is truly relevant. Nevertheless, the search for consensus must never be abandoned. Taxpayers are
justifiably aroused when they discover that they pay higher taxes than others who appear to be similarly situated.

3. Difficult questions also arise which involve vertical equity. How much of what differences will warrant how much difference in tax? There is little consensus in answering this question, but the unequal treatment of taxpayers must rest on reasonable, not capricious, bases.

There is wide acceptance of the view that a fair sharing of tax burdens is one which reflects “ability to pay.” This concept, however, is about as unclear as “fairness.” It is now usually identified with the idea that the tax system should be progressive.

Nevertheless, proportional taxes take more from large than from small incomes. What basis is there for deciding how much more in taxes it is fair to demand from the family with an income of $10,000 than from the almost similarly situated family with $9,800 or the very differently situated family with $8,000 or $12,000? Supporters of progression as a device for getting fair discrimination may disagree strongly on the fairness of a given set of rates. When does steep rate progression become unfair?

Serious inequity can grow out of the unequal taxation of people who by general agreement ought to be taxed unequally. The actual inequality may exceed—or fall short of—what is fair.

Today, the inequality in the taxation of income from additional effort ranges from zero to 91%. The recipients do have different economic positions. But do the differences justify such great variations in tax? The strong presumption must be against such heavy discrimination.

C. REDUCING OBSTACLES TO EFFICIENT OPERATION OF THE ECONOMY

1. Importance of the Market Economy

Over 85% of the total goods and services created in this country are produced by privately owned businesses, including individuals who work for themselves. Even governments and non-profit organizations buy, and sometimes sell, in the market economy. Obviously, the nation’s economic well-being depends predominantly upon the efficiency with which individuals and businesses carry on their affairs. This, in turn, depends heavily upon the effectiveness of the market economy in attracting productive resources and in putting them to use where they can be most productive.

Long ago economists showed that human beings could be counted upon to try to meet the needs of others if by doing so they could benefit themselves. The way to get production is to offer rewards. And, with some exceptions, the way to get the right kind of production, turned out most efficiently, is to insure the free and effective play of competition, directed by the desire to earn profit and avoid loss.

One basic function of government is to provide conditions in which people can buy and sell goods and services in the market as freely and as effectively as possible—in producing for others and in getting what others produce.

2. Keeping Allocation Distortions at a Minimum

Efficiency in the allocation of productive resources (human and material) is important in advancing the general welfare. Taxes affect resource allocation. The general objective should be taxes which hinder as little as possible the efficient operation of free markets. As a guiding principle, taxes should be neutral or impartial in their effects on resource allocation—among private industries, regions, occupations, methods of operation, forms of organization, and so on.

Inevitably, however, taxes lead some individuals and some businesses to act differently from what would otherwise seem to be in their best interests. If tax rates are low, the sacrifice of what is essentially one’s best interest to save tax will rarely be worth while. But when tax rates are high—and when the differences in the tax consequences of different actions are large—purely tax considerations can be decisive. What is basically a less efficient alternative seems best when taxes are taken into account. Private benefit conflicts with the public welfare in two ways. The taxes one person saves may have to be paid by others. Resources are not used as productively as possible.

One objective of tax revision should be to minimize such losses for the economy as a whole. When there are choices about tax changes, the presumption is in favor of the choice which will do the most to help the market economy operate more freely.

3. Use of Tax Measures for Specific Economic Effects

Tax measures, of course, may be deliberately designed to alter the operation of the market system. The hope is to restrict some activities, and by lowering tax barriers to stimulate other activities, in order to produce results that differ from those which would otherwise ensue.

Such policies, however, call for cautious and even skeptical appraisal. For one thing, they are expensive. The favor granted goes to everyone in the group, whereas the additional action may be relatively small. Some or
much of what qualifies for the tax favor would have been done in any case. The "cost" of the incremental accomplishment may be very high. Other reasons add to the general presumption that tax laws are not the best instruments for seeking specific economic objectives. The costs are not clear. Neither are the benefits, especially those for the general public. Keeping up to date is exceptionally difficult. One provision leads to another for which the case is not so persuasive.

Today, in fact, many features designed to promote some activities, and to discourage others, can be found in Federal tax law. Some of these provisions were adopted when economic conditions were very different from those of today. Their continuation may be inevitable, and it is difficult to get rid of them even when they have largely served their purpose. An increase in their number, however, is a matter for sharp scrutiny. For some, such as those which would clearly help in meeting the current balance-of-payments problem, the case may have immediate merit. In general, however, the wisest public policy seems to be to resist appeals to modify the tax law as a means of achieving specific objectives.

4. "Business" as an Object of Taxation

Although "business" is a favorite object of taxation, one can well ask, "Why tax business?" In this country, business is the major agency for organizing to produce—for allocating productive capacity and its use today and for undertaking economic growth. Taxes are not likely to help business serve efficiently in producing.

Broadly, the public interest calls for each business (a) to turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market or through governmental agencies, and (b) to use methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

However, taxes on business do not improve the process by which consumers indicate their desires. Furthermore, business taxes do not help indicate to managers which inputs most need economizing. A business has an incentive to save on taxes. Unfortunately, methods adopted to cut the tax bill may not cause the business to operate more efficiently in the sense of less labor or fewer materials per unit of output.

The broad public interest would be advanced by generally freeing business decisions from most tax considerations. Exceptions may appear if business as such puts government to special costs—or receives special benefits from expenditures. Examples at the Federal level are rarely important.

5. Enlarging the Freedom of Choice

Market freedom is a powerful instrument for preserving and enlarging freedom as conceived more broadly. The free market provides a maximum of decentralization of economic decisions. It tends to produce the best allocation of economic resources for the myriad of demands and wants of individuals. Consequently, the broad public well-being calls for tax changes which would help the market operate with greater freedom from tax considerations.

Tax rates which are both high and unequal, and numerous differentials which affect different kinds of economic activities differently, reduce the freedom of choice. They thereby reduce the efficiency of the market system. The result is almost certain to be an imbalance in the sense of a pattern or composition of output or jobs which is less satisfying to the public as a whole than what would develop from a more neutral tax structure.

D. ENCOURAGING ECONOMIC GROWTH

Removing as fully as possible the tax obstacles to efficient operation of the market economy will in itself aid growth. Perhaps there is little more which can and should be done by tax policy to improve the conditions for long-run growth. Special provisions which seem desirable can bring unforeseen disappointments and yet be difficult to change, e.g., the use of very high tax rates to discourage saving in the 1930's.

Economic growth is the result of many interrelated factors. Key elements can certainly be influenced by taxation — the accumulation of capital, the intensity of incentive, the direction of skill (into research, for example), or investment (into domestic or foreign fields, for example). Unfortunately, knowledge of the balance of importance of the factors determining growth is far from satisfactory. There will remain honest doubt about how far to go in directions which seem clearly desirable—about the kind of tax change which will aid growth.

The objective is important. But to what extent does achieving it require tax policies different from those which will remove the obstacles to efficiency in the market economy?

The reduction in business taxes would presumably lead to an increase in taxes on individuals and the eby enlarge the influence of taxes on personal decisions. To some extent production as well as consumption would be involved. On the whole, however, the total effect on the creation of income would doubtless be less than when "business" pays the same amount.
E. SIMPLICITY AND EASE OF ADMINISTRATION AND COMPLIANCE

Complications that require much head scratching, record keeping that would not otherwise be needed, and consultation with experts, these and other requirements add to the taxpayer's burdens of compliance. Complexities also add to the costs of tax administration and enforcement.

The costs to the Treasury of Federal tax collection are large — about $500 million for fiscal 1963 (not counting costs of collecting customs duties). When related to the amounts collected, the total may not seem large — 0.5% — but only because collections are so tremendous. Unquestionably tax revisions which reduce the government's administrative costs are to be favored over those which will add to the costs.

Information on the cost to taxpayers of complying with tax laws is scarce. The total must be far greater than the amount the government spends on administration.13 Businesses in paying their own taxes and in acting as a withholding agent for government incur expenses which are difficult to measure but which are certainly substantial. Individuals spend untold millions of dollars — and endless hours of their "leisure" — in complying with tax laws. Tax revision should seek to reduce these burdens.

