An Updated Agenda for Progressive Taxation

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Since the publication of the *Agenda* in 1947, remarkably little of its recommendations have seen implementation, while in spite of sporadic moves toward "simplification," the bulk of the internal revenue code and regulations has increased explosively. While many of the original recommendations remain valid, new circumstances call for a fresh look.

I. Capital Gains

The perennial ignis fatuus of special concessions to capital gains, ostensibly for the purpose of increasing investment, is again in the news. Here the sovereign remedy is the use of cumulative assessment, first proposed as a form of averaging in 1939, under which neutrality is achieved among various forms of investment and accounting systems by making the ultimate total discounted tax burden substantially independent of the time at which a gain is realized or income reported.

This is achieved by carrying forward the cumulated income and the cumulated tax balance from the previous year's return. Interest is then added at an appropriate rate to this previous tax balance to get a new cumulated tax balance, and this interest and the current year's taxable income are added to the previous cumulated income to get a new cumulated income. A global tax on this cumulated income is then calculated according to tables appropriate to the period over which the income was cumulated, and the cumulated tax balance is subtracted to get the tax currently due. The result is that the deferral of the reporting of income, by whatever means, will be equivalent to borrowing the postponed tax at the appropriate rate of interest, which can be varied from year to year as an additional fiscal policy measure.

Without cumulative assessment, even full taxation of gains as ordinary income leaves gains favorably treated by comparison to investments yielding taxable income on an annual basis. The advantage to long-term capital gains can be substantial, especially as most investors realizing large capital gains leverage their investment by using it as collateral for borrowing. Consider an investor who with a 30 percent marginal tax rate uses $10,000 of his own to acquire for $20,000 a capital asset that appreciates at 10 percent per year, on margin, borrowing $10,000 at 10 percent interest payable and deductible annually. Next combine the tax saving at 30 percent of this interest with a 7 percent increase in the loan principal to finance the interest charge. If after 20 years the asset is sold for $133,200, the taxpayer would realize a net gain of $59,900 after tax and loan repayment, compared to a net gain of only $39,900 from a 10-percent investment taxed annually with reinvestment of the after-tax yields.

Increasing, rather than decreasing, the tax rate as the holding period lengthens would thus produce a more nearly neutral tax. It would also help reduce opportunities for tax avoidance by systematically turning over more frequently those assets showing losses and deferring the realization of gains, and it would obviate the need for restrictions on the deductibility of losses that often puts the IRS in the position of playing

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"heads I win, tails you lose," with consequent resentment at the appearance of unfairness, to say nothing of the additional business generated for "tax techies." In any case, the "lock-in" effect can be substantially reduced by requiring accrued gains at time of non-arms-length transfer (as by gift or bequest) to be included in taxable income.

II. Inflation

A superficially appealing argument is often made for making some allowance for the fact that much of nominal capital gains represent inflation rather than appreciation in real value. However, to allow for this by some form of indexing procedure, if applied only to capital gains, would be grossly discriminatory against returns to capital in other forms, highly regressive, and would open the door to tax avoidance on a grand scale by arbitrage between indexed assets and nonindexed liabilities.

Strictly, one might argue for an across-the-board adjustment of all income from capital so as to eliminate the effects of inflation. In practice, however, unless the rate of inflation is extremely high, the effect of any such adjustment is likely to be a distinctly inferior tax. Not only would the required calculations be a substantial burden, but the disincentive effects of the tax would be worsened, or the progressivity of the tax would be impaired, or both.

Nominal accrued income is, indeed, the sum of real accrued income plus a percentage of net worth equal to the rate of inflation. While this may not be what is meant by a theoretical concept of net income, it is in many respects a superior tax base, being broader and hence requiring lower marginal rates to achieve a given level of revenue and progressivity.

III. Corporation Income Tax

Rather than cutting capital-gains tax, cutting the corporation income tax offers far better prospects for encouraging investment. Unlike the capital-gains tax, which is largely a tax after or below the market, affecting the net return to individuals without directly affecting rates of return or prevailing costs of obtaining capital funding, the corporate income tax is above the market, raising the rate of return required on new equity investments above the market level of capital returns by the amount of the tax. It has a double effect on the economy, not only removing purchasing power from the income stream, but in addition discouraging new investment that would add to this income stream. This means that it is impossible to talk realistically about the incidence of the tax without specifying the changes, if any, in macroeconomic policy that would accompany a change in the tax. For instance a revenue-neutral reduction in the corporation tax accompanied by an equivalent increase in the upper brackets of the individual income tax would have a stimulating effect on the economy. Thus, this move should make an attractive proposition for those who would like to stimulate the economy but feel constrained by inhibitions against increasing the nominal budget deficit.

If the economy were at full employment, this stimulus would tend to produce inflation unless countered in some way. If it is countered by a monetary contraction leading to an increase in interest rates sufficient to offset the stimulating effect of the reduction in the corporate tax on investment, the result would be to increase the returns to capital: the burden of the corporate income tax could then be considered to fall on capital generally, in the medium long run. On the other hand, if the inflationary tendency is countered by a further increase in personal income taxes and a reduced budgetary deficit, the result could be a reduction in consumer spending, an increase in investment, and ultimately an increase in wages (in the future when labor has more capital to work with and thus has a higher marginal productivity). In this scenario the burden of the tax would be on future wage-earners.

