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Adjusting Tax Rules for Inflation—Capital Gains and Capital Income

By Martin Feldstein

The tax changes that were enacted in 1978 brought some welcome relief to individual investors and corporations. There is no doubt that the reduction in the capital gains tax marked a fundamental rejection of the liberal tax reform tradition that has directed Congressional action for the past decade. These tax cuts will provide a helpful stimulus to capital formation.

But it would be wrong to be too sanguine about the changes that have been made. I believe that the most fundamental tax problem affecting capital formation has not been tackled: adjusting tax rules for inflation. With anything like the existing rate of inflation, our current tax system imposes an extremely heavy burden on capital income, depressing total investment and distorting decisions about its form. Modifying the tax rules to deal with the reality of inflation is the most urgent task of tax reform and is likely to be a major focus of tax legislation in the coming year . . . .

Capital Gains

Since 1969, a number of different legislative changes in the minimum tax, the maximum tax, and the alternative tax have combined to raise the effective capital gains tax rates very substantially. On top of that, and I think of even greater total importance, has been the impact of inflation on the taxation of capital gains.

In 1977, the National Bureau of Economic Research released a study of the impact of inflation on the taxation of capital gains.[1] In this study, Joel Slemrod and I looked first at the experience of someone who invested in a broad portfolio of securities like the Standard and Poors five hundred securities in 1957, held it for twenty years and sold it in 1977. An investor who did that would have been fortunate enough to have his investment slightly more than double during that time. Unfortunately, the price level also more than doubled during that time. In terms of actual purchasing power, the investor had no gain at all on his investment. And yet of course the tax law would hold him accountable for a tax liability on this nominal gain.

After seeing this experience for a hypothetical investor, we were eager to know what has been happening to actual investors who have realized taxable capital gains. Fortunately, the Internal Revenue Service has produced a very interesting set of data: a computer tape with a sample of

This Issue In Brief

In this issue, Professor Feldstein maintains that, while some progress was made under the Revenue Act of 1978 toward reducing tax obstacles to capital formation, "the most fundamental tax problem affecting capital formation has not been tackled." He emphasizes the need to adjust tax policy for the effect of inflation, particularly to achieve a more realistic measurement of capital income subject to tax.

This piece was excerpted from remarks delivered by Professor Feldstein at the Tax Foundation's 30th Annual Conference on December 6, 1978. Views expressed were his own and should not be attributed to any organization.

[1] See National Bureau of Economic Research Working Paper No. 234, "Inflation and the Excess Taxation of Capital Gains," by Martin Feldstein and Joel Slemrod. This study is summarized in "How Inflation Distorts the Taxation of Capital Gains," *Harvard Business Review*, September-October 1978.

more than 30,000 individual tax returns reporting realized capital gains on corporate stock in 1973. While the sample is anonymous, it is the kind of scientific sample that can be used to make accurate estimates of national aggregates.

The results of this analysis were quite astounding. In 1973, individuals paid tax on $4.6 billion of capital gains on corporate stock. When the costs of those securities are adjusted for the increase in the price level since they were purchased, that $4.6 billion capital gains really represents a loss of nearly one billion dollars. Thus, people were paying tax on $4.6 billion of capital gains when in reality they actually sold stock that represented a loss of nearly a billion dollars. Moreover, although people paid tax on artificial gains at every income level, the problem was most severe for those with incomes of less than $100,000.

The Internal Revenue Service data were also useful for studying another very important issue. With it, we were able to assess the sensitivity to tax rates of individuals' decisions to realize capital gains.[2] The evidence again was quite striking. It indicated that, on the average, decisions to realize gains are so sensitive that reducing the maximum tax to 25 percent across the board would have increased realizations by so much that tax revenues would actually increase. Under existing tax law, unrealized gains just remain permanently locked into portfolios; a lower tax rate could unlock them, making investors better off and the Treasury richer in the process....

[2] M. Feldstein, J. Slemrod and S. Yitzhaki, "The Effect of Capital Gains Tax Rates on the Selling of Corporate Stock and the Realization of Capital Gains," *National Bureau of Economic Research Working Paper No. 250*, 1978.