Among the often onerous, but usually unseen, costs of complying with tax laws are some which result from uncertainty. Business and personal decisions are held up or modified because of doubt about the tax features. Who can say how much the delays and the choices of "second best" alternatives cost the economy? Uncertainty can lead to another, an ugly, result. The taxpayer can find himself at the mercy of an unscrupulous official. Fortunately, abuses of this sort seem to be rare. One way to keep them at a minimum is to make the law clearer and more certain; fewer opportunities for abuse can then arise.

F. SUMMARY

The considerations to be taken into account in modernizing the tax system are numerous, far from simple, and not always easily reconciled. (1) The system should bring at least enough revenue to pay expenses, except in periods of recession, without burdening business so heavily as to keep the economy below full employment. (2) The total tax burden ought to be distributed to meet generally accepted concepts of fairness. To do so, it will
tax equally those who are similarly situated. It will vary the burdens on those whose conditions differ; the differences in tax will be related reasonably — not arbitrarily, capriciously, or maliciously — to circumstances which occasion the differences in burden. (3) The tax laws should be devised to keep at a minimum obstacles to the efficient operation of the economy. (4) Tax changes ought to seek to reduce the costs of administration and compliance. (5) Tax provisions which are least likely to impede economic growth may well be preferred. (6) Finally, as indicated at the opening of this chapter, the changes which will do most to help achieve most objectives are cuts in high tax rates.

13 An analysis of the costs to corporations of paying taxes in Canada showed that for the 125 companies surveyed, the cost of paying their own taxes amounted to three quarters of 1% of the total amount of taxes paid. Canadian Tax Foundation, The Costs of Tax Compliance (by Marion H. Bryden), p. 29.
III. THE INDIVIDUAL INCOME TAX

The individual income tax needs revision. Agreement on this point appears to be universal. There is less agreement, however—in fact differences of opinion are extensive—about the character and the extent of the changes which would best serve the public interest. This section examines the major considerations.

Although the individual income tax is a tax on people, it is also a tax on unincorporated businesses. The owner of a one-man enterprise or the members of a partnership must pay tax on all of their share of the earnings of the business. The personal income tax, therefore, applies directly to businesses. It will directly affect the decisions of their owners. The economy, in fact, has nearly 10 unincorporated businesses (including farms) for each corporation. On tax returns for 1960 the net profit of unincorporated businesses plus earnings in the professions was greater than the total of dividends, interest, net capital gains, rents, royalties, pensions, and income from trusts reported by all taxpayers.

A. THE RATE AND BRACKET STRUCTURE

The rate and bracket structure can be examined from two main points of view: equity and economic effects. On both grounds there is good reason for substantial revision.

1. The Rate Structure and Equity

Rates

The present rate structure rises from 20% on the first $2,000 of taxable income to 91% on taxable income over $200,000 for single returns ($4,000 and $400,000 respectively for joint returns). It produces the burdens shown in Table 6. Obviously, the taxes on modest incomes are heavy. Ever: the single person earning only a few dollars a day pays tax at the rate of 20% on all above about $13 a week!

Burdens vary greatly. Are they fair? If a family with a $5,000 income pays tax of 10% of its income, is it equitable for a family with a $25,000 income to be required to pay 25%? Is it fair for a family receiving $100,000 to pay 52%—over five times the percentage and 100 times the dollar amount of the family with $5,000? Opinions will differ. There is no evident basis for saying that such large differences are the most equitable. Any argument to such effect could be matched by one equally well, or poorly, founded for establishing that the differences are highly inequitable.

The progression in the United States at high income levels is greater than in most other countries using a personal income tax. 14 To appreciate the steepness of the present rate structure, one must look at marginal rates (those applicable to successive brackets of income) (Table 7).

The present rate structure was never justified by a reasoned calculation of the relative tax burdens at different income levels needed to meet the most widely accepted standards of equity. The highest rates reflect a “soak-the-rich” animus of the 1930’s, a belief that large rate increases on low incomes, needed to pay war costs, called for increases on the already high rates over $25,000 or so, and to some extent a desire to put a limit on the size of after-tax incomes as a part of wartime wage and profit controls. There was also an element not in-

14 Comparisons of income tax structures in various countries are exceedingly difficult. The domestic purchasing powers of currencies may differ appreciably from the official rates of exchange. Many details of the laws have significance whose measurement requires expert knowledge of the economies and societies whose taxes are being compared. See L. Needleman, “The Burden of Taxation: An International Comparison,” Economic Review (London: National Institute of Economic and Social Research, March, 1961), pp. 53-61. If state income taxes were taken into account, the “extra” weight of U.S. taxes would be greater.
Table 7
Federal Individual Income Tax Rates
Selected Income Years, 1930-1962

<table>
<thead>
<tr>
<th>Taxable Income (Thousands)</th>
<th>Combined normal and surtax rate (percent) on income in bracket</th>
<th>1930</th>
<th>1934</th>
<th>1944</th>
<th>1962</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 2</td>
<td></td>
<td>4</td>
<td>23</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>2-under 4</td>
<td></td>
<td>4</td>
<td>25</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>4-under 6</td>
<td></td>
<td>6 1/2</td>
<td>8</td>
<td>29</td>
<td>26</td>
</tr>
<tr>
<td>6-under 8</td>
<td></td>
<td>13  9</td>
<td>33</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>8-under 10</td>
<td></td>
<td>10</td>
<td>37</td>
<td>34</td>
<td></td>
</tr>
<tr>
<td>10-under 12</td>
<td></td>
<td>12</td>
<td>41</td>
<td>43</td>
<td></td>
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<tr>
<td>12-under 14</td>
<td></td>
<td>12</td>
<td>46</td>
<td>43</td>
<td></td>
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<tr>
<td>14-under 16</td>
<td></td>
<td>16</td>
<td>50</td>
<td>47</td>
<td></td>
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<tr>
<td>16-under 18</td>
<td></td>
<td>18</td>
<td>53</td>
<td>50</td>
<td></td>
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<tr>
<td>18-under 20</td>
<td></td>
<td>20</td>
<td>56</td>
<td>53</td>
<td></td>
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<tr>
<td>20-under 22</td>
<td></td>
<td>22</td>
<td>59</td>
<td>56</td>
<td></td>
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<tr>
<td>22-under 26</td>
<td></td>
<td>26</td>
<td>62</td>
<td>59</td>
<td></td>
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<tr>
<td>26-under 32</td>
<td></td>
<td>32</td>
<td>62</td>
<td>62</td>
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<tr>
<td>32-under 38</td>
<td></td>
<td>38</td>
<td>68</td>
<td>65</td>
<td></td>
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<tr>
<td>38-under 44</td>
<td></td>
<td>44</td>
<td>72</td>
<td>69</td>
<td></td>
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<tr>
<td>44-under 50</td>
<td></td>
<td>50</td>
<td>75</td>
<td>72</td>
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<tr>
<td>55-under 60</td>
<td></td>
<td>60</td>
<td>81</td>
<td>78</td>
<td></td>
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<tr>
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<td>65</td>
<td>84</td>
<td>81</td>
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<td>84</td>
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<td>87</td>
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<td>97</td>
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<td>90</td>
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<td>200-under 300</td>
<td></td>
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<td>91</td>
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<tr>
<td>300-under 500</td>
<td></td>
<td>500</td>
<td>94</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td>500-under 1,000</td>
<td></td>
<td>1,000</td>
<td>94</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td>1,000 and over</td>
<td></td>
<td>25</td>
<td>63</td>
<td>91</td>
<td></td>
</tr>
</tbody>
</table>

(b) Before 1934, the entire net income was subject to surtax; for 1934 and later years net income less personal exemptions and credits for dependents was subject to surtax. In this table, as in 1929, the normal tax rates were added to the surtax rates by including in "taxable income" for normal tax the exemptions for a married couple for joint returns is computed on half of the taxable income and then multiplied by two.

(b) The maximum effective rate was 90% of net income in 1944 and 87% of taxable income in 1962.