In a context of substantial unemployment, if the reduction in the tax were so foolishly managed as to retain the same level of employment, the results would be comparable to the full-employment case. However, if a revenue-neutral replacement of the corporate tax by increased upper-bracket individual income taxes is carried out without monetary stringency, employment and total national income would be increased, so that the burden of the tax could be considered to involve not only an impact on individual incomes but an even more important excess burden from its impact on investment and employment. Indeed, if the revenue-neutrality is specified in terms of currently expected tax bases, the increase in activity would turn a budgeted revenue neutrality into a realized budgetary gain. In the not-too-long run, the abolition of the corporate income tax might even turn out to be revenue-enhancing even in the absence of countervailing increases in top personal income tax rates.

In addition to its doubly depressing macroeconomic impact, the tax has serious distortionary effects on the allocation of capital between investments that can be financed with debt and those that require equity financing. Also it encourages thin equity financing, with consequent increased incidence of costly reorganizations and bankruptcies; and it lubricates mergers and takeovers of dubious merit. Thus, while reducing capital gains rates increases distortionary impacts, reducing corporate income taxes mitigates them. In spite of all of these defects, it has a fatal political popularity, due to the tendency of all of the parties concerned to believe strongly that it is paid by someone other than themselves; and in some scenarios, the impact would be felt mainly by future generations.

An important consideration is that a sudden substantial cut in the tax would lead to substantial windfall gains. An intriguing way of avoiding the creation of such windfalls, suggested by Harold Watts (pers. comm.) is to offer corporations an opportunity to contract out of future corporation income taxes by issuing to the Treasury new shares equal to some percentage of the shares outstanding at some base date, the shares being nonvoting as long as they are held by the Treasury. In a recession context, treating the market value of the shares as a revenue, either immediately or upon sale, might serve to relax budgetary constraints and authorize a fiscal stimulus to the economy. Alternatively, one might simply tolerate the inequity of the windfalls for the sake of the consequent stimulus to the economy, expecting to recoup at least some of the windfalls through capital-gains taxation.

Even this will be difficult and perhaps even impossible politically, unless some substantial tax can be kept that will be perceived as being a tax on the soulless monsters. One way to do this would be to convert the tax into a withholding at source of the individual income tax, as indeed it was to some extent in a rough sort of way before 1936. Perhaps the cleanest way of doing this would be to split the individual income tax into a flat rate normal tax from which corporate dividends would be exempt, and a graduated surtax, the corporate tax being imposed at the same rate as the normal tax. Instead of the awkward British procedure of "grossing up" net dividends to include the tax notionally withheld, a cleaner result can be achieved by allowing the normal tax paid on noncorporate income to be deducted in computing the base for the graduated surtax.

IV. Undistributed Profits

There remains the problem of deferral of surtax through the accumulation of undistributed profits in corporations. The neat and equitable answer to this problem is again the use of cumulative assessment. Absent such assessment, a very rough countervailing tax could be levied annually on the accumulated surplus of corporations at a rate equal to a suitable rate of interest applied to the surtax rate payable by a typical shareholder. Thus, for a surtax rate of 30 percent and an interest rate of 8 percent, the annual rate on accumulated surplus would be 2.4 percent.

V. Transnational Income

With the increase in the openness of the U.S. economy, the problem of how to treat income flowing across jurisdictional boundaries has become quite important. The existing treatment, starting with a greedy practice of bringing into the same tax base income that either arises in or is paid to individuals in the taxing jurisdiction, is fatally flawed, even when mitigated by a granting of a credit against the tax assessed by one jurisdiction for the tax paid to the other. At best it results in transnational income being discriminated against in that individuals with such income have to pay whichever rate happens to be higher. In practice it also raises knotty questions as to precisely which taxes shall be eligible for the credit, to inequities in which taxes that function economically as substitutes for the income tax are denied credit eligibility, to fiscal imperialism in putting pressure on foreign countries to adapt their taxes to the U.S. definition of a creditable tax, and to demands for "tax sparing," in which a country wishes to encourage particular industries by tax abatements.

It is hard to exclude debtor countries from levying a tax on income derived within their jurisdiction. One fairly clean solution would be to divide the income tax into two distinct parts, a flat-rate, "normal" tax, levied exclusively on the basis of source, and a progressive surtax, levied exclusively on the basis of residence. Source countries can then levy the source tax at rates and with exemptions and variations that suit them without having to worry about international repercussions. Questions of tax imperialism, what qualifies for the credit, and calls for tax sparing would be largely eliminated.