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Although the Treasury insisted on ignoring this important behavioral response and argued that there would be a revenue loss of several billion dollars, Senator Russell B. Long, to his credit, insisted that these feedback effects were large and therefore that the capital gains tax rate reduction would cost no revenue. In the end there was a compromise in which the Treasury tried to save face by admitting that a reduction in the capital gains tax rates would have some small impact on selling behavior. But Congress really ignored what the Treasury and the White House had to say in this area and passed a compromise bill cutting everyone's tax rate on capital gains, especially the tax rates of high income investors.

I think that these tax cuts were a good legislative initiative that will have positive effects on the economy. But I am sorry that, in the legislative process, the problem of adjusting for inflation got put aside. You may recall that, at one point, there was a proposal to tax capital gains only on the difference between the final selling price and the cost as adjusted for the inflation that occurred during the holding period. Congressman Bill Archer, a conservative member of the Ways and Means Committee, introduced such a proposal at one stage in the Committee's deliberations. What followed was a very strange bit of political maneuvering. The Archer proposal was immediately backed by the Committee liberals and voted against by most of the mainstream Republicans on the Committee. The liberals hoped that, by adding the Archer amendment to the existing bill, they could sink the whole tax bill by making it just too favorable to investors for Congress to pass. The Archer amendment was passed by the Committee and then, much to everyone's surprise, it was also passed overwhelmingly by the whole House. It was only when the tax bill got to the Senate that the Archer amendment was dropped.

While the lower tax rates on capital gains that have been enacted will reduce the adverse effects of inflation, lowering the tax rate does not alter the fact that people will pay taxes on nominal gains even when there are no real gains. They will now pay a lower tax on those artificial gains but they will still pay a tax on what is really a loss. I believe that Congress will return again to the idea that only real capital gains should be taxed and that this will become a major legislative issue.

Adjusting Taxes for Inflation

This brings me to the more general subject of adjusting taxes for inflation. During the past session, Congress began for the first time to give serious attention to this issue. I think that inflation adjustment will become the most important aspect of tax reform in the 1980's....

There are really two separate problems with our current tax rules: the "bracket rate" effect and the mismeasurement of capital income. The bracket rate effect is beginning to be rather generally understood and appreciated by the public and the Congress. Inflation pushes people into higher tax brackets, thereby raising their effective tax rates....

There is a simple remedy for this: automatically adjusting the tax rates each year in line with inflation. More specifically, the bracket rate effect can be avoided by widening the brackets by the rate of inflation. For example, if today the 32 percent tax bracket begins at $20,000 and we have a seven percent inflation, the 32 percent tax rate bracket should be raised to $21,400. The Canadian tax law now provides that this be done automatically every year. Some European countries do it as a matter of policy without writing it into their law.

One of the most significant but least noticed of the things that happened in Congress in 1978 was adoption of this principle of bracket adjustment. In 1977, the administration introduced a proposal to "cut taxes" in a haphazard way that would have produced significant real reductions at low incomes but real increases at higher incomes. The Ways and Means Committee rejected these rate changes and adopted instead the bracket broadening approach, increasing each bracket point by six percent. In the Senate, more tax cuts were added to the House reductions but nobody became worse off than they would have been under the House bracket broadening approach. The 1978 tax cuts thus established an extremely important precedent....

The mismeasurement of capital income is a more complex issue and yet an even more important one. Without legislative action or public debate, effective tax rates on capital income of different sorts have been raised dramatically in the last decade. Moreover, unlike the bracket rate effects, this process of raising the effective tax rate on capital income is insidious because it is too hard for the public at large or even for most members of Congress to understand what has happened. What appear to be relatively low rates of tax on interest income of capital gains and corporate profits, as measured under current accounting rules, are actually very high rates, in some cases more than 100 percent, because our accounting definitions are not suited to an economy with inflation. I have already commented on the taxation of capital gains and the fact that taxes are being paid on large nominal gains by individuals with large real losses. The depreciation rules are even more important.

Under current law, depreciation as a deductible business expense is calculated at the original cost of plant and machinery. Whenever prices are rising, this leads to an understatement of the real costs of production and therefore an overstatement of taxable profits. We are doing a study of this problem now at the National Bureau of Economic Research; I therefore do not know as much now as I hope I soon will. Some preliminary figures are available and indicate the great importance of this problem.[3] First, our analysis shows that the understatement of depreciation caused the effective corporate tax rate to rise over the last decade from 41 percent to 52 percent. Although Congress was voting lower tax rates and more accelerated depreciation, the effective tax rate rose by nearly one-quarter of its original value.