Source: Treasury Department.

accurately described as accidental.\(^{15}\)

With the important exception of income splitting, the structure of taxable income brackets is still that of the Revenue Act of 1942, despite the fact that the value of

\(^{15}\) "in 1932 . . . substantial additional revenue had to come from the bottom-income brackets, because that is where the bulk of the income is. The lowest tax rate was increased from 1% to 4 per cent, and the question immediately arose as to the appropriate increase in the top bracket, which had been 25 per cent. This is the point in the history of our tax legislation where the fetish of progressive taxation created confusion, and the confusion led to what has thus far been an irreversible error in tax policy. It was apparently thought that, since the bottom rate was increased by about 150 per cent from 1% to 4 per cent, the top rate should be increased by at least the same proportion. It was increased from 25 to 63 per cent, almost exactly 150 per cent. The error arose from looking at the increase in rates alone." D. T. Smith, Federal Tax Reform (New York: McGraw-Hill Book Company, Inc., 1961), pp. 35-36.

the dollar, as measured by the consumer price index, fell 46% from 1942 to 1962. Thus, as shown in Section I, although statutory rates and brackets have remained essentially the same, inflation has changed the burden of the tax substantially. Inflation has provided the government with more revenue by raising automatically the tax rates which actually apply as money incomes have gone up to offset inflation. Government has thus avoided the need for public debate about raising real tax rates.\(^{16}\)

If the rate structure adopted during the war seemed equitable, then, the present structure in its real sense would have seemed inequitable for it is more severe. Without agreeing that the 1942 rates were then reasonably related to acceptable concepts of fairness and justice for wartime, one conclusion must receive general agreement: On grounds of equity as among persons at different income levels, revision of the income tax should include a reduction of the degree of progression.

There are, of course, other reasons for such a revision though no solid, objective basis for a new rate scale can be expected. For example, a rate structure rising to a top of 50% would probably be much closer to most peoples' ideas of relative equity than anything like the present.\(^{17}\) Thc 50% figure does have one rational justification as a top limit—it would mean that the individual will always have at least as much interest in his marginal income as will the tax collector.

Brackets

Rate revision should include a revision of the bracket structure.\(^{18}\) As with rates, there is no clearly accepted, certainly no "scientific," basis for arriving at a more or less ideal bracket structure. However, some rough and ready guides are available. Thus it seems logical that there should be "a roughly similar differentiation of marginal rates over a range of income from $5,000 to $10,000, for example, over a range of income from $50,000 to $100,000."\(^{19}\) The need for simplicity leads to the selection of figures in rounded thousands as bracket limits. Suggestions for alternatives to the present bracket structure to accompany alternative rate structures have been made elsewhere.\(^{20}\)

\(^{15}\) This result would not occur if tax rates were proportional. If all income were taxed at the same rate, say 20%, increases in income received to offset the effects of inflation would all be taxed at the same rate. The real burden of the tax would not rise as it does when the additions to income are taxed at progressively higher rates.

\(^{16}\) Opinion surveys have found, time and time again, that although most of the public favors rate progression, they would, if setting the rates, provide a degree of progression above the middle brackets far less severe than that in the present law.

\(^{17}\) If "political" considerations make large reduction in top rates difficult, the inequitable and distorting effects can be alleviated by broadening brackets; in the 1930's, for example, the top rates (65% and 77-79%) did not become effective until $1,000,000 (over $2,000,000 of 1962 dollars).


\(^{19}\) Ibid., p. 18 ff.
Such revisions would be directed toward greater equity as among persons at different income levels. Such revisions would also ease the task of achieving greater equity as among persons at the same or similar income levels. Many of the present tax differentials — the much discussed but poorly defined "loopholes" — are the result of attempts to soften the impact of the present rates in particular cases as distinguished from all taxpayers. If tax rates were cut, the practical significance of provisions favoring a limited group of persons would be reduced.

2. The Rate Structure and Economic Effects of the Income Tax

Steeply progressive tax rates are to be condemned not only on grounds of equity. The economic effects harm the whole country, not merely the upper income groups. Marginal rates that leave a taxpayer as little as nine cents of an additional dollar of income obviously curtail, sometimes virtually destroy, the scope for the normal operation of monetary incentives in guiding economic activity. At high income levels efforts to reduce taxes exert an important, often a major, influence. Prosperous individuals, of course, respond to nonpecuniary incentives. Effort and skill have not disappeared.

Unfortunately, however, too much top-quality effort and high skill are directed toward reducing tax rather than toward producing efficiently. This is sheer economic loss. This is loss, however, which is not obvious to the public. It is certainly not measurable. But it is society not foolish to create powerful incentives for its highest executives, artists, professional men and women, to put their efforts into cutting taxes? Or into activities which are second best in terms of serving the public but better for the person because of tax advantages?

Capital accumulation suffers under a tax system which discriminates heavily against upper income groups. Unquestionably, the self-financing of small businesses is made more difficult. The great majority of small, and not so small, companies rely upon one or a few people for equity capital. When the business is successful, however, taxes take much of what might be available for financing growth. This result is especially probable when the businesses are not incorporated and earnings are subject to progressive rates.

High and progressive tax rates, moreover, increase the riskiness of investing in business. The greater the success of the venture, the more of the earnings which are taken away in taxes. Business, however, is risky. The kinds of new undertakings which do most to change, and to advance living standards, involve much risk. The chances of loss are great. And there is no negative income tax offering progressively larger payments from the Treasury as a company's loss grows progressively larger. True, the businessman or investor in a business who loses does receive some opportunity to offset losses against past profit, if any, and against other income, if any. Yet the bracket affected will almost always be lower than that in which high profits are taxed. Consequently, there is a one-sidedness about the tax effects of progressive rates on risk-taking.

High tax rates influence the pattern of personal investment. Remarkable shifts in the volume and sources of income of the upper income groups over the past 40 years are undoubtedly attributable in substantial part to the characteristics of the Federal tax system. No one can be precisely certain about the effects of the innumerable tax-induced alterations in investment. Nevertheless, the allocation of capital can hardly be as productive as if investment decisions were governed by basic economic factors alone. The whole public is a loser when capital is put into less productive investments for tax reasons.

3. Revenue Effects of Rate Revision

An obviously important consideration in rate revision is the effect on revenue. Estimates of the revenue effects of proposed rate changes are based upon a distribution of taxable income by taxable income brackets — one which shows how much income is subject to each tax rate. Such a distribution appears in Table 8. It shows the amount of income subject to each rate in the structure (Column 3), the tax yield from the basic 20% rate (Column 4), the tax yield from rates above 20% (Column 5), and the total amount of tax from each bracket (Column 6).

The figures tell an important story about the revenue effects of the rate structure. Thus if the first bracket rate of 20% alone were applied to all taxable income, the total revenue would amount, at 1962 income levels, to $43.3 billion or 85% of the total revenue under existing rates. The excess of all rates above 20% accounted for only 15% on the yield of the individual income tax.

This table may also be used to show the revenue effect of cutting off the present rate schedule at a maximum of say 50%. If the present rate schedule were changed in this respect only — so that all rates in the present structure were maintained except for those above 50%, all of which would be reduced to that level — the revenue loss would amount to about $866 million.

Such calculations assume that there would be no change in the amount of taxable income reported in each bracket as a result of the change in rates. This

21 This figure is obtained by taking 50% of the total taxable income for brackets above $18,000 (.50 x $57.91 million = $28.956 million) and subtracting it from the existing tax on income in these brackets ($3,762 million).
### Table 8

**Estimated Taxable Income and Tax Distributed by Taxable Income Brackets**

*(Based on estimated 1962 taxable brackets)*

<table>
<thead>
<tr>
<th>Taxable Income Brackets (thousand dollars)</th>
<th>Tax (rates) (percent)</th>
<th>Taxable Income (million dollars)</th>
<th>Tax from 20 percent basic rate (million dollars)</th>
<th>Tax from rates above 20 percent (million dollars)</th>
<th>Total (million dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 1</td>
<td>20</td>
<td>78,910</td>
<td>15,782</td>
<td>—</td>
<td>15,782</td>
</tr>
<tr>
<td>1 - 2</td>
<td>20</td>
<td>49,422</td>
<td>9,884</td>
<td>—</td>
<td>9,884</td>
</tr>
<tr>
<td>2 - 4</td>
<td>22</td>
<td>37,343</td>
<td>7,469</td>
<td>747</td>
<td>8,216</td>
</tr>
<tr>
<td>4 - 6</td>
<td>26</td>
<td>12,605</td>
<td>2,561</td>
<td>768</td>
<td>3,329</td>
</tr>
<tr>
<td>6 - 8</td>
<td>30</td>
<td>6,241</td>
<td>1,248</td>
<td>624</td>
<td>1,872</td>
</tr>
<tr>
<td>8 - 10</td>
<td>34</td>
<td>3,702</td>
<td>740</td>
<td>518</td>
<td>1,258</td>
</tr>
<tr>
<td>10 - 12</td>
<td>38</td>
<td>2,662</td>
<td>532</td>
<td>479</td>
<td>1,911</td>
</tr>
<tr>
<td>12 - 14</td>
<td>43</td>
<td>2,038</td>
<td>408</td>
<td>469</td>
<td>877</td>
</tr>
<tr>
<td>14 - 16</td>
<td>47</td>
<td>1,535</td>
<td>307</td>
<td>414</td>
<td>721</td>
</tr>
<tr>
<td>16 - 18</td>
<td>51</td>
<td>1,202</td>
<td>240</td>
<td>361</td>
<td>601</td>
</tr>
<tr>
<td>18 - 20</td>
<td>55</td>
<td>819</td>
<td>164</td>
<td>270</td>
<td>434</td>
</tr>
<tr>
<td>20 - 22</td>
<td>59</td>
<td>655</td>
<td>131</td>
<td>236</td>
<td>367</td>
</tr>
<tr>
<td>22 - 26</td>
<td>62</td>
<td>976</td>
<td>195</td>
<td>381</td>
<td>576</td>
</tr>
<tr>
<td>26 - 32</td>
<td>65</td>
<td>585</td>
<td>117</td>
<td>263</td>
<td>380</td>
</tr>
<tr>
<td>32 - 38</td>
<td>69</td>
<td>377</td>
<td>75</td>
<td>185</td>
<td>260</td>
</tr>
<tr>
<td>38 - 44</td>
<td>72</td>
<td>266</td>
<td>53</td>
<td>138</td>
<td>191</td>
</tr>
<tr>
<td>44 - 50</td>
<td>75</td>
<td>294</td>
<td>59</td>
<td>162</td>
<td>221</td>
</tr>
<tr>
<td>50 - 60</td>
<td>78</td>
<td>171</td>
<td>34</td>
<td>99</td>
<td>133</td>
</tr>
<tr>
<td>60 - 70</td>
<td>81</td>
<td>121</td>
<td>24</td>
<td>74</td>
<td>98</td>
</tr>
<tr>
<td>70 - 80</td>
<td>84</td>
<td>83</td>
<td>17</td>
<td>53</td>
<td>70</td>
</tr>
<tr>
<td>80 - 90</td>
<td>87</td>
<td>57</td>
<td>11</td>
<td>38</td>
<td>49</td>
</tr>
<tr>
<td>90 - 100</td>
<td>89</td>
<td>159</td>
<td>32</td>
<td>110</td>
<td>142</td>
</tr>
<tr>
<td>100 - 150</td>
<td>90</td>
<td>70</td>
<td>14</td>
<td>49</td>
<td>63</td>
</tr>
<tr>
<td>150 - 200</td>
<td>91</td>
<td>205</td>
<td>41</td>
<td>146</td>
<td>187</td>
</tr>
<tr>
<td>Total</td>
<td>—</td>
<td>201,651</td>
<td>40,329</td>
<td>6,984</td>
<td>47,313</td>
</tr>
</tbody>
</table>

(a) Taxable income on joint returns is treated as if it were split equally between spouses filing separate returns. Thus the tax rates applicable to single persons may be applied to the respective brackets, and an estimate of total tax liability is obtained. No allowance is made for the lower rates allowed heads of households; the tax is thereby overstated by about $90 million.

(b) Excludes about $1.0 billion for the tax on capital gains at the alternative rate. No allowance is made for about $0.5 billion in tax credits, of which the dividend credit is most important.

Assumption, however, is unrealistic, especially for the high income brackets. The historical record reveals that substantial changes in reported income have accompanied changes in tax rates. These changes in reported income have generally been in the direction opposite to that of the changes in tax rates.\(^22\)

Over the long term the lack of growth, and even at times the decline, in taxable income subject to the highest bracket rates has been remarkable. Thus in 1916 total taxable income (then called “surtax income”) in excess of $100,000 per return amounted to $1,143 million. In 1690 taxable income in excess of $100,000 per return ($200,000 for joint returns) was only $434 million. If rates were cut, substantial amounts of income might eventually “come out of hiding” — from tax-sheltered investments.

A revision of rates and brackets that encompassed the whole structure could obviously involve substantial revenue, as shown in a recent Tax Foundation study which examined alternatives.\(^24\) One rate structure with a schedule of rates beginning at 18% and rising to 78% would have involved a revenue loss of about $4 billion at 1957 levels of income. Another set of rates beginning at 18% and rising to 64% would have meant a revenue loss of about $4.5 billion.


\(^23\) Ibid., p. 28.

B. THE TAX BASE

Rate reduction possibilities depend primarily upon control over expenditures and the size of the tax base. Growth of national income will enlarge the tax base, even if there is no more inflation. The size of the tax base will also depend upon what Congress says shall be included. Some of the hardest choices of tax revision will be between broadening the tax base to get higher rate reduction and meeting special needs in ways that narrow the tax base and thereby restrict the opportunities for rate reduction. Underreporting of income and the exaggeration of deductions also influence the tax base; space limits do not permit discussion here of the problems involved.25


The Internal Revenue Code begins with a broad concept of "gross income" which is defined as "...all income from whatever source derived..." "...except as otherwise provided..."

The most important exceptions or "exclusions" — items specifically excluded from "gross income" — are the following:

— veterans' pensions
— social insurance benefit payments
— workmen's compensation benefits and some sick pay
— life insurance payments by reason of death
— employer contributions to employee pension, accident or health plans, and premiums paid by an employer for group term life insurance policies
— interest on state and local governmental obligations
— scholarship and fellowship grants (subject to limitations)
— income earned abroad under certain conditions
— gifts and inheritances
— dividends received up to $50 per year per taxpayer.

In addition to these explicit exclusions, the law as interpreted by the courts also generally excludes unrealized and "imputed" income.26 Thus, a capital gain which is not realized — e.g., a rise in the market price of stock which is not sold — is not included in gross income.

Having defined "gross income," the law then goes on by stages to reach "taxable income," the base to which the statutory rates are applied. These stages involve the following deductions from gross income:

1. Ordinary and necessary expenses of carrying on any trade or business or, in the case of employees, expenses incurred on behalf of the employer; the figure obtained is adjusted gross income;

2. personal deductions for interest, medical expenses, charitable contributions, etc., or alternatively, the optional standard deduction (10% of adjusted gross income or $1,000, whichever is smaller);

3. personal exemptions ($600 per taxpayer and each dependent, with double exemptions for those over 65 and the blind); what is left is taxable income.

Each step raises questions. Proposals for revision are numerous. The questioning and the proposals are in addition to a more fundamental issue: Is income the best tax base? However, a complete departure from use of the income tax is neither likely nor desirable. Consequently, the discussion here proceeds on the assumption that the personal income tax will remain a major part of the Federal tax system.

Table 9 indicates the quantitative importance of the steps taken in arriving at taxable income. The table shows the relation between total personal income as shown in the national income accounts and total taxable income on returns.27 These figures do not indicate the extent to which the tax base should be "broadened." Such a calculation obviously depends upon the extent to which it would be feasible and desirable to include in taxable income items now excluded.

2. Exclusions

Fully Excluded Forms of "Income"

The chief forms of completely excluded income are social insurance benefits, imputed income, unrealized income of various kinds, and interest on state and local bonds.

i. Social Insurance Benefits and the Retirement Income Credit. In 1961, Old-age, Survivors, and Disability Insurance and related benefits were $13.7 billion; unemployment insurance benefits came to $4.7 billion. Do such receipts represent taxpayers' capacity?

When these systems were established in the 1930's, there was little question about the taxability of benefits.28 Most of the people to be covered were not subject to income taxation because of the relatively high level of exemptions, $2,500 for a couple. The benefits under

25 Treasury proposals to require withholding on dividends and interest were rejected by Congress in 1962. The underreporting of income was estimated to cost $1 billion or more.