Second, we estimate that, in 1977, corporations paid tax on $35 billion of phantom profits because of understated depreciation. This caused a 30 percent increase in their total tax bill, a tax increase equal to nearly one-third of current after-tax profits.

Taxing firms on the basis of historic cost depreciation not only lowers the after-tax yield on investment but also increases its uncertainty. Because the future price level cannot be predicted, the real value of future depreciation allowances becomes uncertain. This extra source of unpredictability makes even the safest investment more uncertain and therefore less attractive.

I think that all of this indicates the need for a fundamental overhaul of the depreciation rules in our tax law. Fortunately, there is growing Congressional recognition of this problem and interest in achieving it. But not everyone agrees and the Treasury, in particular, opposes any such change in depreciation rules. The opponents of reforming our current depreciation rules argue that it is unnecessary to do so because there is an offsetting effect of inflation on corporate debt that compensates the corporate owners for their losses due to inadequate depreciation.

[3] The full study will be reported in M. Feldstein and L. Summers, "Inflation, Depreciation and the Investors' Rate of Return," National Bureau of Economic Research, forthcoming.

This opposition view can be stated as follows: corporations make real profits for their shareholders when inflation reduces the real value of corporate debt. Since firms are not required to reflect this in their profit and loss accounts, they understate taxable profits to the extent of these gains. Some studies of the experience of selected companies indicate that, for recent years, the debt effect and the depreciation effect cancel each other out.

Although this argument has apparently convinced the Treasury staff and other opponents of depreciation reform, there are two important errors in this form of analysis. First, it is wrong to look at the past experience in which an increased inflation rate took bondholders by surprise and produced windfall gains for corporate borrowers. Such windfall gains will not continue. The statistical evidence clearly shows that the interest rate on corporate bonds rises approximately point-for-point with the inflation rate. The recent historical experience of selected companies is therefore not relevant.

It is nevertheless true that, even in the long run, when interest rates are fully adjusted, companies will deduct nominal interest payments that exceed their real interest costs. To that extent, taxable profits will understate true profits. It is not clear to what extent this understatement of profits offsets the overstatement caused by inadequate depreciation.[4]

The much more important error in the opposition argument is their focus on the *corporation* as the object of taxation. The real issue is not the effect of inflation on the *corporation's* tax liability but the effect of inflation on the taxation of *capital* used in the corporate sector. It is important to look through the corporation to the individuals and institutions that provide the equity and debt capital.

This is particularly important with respect to interest income. While corporations are able to deduct nominal interest payments and are thereby undertaxed, the lenders pay tax on nominal interest and are thereby overtaxed. If the tax rates of lenders and borrowers are equal, the gains of the corporations are just offset by the losses of the lenders. In this case, the debt effect is irrelevant and only the excess tax due to depreciation remains.

The extent to which the relevant tax rates are approximately equal remains to be determined. On the basis of what I have seen in the NBER study, I believe that the relevant weighted average of bondholders' marginal tax rates is only slightly less than the marginal tax rate of corporate borrowers. If the final facts support this conclusion, there would be little error in ignoring debt and adjusting only the tax treatment of depreciation. This solution would be particularly attractive if some method is also found for reducing the excess tax that low-income and middle-income savers now pay on the interest earned on time deposits.

Those who agree that the current depreciation rules should be changed have discussed two quite different approaches: (1) a very rapid or immediate write off of investment and (2) adjusting the cost basis of depreciation for changes in some price index. Either method would offset the current adverse consequences of inflation on the overstatement of taxable profits. I think that the second approach—adjusting the depreciation base for changes in the price level—is the better method for two quite different reasons. First, very rapid depreciation would distort management incentives and cause a misallocation of capital. The second reason is political. Very rapid depreciation would be regarded as a "tax subsidy" or "tax expenditure." Official figures would indicate a low effective tax rate. This would cause continued resistance to further reductions in the true effective tax on corporate source income.

I hope that I have now given an indication of why I think adjusting the tax laws for inflation will be the major tax reform issue in the years ahead. Adjusting for inflation involves a substantial reduction in tax revenue and a significant redistribution of the tax burden. Adjustment will therefore be resisted by those who stand to benefit from the current rules. But if something is not done to offset the impact of inflation, the fundamental process of capital formation is clearly headed for very serious trouble.

[4] The NBER study is examining these two magnitudes. The preliminary results indicate that the untaxed debt gains are large but not as large as the depreciation losses.