26 Roswell Magill, Taxable Income. (New York: The Ronald Press, 1958), Chapter I. The Revenue Act of 1962, however, requires U.S. corporations to pay tax on certain foreign income not received in this country.

27 The "national income accounts" are the various measures of income and of the economy as a whole. There is no presumption that "personal income" as defined for the purpose of national income accounting is the ideal "total income" for purposes of taxation.

28 The exclusion resulted from Treasury ruling, not explicit Congressional action.
the original plan would generally have been less than $1,000 a year for a retired couple. Since World War II, however, coverage has expanded greatly, the benefit payments have increased, and there has been an increase in the proportion of OASDI beneficiaries who are subject to the income tax.

The broader problem of the economic position of the aged arises in considering the taxation of social insurance benefits. The long-standing principle of the law has been to exclude from gross income the part of a pension benefit which has once been treated as a part of gross income, while including the rest. The principle seems sensible. The general income status of older people has improved significantly over the years. Inflation, however, has eaten away at the purchasing power of past savings; and most of those in the upper age groups are hard-pressed for enough dollars to maintain a living standard of modest comfort. Some are in unquestioned need.

The increase in income tax coverage, along with inflation and other changes in the circumstances of retired persons, led in the post-war period to numerous situations in which retired persons in similar income situations were subject to very different tax liabilities. Relatively large tax consequences depended on the form of current income and also on the method by which the pensioner acquired his rights. The retirement income credit was introduced to help meet some of the problems. It gives retired persons living on private pensions and other forms of "retirement income" (almost all pension and investment income), a tax status approximately equal to that of persons with social security benefits.

Since the recipient of unemployment benefits has paid no part of the cost, all receipts would seem logically treated as part of gross income. If they fall above exemptions and deductions, they presumably represent taxing capacity essentially on a par with wages. Similar arguments apply to other transfer payments such as veterans' benefits and military pensions.

The total of social insurance benefits — now about twice as much as dividends from corporations — will reach much larger amounts within a few years. Both the Treasury's revenue and the differences in the taxation of individuals, especially the contrast between those working and those retired, will grow more significant.

ii. IMPUTED INCOME, UNREALIZED GAINS AND LOSSES, AND INCOME IN KIND. The U. S. income tax follows the general practice of including only realized amounts — as to both receipts and expenses — in the tax base. With a few exceptions no effort is made to tax what may be called imputed income or income in kind.

One argument for the exclusion of such items is that since taxes must be paid in cash, the taxation of non-cash income would at times distort a taxpayer's financial position. Another argument is the fact that the uses to which imputed and unrealized income can be put are in the nature of the case limited as compared with money income. Moreover, a weighty practical obstacle would be the difficulty of getting agreement on how much various non-money benefits are worth in dollars.

The rental value of owner-occupied housing is probably the largest such item which has been proposed for inclusion in gross income. The present treatment, it is argued, discriminates in favor of the home owner and against the renter. To try to include the rental value of an owner-occupied dwelling would present difficult administrative and compliance problems. The possibility of allowing rent as a deduction has been suggested as a method of removing present discriminations. Here again, however, formidable practical difficulties would arise in deciding what portion of rental payments would be appropriately deductible.

There are other benefits — "fringes" — not included in gross income even though they are sought, provided, and serve as real income. Group insurance, medical services, lunch subsidies, and numerous other items can be excluded entirely from gross income. The largest outlays, employers' contributions for pensions, whether or not vested, are not included in the worker's gross income until he draws a pension. The postponement of tax is worth a great deal in itself; the "tax money" is available to earn income, and the pension will probably be taxed in lower brackets than wages, or not at all.

The fact that the employer can deduct what he spends for fringes but that the employee need not include them creates a big tax stimulus to this form of "compensation." For tax purposes the issue is not whether fringes are "good things." The issue is whether they represent income in a sense meaningful for the sharing of the costs of government. If so, what practical problems of administration and compliance would arise in trying to include them in gross income?

In some respects the law may include as income what is a reimbursement of expense. For example, payments of moving expenses of a new employee have been held to be taxable income. So are a variety of payments to employees abroad. The sweep of the law may be unfairly broad in such cases.

Attempts to include unrealized capital gains and losses in each year's computation of income would give rise to well-nigh insuperable practical difficulties.

\[29\]

Depreciation in a sense presents an exception. Businesses may deduct estimated amounts as expenses without being required to prove how much was realized.
iii. INTEREST FROM STATE AND LOCAL BONDS. Interest from state and local government bonds is income, but Congress has explicitly excluded it from taxation.21 The exemption of interest on Federal securities from Federal tax was removed for newly-issued bonds beginning in 1942.

The present exemption aids state and local borrowing by reducing the rate of interest which must be paid. The interest rate benefit has declined in relative importance in recent years.22 To sell more and more tax-exempt bonds as the amount outstanding has grown, states and localities have been forced to issue bonds at interest rates which appeal to investors for whom tax exemption is worth much less than it is to the highest income groups. Though the exclusion remains as a form of Federal aid to state-local borrowing, it is inefficient in the sense that the revenue loss to the Federal government is distinctly more than the interest saving enjoyed by the states and localities. In many states municipal bonds may be sold to finance facilities for private businesses. Such use is widely held to be a misuse of tax exemptions.

Any attempt to tax interest from bonds already outstanding would violate an implied agreement and for that reason cannot be justified. As to future issues, however, some arrangement more rational than the present may be possible. The only realistic possibility would be a proposal which would preserve for states and localities as much borrowing advantage as they have at present while giving the purchasers of (newly issued) bonds no more advantage than the borrowing governments receive. One proposal is to grant a Federal tax credit to buyers of future issues of state and local bonds sold without the present form of exemption. The cost to the Treasury would be less than the present revenue loss.

Capital Gains and Losses: Partially Excluded Items

In addition to receipts that are fully excluded from "gross income," there are some that are only partially subject to tax or are taxed at a lower rate than ordinary income. The most important are long-term capital gains.

i. DIFFICULTY OF DISTINGUISHING CAPITAL GAINS AND LOSSES FROM INCOME. Capital is not income. Unfortunately, however, income and capital are sometimes so closely related that reasonable men will not agree on where to draw the line between changes which are changes in capital — and presumably not income — and those changes which are the fruits of capital and thus income. But when a change of the latter type is not separated from the source, when it is added to the capital, is it appropriately taxed on the same basis as dividends or interest or rent?

Some changes in capital values are essentially of the same character as ordinary income. Depreciation, for example, is a decline in the worth of capital assets which must be taken into account to determine income. Some rises in capital value result from the plowing back of earnings and thereby represent the addition of income to capital. This income, however, does differ from most receipts. It is not available for consumption; by its addition to capital, it will generally increase productive capacity. Owners of property have varying amounts of opportunity to convert profit, rent, interest, and salary into capital gain. Gains from the sale of capital assets may represent a way in which income from investments is realized.

Capital gains and losses result from a wide variety of causes, not merely the plowing back of earnings. Existing assets also change in value because of inflation and deflation, because of the general process of economic growth, and because of changes in expectations of future net income from a particular piece of property.

A highly developed, capitalistic economy cannot expect to find for tax or for other purposes clear and unambiguous distinctions between capital and income. The inherent difficulties are compounded by others. When income is produced by corporations which add it to capital with passing the earnings through the pockets of the owners, perplexing issues must arise in deciding on when and how to tax the owners, if at all. Changing price levels and interest rates add more complications. Some capital gains, notably those in land values due largely to population growth, have an element realistically termed "unearned"; this fact injects an emotional element even where other types of capital changes are involved. How can account be taken of the differing practical opportunities of individuals to convert into capital gains what would otherwise clearly be income? Certainly, of prime importance are the very high rates of tax imposed on ordinary income in high brackets; such rates are condemned for slowing the accumulation of additional capital; they would strike even more harshly at the foundations of the economy if they applied to capital generally.

Compromises are essential. Because they are compromises they will seem defective by one or another criterion.

ii. ISSUES INVOLVED IN TAXING THE INCOME ELEMENT OF CAPITAL GAINS. Even if it were clear what por-

21 This exclusion raises the issue of the legal doctrine that governments enjoy reciprocal immunity from taxation. Before 1938 the immunity was believed to extend to salaries of government employees. i.e., states could not tax Federal employees on salaries, and the Federal income tax could not apply to the salaries of state and local employees. However, the Supreme Court ruled in 1938 that each level of government could subject the employee of the other to taxation on the same basis as imposed on the public generally. The Court has not ruled on the constitutionality of non-discriminatory Federal taxation of interest from state-local bonds, but there is at least a very real possibility that such taxation would be permitted as regards interest from future issues.

tion of capital gains is income rather than capital, there
would be convincing reasons against applying ordinary
tax rates in full. For one thing, the part of a realized
capital gain which is income may have accrued over a
long period of time. To tax it in full under a progressive
system at the rates of the year in which such gains are
realized, would impose a burden which could be much
higher than if the income had been taxed bit by bit from
year to year.

Secondly, to tax income appearing in the form of capi-
tal gain as heavily as ordinary income would have ad-
verse effects on the economy. It would often discourage
the transfer of capital funds from one investment to
another. By delaying sale, an owner can at least keep
what would otherwise be paid in tax earning income for
him. Moreover, by holding the asset until death, the
owner and his heirs can escape income tax on capital
gain permanently. Taxation of gains more heavily would
reduce the benefits which society obtains from a freely
operating capital market — a market through which
hundreds of billions of capital funds flow annually.
Throwing a gigantic monkey wrench into the marke-
t through which assets and on investment decisions in general. Present
treatment, however, does limit the tax paid to a maxi-
num rate of 25%. And some of the gains can reason-
ably be said to bear a very close resemblance to divi-
dends, interest, or other income.

The exclusion of 50% of long-term capital gains is a
practical, although crude, method of limiting the taxa-
tion of gains which have built up over what may have
been a long period. Heavier taxation of such gains would
doubtless exert an unduly distorting influence on the sale
of assets and on investment decisions. Present
treatment, however, does limit the tax paid to a maxi-
num rate of 25%. And some of the gains can reason-
ably be said to bear a very close resemblance to divi-
dends, interest, or other income.

The criticism just implied results not so much from
the ceiling rate of 25% as from the classification as capi-
tal gain of what, more fundamentally, is ordinary in-
come. Congress has extended capital gains treatment to
tsituations which have little of the true element of capital
gain, except perhaps in the eyes of the beneficiaries. A
1962 change, however, reduced substantially the possi-
bilities of converting income earned by machinery into
capital gain (by rapid depreciation and then sale).

What may seem an unreasonable restriction on the
eductibility of losses is the result in part of the fact that
the taxpayer ordinarily controls realization. Neverthe-
less, an economy that wants the kind of risk-taking which
seems necessary for rapid economic growth might well
find that allowing more generous tax treatment of capi-
tal losses would encourage pioneering.

iv. PROPOSALS FOR CHANGE. Numerous proposals
have been made for revision of the taxation of capital
gains and losses. At one extreme is a proposal to tax
capital gains in full at ordinary rates but with an aver-
ging provision to prevent undue burdens on gains ac-
crued over long periods. Such a treatment of capital
gains would discourage the mobility of capital, while
distorting capital movements which do take place, e.g.,

ii. PRESENT TAX TREATMENT. Present law takes
account of gains and losses only when they are realized,
usually by sale. Ordinarily, the owner therefore has sub-
stantial control because he can decide whether or not
to realize.

The law distinguishes two kinds of gains. Those from
the sale of assets which have been held less than six
months are classed as short-term. They are included in
full in gross income and are taxed at ordinary rates.
If the asset has been held six months or more, the gain
is long-term. Only 50% of net long-term capital gains
are included in gross income; the half that is taxed is
subject to a maximum rate of 50%, i.e., 25% of the
total gain. Capital losses when realized may in general
be deducted from capital gains. Any additional loss may
be deducted from ordinary income up to a maximum of
$1,000 during the year; any remaining losses which have
not been deducted may be carried forward for five years
to offset against capital gains, and against $1,000 a year
of other income. Gains and losses not realized before
death are not included in gross income.

The six months' demarcation line is arbitrary but clear.
It is defended as a way of segregating approximately
those gains which result from "in and out," speculative
trading in securities. Such gains create no problem of
the lumping in one year of gains which have accrued
over a period of years.

The exclusion of 50% of long-term capital gains is a
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tion of gains which have built up over what may have
been a long period. Heavier taxation of such gains would
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less, an economy that wants the kind of risk-taking which
seems necessary for rapid economic growth might well
find that allowing more generous tax treatment of capi-
tal losses would encourage pioneering.
stimulation of the realization of losses. The practical problems of averaging would be substantial.

Other writers have proposed a sharp reduction in the present tax on capital gains. The argument in some cases rests on the belief that capital gains and losses have little or no income element. In other cases the arguments advanced are that risk-taking would be encouraged, that mobility of capital would be increased, and that capital would accumulate more rapidly.

Another proposal is to exempt from tax those capital gains which are promptly (within, say, 30 or 60 days) reinvested in other assets. This would correspond to the present "roll-over" treatment for capital gains on sale of residences; gain which is used to purchase another home within 18 months is not taxable. A similar treatment for gains on other assets would go far to eliminate any adverse effects of taxation on capital markets.

The permanent avoidance of capital gains tax on gains unrealized at death would be ended by a proposal to treat transfer at death as realization. Another possibility would be to have the heir assume the decedent's basis. Either change would reduce objections to the liberalization of other features, such as loss offsets; owners of assets with gains would then have less reason to hold them till death. However, the problem of estate liquidity would be more difficult in more cases if a larger tax were due soon after death.

The types of property and transactions which qualify for capital gains treatment would be changed under some proposals. Stricter, more exacting requirements would, of course, tend to broaden the tax base; on the other hand, extension of capital gains treatment to situations not now qualifying would tend to reduce the tax base while benefiting certain groups.

3. Personal Deductions

There have been numerous proposals for limiting the deductions allowed under present law. These proposals are aimed largely at "broadening the tax base" in order to facilitate rate reduction. Arguments for restricting some deductions are also made on equity and policy grounds. The arguments have varying degrees of merit. Some of the changes proposed might themselves produce inequities.

The taxpayer may choose to itemize his deductions or to take the "optional standard deduction." The latter permits the deduction of 10% of adjusted gross income or $1,000, whichever is less. Personal deductions which may be itemized consist largely of the following:

1. state and local taxes (except for "improvement" taxes and charges);
2. interest on indebtedness (with certain exceptions);
3. contributions to charitable, religious, educational, and certain other types of nonprofit organizations (limited in general to 20% of adjusted gross income);
4. medical expenses to the extent that these exceed 3% of adjusted gross income (plus cost of drugs to the extent that they exceed 1% of adjusted gross income) up to a maximum of $10,000 on a single return, or $20,000 on a joint return;
5. certain other specified items including alimony paid, losses from fire, theft, etc., and expenses of child care for working mothers.

Deductions for interest paid, taxes, and casualty losses were allowed under the Civil War Income Tax and under the tax law of 1913. Deductions for charitable contributions date from 1917. In 1942 medical and dental expenses were added with limitations to exclude a normal amount of such expenses. A variety of other personal expenses have been added as permissible deductions.

Several purposes are evident. One is to take account of certain expenses of earning income. A second is to adjust for extraordinary and unavoidable expenses which if added to the usual tax liability would cause unusual hardship. A third purpose is to encourage certain kinds of expenditures or activities, such as contributions to religious, educational, and charitable institutions.

Some deductions, however, may seem harder to justify. Their existence is explained in part because the personal income tax is also a tax on the income of unincorporated businesses. Expenses of operation must be allowed as deductions. And there appears to be no feasible way to segregate personal from business expenses with enough accuracy to serve as a basis of taxation.

Do the deductions constitute erosion of the tax base? As shown by Table 9, deductions accounted in 1960 for over $44 billion of the difference between reported income and taxable income. This is a large sum both absolutely and in relation to total reportable income. Yet the percentage of deductions to adjusted gross income has increased relatively little. Deductions amounted to 11% of adjusted gross income in 1946 and to 14% of adjusted gross income in 1960. This increase in the ratio of deductions to adjusted gross income is accounted for largely by two related developments: first, deductions rise more rapidly than income; second, a smaller portion of the population find the optional standard deduction advantageous; when they itemize, they deduct more.

24 The effects on the tax base are not always clear, for the amount of realization will depend somewhat upon the height of the tax.

Table 9
Relationship of Personal Income to Reported Adjusted Gross Income and Taxable Income
Calendar Year 1960

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income a</td>
<td>$400.8</td>
</tr>
<tr>
<td>Less: Items of personal income not included in adjusted gross income</td>
<td></td>
</tr>
<tr>
<td>Transfer payments</td>
<td></td>
</tr>
<tr>
<td>Old-age and survivors' insurance benefits</td>
<td>11.1</td>
</tr>
<tr>
<td>Unemployment insurance benefits</td>
<td>2.8</td>
</tr>
<tr>
<td>Veterans' benefits</td>
<td>4.5</td>
</tr>
<tr>
<td>Public assistance</td>
<td>3.2</td>
</tr>
<tr>
<td>Military pensions, etc.</td>
<td>4.1</td>
</tr>
<tr>
<td>Other</td>
<td>3.7b</td>
</tr>
<tr>
<td>Other labor income</td>
<td>11.0</td>
</tr>
<tr>
<td>Employer contributions to private pension and welfare funds</td>
<td>8.6</td>
</tr>
<tr>
<td>Other</td>
<td>2.4</td>
</tr>
<tr>
<td>Imputed interest</td>
<td>11.1</td>
</tr>
<tr>
<td>Imputed rent on owner-occupied homes</td>
<td>6.7</td>
</tr>
<tr>
<td>Other</td>
<td>15.7b</td>
</tr>
<tr>
<td>Add: Items of adjusted gross income not included in personal income</td>
<td>17.3</td>
</tr>
<tr>
<td>Employee contributions for social insurance</td>
<td>8.5</td>
</tr>
<tr>
<td>Net capital gains</td>
<td>5.3</td>
</tr>
<tr>
<td>Other</td>
<td>3.5b</td>
</tr>
<tr>
<td>Less: Income not reported on tax returns f</td>
<td>28.7b</td>
</tr>
<tr>
<td>Equals: Adjusted gross income reported on tax returns</td>
<td>315.5</td>
</tr>
<tr>
<td>Less: Adjusted gross income on nontaxable returns</td>
<td></td>
</tr>
<tr>
<td>Deductions and exemptions on taxable returns</td>
<td></td>
</tr>
<tr>
<td>Standard deductions (estimated)</td>
<td>11.6b</td>
</tr>
<tr>
<td>Itemized deductions</td>
<td>32.8</td>
</tr>
<tr>
<td>Personal exemptions</td>
<td>81.2</td>
</tr>
<tr>
<td>Equals: Taxable income of individuals</td>
<td>171.6</td>
</tr>
</tbody>
</table>

(a) Personal income as shown in the national income accounts.
(b) Estimated by Tax Foundation.
(c) About half of this item reflects services furnished without payment by financial intermediaries except insurance companies.
(d) Includes food and fuel consumed on farms, excludable dividends and sick pay, tax-exempt interest, undistributed fiduciary income, accrued interest on savings bonds, etc. Actual value of these item in 1959 was $12.7 billion.
(e) Miscellaneous reported income, annuities, and pensions.
(f) Includes income of persons not required to file, income disclosed by audit, income of tax evaders, estimating errors in personal income, etc.
Source: Department of Commerce, Survey of Current Business, July 1962; and Treasury Department, Statistics of Income, 1960, except as noted.

Space does not permit analysis of the arguments for and against each type of deduction. Interest and state and local taxes paid must be deductible when they are business expenses. To allow them in such cases requires that in practice they be allowed in many personal situations. Deduction of state and local taxes is an important factor in reducing potential conflict between the Federal government and states and localities.

Medical expenses in most cases are “normal,” but those which are extraordinary in size do present a special problem. They make heavy, insistent demands on the family budget. Families suffering unusual illness in
a particular year may reasonably be said to have less
taxpaying ability as a result.

A sharp cut-back in allowable deductions would, of
course, be accompanied by shifts in the distribution of
the tax burden. It would have its greatest effects on those
who now itemize deductions. Thus Table 10 shows that
for nontaxable returns with itemized deductions, total
deductions amounted in 1960 to about 46% of ad-
justed gross income as compared with an average of
19% for all taxable returns.

The effects of different taxpayers of a substantial
change in the present system of deductions, although ac-
compared by a cut in tax rates, would be very uneven.
An addition of some $25 billion to the tax base would
make possible an average reduction of approximately
12% in tax rates (not 12 percentage points). The effects
of altering the deduction system would not be confined
taxpayers. State and local governments, philanthropic
and other institutions which depend on contributions
would be affected, though to what extent is not clear.

Every taxpayer would probably be willing to agree
that one or more of the myriad aspects of the deduction
system could well be exchanged for a reduction in tax
rates. It is even more probable that on concrete issues
there would be strikingly more diversity than agreement.
Individual situations differ. The system of deductions
exists to take account of just such differences. Any
broadside attack on deductions runs the risk of destroy-
ing strengths, as well as correcting weaknesses, of the
system.

4. Personal Exemptions

The history of personal exemptions shows notable
changes in the purpose they are intended to serve. Until
World War II the major purpose seems to have been the
exemption from tax of enough income to pay for at least
a minimum level of living. Wartime demands for rev-
ue, however, resulted in a sharp reduction in th. ex-
emption while the cost of living was rising. The number
of taxable returns rose from 4 million in 1939 to 43
million in 1945. The coverage of taxable returns was

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Table 10

<table>
<thead>
<tr>
<th>Adjusted Gross Income Class (Thousands)</th>
<th>Taxable returns:</th>
<th>Nontaxable returns:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6-under $1</td>
<td>Contributions:</td>
<td>Under $1:</td>
</tr>
<tr>
<td>1-under $6</td>
<td>21.8</td>
<td>70.8</td>
</tr>
<tr>
<td>3-under $9</td>
<td>24.1</td>
<td>44.7</td>
</tr>
<tr>
<td>5-under $12</td>
<td>21.7</td>
<td>45.8</td>
</tr>
<tr>
<td>10-under $19</td>
<td>19.5</td>
<td>46.0</td>
</tr>
<tr>
<td>20-under $29</td>
<td>17.1</td>
<td></td>
</tr>
<tr>
<td>50-under $89</td>
<td>15.0</td>
<td></td>
</tr>
<tr>
<td>100 and over</td>
<td>15.5</td>
<td></td>
</tr>
<tr>
<td>All taxable returns</td>
<td>18.7</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deductions:</th>
<th>Contributions</th>
<th>Interest</th>
<th>Taxes</th>
<th>Medical and Dental Expenses</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent of Adjusted Gross Income:</td>
<td>3.6</td>
<td>1.4</td>
<td>5.9</td>
<td>4.9</td>
<td>3.1</td>
</tr>
<tr>
<td>$6-under $1</td>
<td>1.4</td>
<td>5.9</td>
<td>4.9</td>
<td>3.1</td>
<td>67.3</td>
</tr>
<tr>
<td>1-under $6</td>
<td>2.7</td>
<td>6.1</td>
<td>6.7</td>
<td>3.4</td>
<td>43.2</td>
</tr>
<tr>
<td>3-under $9</td>
<td>4.2</td>
<td>4.3</td>
<td>5.8</td>
<td>4.6</td>
<td>39.4</td>
</tr>
<tr>
<td>5-under $12</td>
<td>3.3</td>
<td>5.4</td>
<td>5.8</td>
<td>2.7</td>
<td>31.5</td>
</tr>
<tr>
<td>10-under $19</td>
<td>2.4</td>
<td>4.4</td>
<td>5.5</td>
<td>1.8</td>
<td>17.5</td>
</tr>
<tr>
<td>20-under $29</td>
<td>2.8</td>
<td>2.6</td>
<td>5.5</td>
<td>1.3</td>
<td>2.0</td>
</tr>
<tr>
<td>50-under $89</td>
<td>2.3</td>
<td>2.6</td>
<td>5.4</td>
<td>.9</td>
<td>2.4</td>
</tr>
<tr>
<td>100 and over</td>
<td>2.8</td>
<td>2.8</td>
<td>5.4</td>
<td>.4</td>
<td>3.0</td>
</tr>
<tr>
<td>All taxable returns</td>
<td>3.6</td>
<td>4.5</td>
<td>5.7</td>
<td>2.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Basic data from Treasury Department, Statistics of Income. Computations by Tax Foundation.
extended—from 5% to about 75% of the total population, including dependents.\footnote{Lawrence R. Seltzer, “The Place of the Personal Exemptions in the Present-Day Income Tax,” Tax Revision Compendium, Vol. 1, p. 453.}

**Present amount**

The amount which is exempted today, $600, will hardly pay for even a “survival” level of living for a single person. A family of five would have difficulty living on $3,000. The decline in dollar amounts of the exemption and in purchasing power is shown in Table 11. For the single person, today’s exemption will buy less than one-fourth as much as in 1929. Would it not seem only reasonable, then, to raise the amount? One argument against doing so is that with a substantially higher standard of living than before World War II, and a much higher level of government expenditures, every income earner should make some direct contribution to government through the individual income tax. The major reason, however, is somewhat different. Unless governmental expenditures can be reduced significantly, the need for revenue will be too great to permit a rise in the exemption.

**Revenue Effect of Increase**

The decisive revenue leverage results from the fact that any change in exemptions applies to every taxpayer — and under the present per capita system to every one of his dependents. Moreover, the reduction in the tax base comes out of each taxpayer’s highest bracket. An increase of only $100 in per capita exemptions would reduce tax revenues by about $3 billion. This would equal a cut of over 6% in all tax rates. About 4 or 5 million taxpayers would be freed from income tax entirely. Any increase which is large enough to help significantly those persons with lowest incomes will reduce total revenue very substantially. And most of the revenue loss would result from reductions in the tax of those with incomes above the new and higher exemption.

In 1960 about three-fifths of all income taxpayers were subject to only the first bracket rate of 20%. Although the jump in the tax rate from zero to 20% seems large, the personal exemption makes for considerable progression. Splitting the first bracket and cutting the lowest rate to 10%, would cost about $8 billion in revenue.

**Purpose of the Exemption under Present Conditions**

The major effect of exemptions today is not so much to free a minimum level of living from tax as to make allowance for differences in family size. (Even the purpose of administrative simplicity — to avoid the processing of large numbers of small income returns — has fallen into the background with the almost universal coverage of the tax and the rapid development of automatic methods of processing returns.) Another element of the tax system — the split income provision — also takes account of family position. For the upper, and high-middle, income groups it is much more significant than any possible change in exemptions.

The consideration of exemptions should be part of a complete examination of the treatment of varying family positions, including the split income provision. The introduction of the latter removed one big inequity — the different treatment of persons in community-property and non-community-property states. Yet it also led to differences between the taxes on single persons and married couples which may be too great by some standards.\footnote{The most important differences are probably those in the $15,000 to $100,000 income range where the contrast in marginal rates can be very striking. In 1960 some 1.5 million married couples, and 107,000 single persons, had adjusted gross incomes in this range. The latter paid an average tax of $4,000 on average taxable income of $21,000. The married couples had average taxable income of $19,300 and paid average tax of $5,600. How many single individuals suffered substantial discrimination? No one can answer for certain, but the number discriminated against seriously will hardly be a big fraction of the 107,000 individuals in the group.}

**Personal Tax Credit to Serve the Purposes of Exemption**

One change sometimes suggested would be to abandon the present type of exemption and replace it with a tax credit of the type used by a few states. The credit

\begin{table}[h]
\centering
\caption{Federal Personal Income Tax Exemptions in Current and Constant 1962 Dollars}
\begin{tabular}{lrr}
\hline
\textbf{Year} & \textbf{Current dollars} & \textbf{1962 dollars} \\
\hline
\textbf{Single person} & & \\
1929 & $1,500 & $2,640 \\
1939 & 1,000 & 2,170 \\
1944 & 500 & 860 \\
1962 & 600 & 600 \\
\textbf{Married couple} & & \\
1929 & $3,500 & $6,160 \\
1939 & 2,500 & 5,440 \\
1944 & 1,000 & 1,720 \\
1962 & 1,200 & 1,200 \\
\textbf{Married couple, 2 children} & & \\
1929 & $4,300 & $7,570 \\
1939 & 3,300 & 7,170 \\
1944 & 2,000 & 3,430 \\
1962 & 2,400 & 2,400 \\
\hline
\end{tabular}
\end{table}

\footnote{Source: Computed by Tax Foundation from data published by Treasury Department and Department of Labor.}
would be a fixed amount per person. It would not, as does the present system of exemptions, give a tax-saving benefit which varies with the marginal rate to which the taxpayer is subject. A proposal of this sort would involve a large departure from customary Federal practice.

A credit system has at least one serious disadvantage.

C. TAX CREDITS

The major credits under the personal income tax are the credit for foreign taxes, the dividend credit, and the retirement income credit, which has already been noted. (The amounts involved on 1960 incomes were $26 million, $304 million, and $113 million, respectively.)

i. FOREIGN TAX CREDIT. The foreign tax credit gives rise to no serious controversy under the individual income tax. A person may credit against his U. S. tax the foreign income taxes paid on the income from abroad which is subject to U. S. tax. This credit prevents two-fold taxation of the same income.

ii. DIVIDEND CREDIT. The dividend credit, however, does arouse controversy. In 1954 Congress provided for the annual exclusion: from gross income of the first $50 of dividends received by each individual. It also provided that 4% of dividends in excess of $50 could be credited against the tax otherwise due. This credit came after a period of 18 years during which dividends received by individuals were taxed in the same way as other income, even though the corporation had already been taxed or the earnings from which the dividends were paid. Prior to 1936 dividends had been exempt from the normal tax, which was generally small, but subject to the surtax portion of individual income tax.

One purpose of the dividend credit is to solve, to some extent, the problem of the twofold, or double, taxation of income as it goes through corporations to stockholders. If the corporation income tax burden falls in whole or in part on the stockholder, then the same income is subject to both corporation and individual income tax. There can be no assurance about how much of the tax on corporation earnings is in effect passed on to consumers, over the long run, and the amount which rests on the corporation (its owners). However, much of the tax on corporation earnings must be assumed to rest on stockholders.

The general corporation tax rate is 52%, and the individual rates range from 20% to 91%. In an extreme case, therefore, as little as 4 cents out of a dollar of corporation earnings will be left to the owner out of income subject to both of these taxes. In the vast majority of cases, the two taxes combined are by no means so crushing. Nevertheless, they are heavier than the taxes on wages, rents, and other forms of income received by the same persons. Relief of such a high burden is required to meet basic considerations of equity.

The credit was intended to do more than make the tax system less inequitable. The credit, it was believed, would also aid corporations in raising new risk capital. It reduces somewhat the big tax-created advantage of debt over stock (equity) financing. The advantage results from the fact that interest is a deductible expense while rewards to equity capital, dividends, are not considered as costs. The dividend credit, however, gives the stockholder an offset which, small as it may seem, makes investment in equity securities more attractive than otherwise.

In proposing the dividend credit in 1954, the Committee on Ways and Means offered various reasons for preferring it to other possible forms of relief from double taxation. Allowing dividends as a deduction to corporations would in effect make the corporation tax a levy on undistributed profits; such a tax, it was feared, would have disturbing effects on investment and economic activity. Adoption of the British system — allowing the taxpayer to "gross up" his dividends reported by the amount of the corporate tax on his dividends, and then to take this corporate tax paid as a credit against the individual tax otherwise due — was rejected. The chief reason given was that it is too complicated, but there was also some belief — poorly grounded at best — that a tax on corporations as such is justified by privileges given under law to this form of business.

The credit is out in the open, to be seen and taken into account by stockholders. It gives no relief where there is no double tax, e.g., to stockholders such as exempt pension funds and non-profit organizations. For persons receiving a substantial part of their incomes in dividends, the 4% tax credit provides a much larger percentage reduction in the tax otherwise due at low income levels than at high.

The controversy over the dividend credit arises not so much over the need to reduce the multiple taxation of dividends. The debate is over which method is most ap-