VI. Determining Income Source

While determining the source of an item of income is in many cases fairly clear-cut, where the operations of a business cross international boundaries many questions arise that are extremely difficult to resolve in terms that conform reasonably well to economic reality and are at the same time administratively practical. The easier but still difficult cases are those in which a product is moved from one country to another within the same organization, where a "transfer price," if it is recorded at all, often cannot be related to any economically meaningful arms-length market price. In many cases the development costs are overwhelmingly greater than the reproduction costs, and no objective basis for their allocation is possible.

Within the United States, the problem has largely been resolved, if not solved, by use of various formulas, a typical one being the "Massachusetts" formula, which obtains the state tax base by multiplying the total income tax base of the taxpayer by an equally weighted average of three ratios of sales (S), payrolls (W), and property (K) within the state to their respective firm totals:

$$\mathrm{TB}_{ij} = \mathrm{TB}_i(S_{ij}/S_j + K_{ij}/K_j + W_{ij}/W_i)/3.$$

This simple but arbitrary and capricious formula has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they ever were taught about statistics or economics. Under this formula, an accounting firm that rents its offices in Boston and has little or no Massachusetts property can reduce its Massachusetts income by nearly one-third by buying a small vacation/conference center in New Hampshire for its employees. A better formula using essentially the same data can be derived by developing a formula for predicting income for a class of firms as a linear function of the three factors and using the ratio of the predicted local income to predicted total income for a given firm as a basis for allocating actual total income:

$$\mathrm{TB}_{ij} = B_i\big[(aS_j + bK_{ij} + cW_{ij})/ (aS_i + bK_i + cW_i)\big].$$

Even so, the situs of sales is a particularly volatile element, often determined by trivial variations in the circumstances of the sale. In a fully competitive world, indeed, the net income of a firm would be attributable to capital and entrepreneurial effort, not to payrolls or sales. Another problem with source-based income taxation is that of delimiting the unit to be considered in the face of the multiplicity of interdependent ownerships to be dealt with. On the whole it would probably be better to avoid pretending that one is levying an income tax and instead levy a specific excise on the gross amount of fees, rentals, and royalties.

VII. Tax-Exempt Bonds

The existence of tax-exempt bonds is a phenomenon peculiar to the United States, a remnant of a doctrine of state sovereignty that at one time was held to require the exemption of salaries of state employees from the federal income tax. Currently its elimination is strongly resisted by states and localities because of the resulting increase in the cost of their borrowing. While some progress has indeed been made in curbing abuses of the privilege through financing capital facilities used by private firms by issuing public bonds, further issues for public purposes continue to be exempt.

This is an inefficient way for the federal government to grant aid to the states. Even if one could justify such a subvention based on the amount of state and local government borrowing, rather than on actual fiscal need, the cost is excessive. To make bonds attractive to a sufficiently large body of purchasers the interest rate must be set at a level attractive to middle-bracket taxpayers, and the loss of federal tax revenue from bonds held by upper-bracket taxpayers will be larger than the saving in interest to the issuers by the differential in marginal rates. Also, encouraging high-income taxpayers to invest in relatively safe local government bonds unduly contracts the supply of badly needed venture capital.

A substantial improvement in the situation can be secured by converting the exemption on both new and outstanding bonds into a taxable tax credit equal to a percentage of the interest sufficient to preserve the market value of the bonds. If tax-exempt bonds yield 8 percent and comparable taxable bonds yield 10 percent, a taxpayer receiving \$80 on a formerly exempt bond would obtain a credit of 25 percent of this, which would bring the total taxable income to \$100. If he is in a 20-percent bracket the credit will then offset the tax on this amount, leaving him where he was with the exemption. A taxpayer in a 35-percent bracket would be left with a net tax of \$15.

VIII. Home Ownership

Rivaling the corporation income tax in its clash between political popularity and economic rationality is the discrimination inherent in the failure to include the imputed income from home ownership in the income tax base. While administrative difficulties in obtaining an equitable appraisal of this imputed rent are serious, this objection certainly does not apply to eliminating the deductibility of property taxes by owner-occupants. It is no answer to say that landlords can deduct these taxes: they must also report as income the rents they collect to cover the tax. The deduction also involves discrimination against those paying separately for garbage collection, water supply, sewer service, and the like.

It is somewhat anomalous that more attention seems to have been given to the deduction of interest on mortgages than to the deduction for taxes. Eliminating the interest deduction increases the discrimination between mortgaged owners and owners free and clear, while mortgaged owners with other earning assets would be given an incentive to sell other assets to pay off the mortgage, decreasing the supply of venture capital.

The present system in which the political clout of the home-owning constituency has preserved the deductibility of mortgage interest, while deductibility is denied to other forms of consumer credit interest, is even worse. While home owners are besieged by lenders urging them to take out second mortgages or "home-equity loans" to consolidate their debts at more favorable rates of tax-deductible interest, renters are denied this opportunity and not only must pay higher interest rates but pay taxes on the income used to pay these charges.

This income tax discrimination against renters is the more serious in that it comes on top of other distortionary factors that operate to limit the supply of housing for the poor, such as rent control and the space hoarding that it engenders, "fiscal zoning" which attempts to exclude those whose taxes might fall short of paying the full cost of services such as schools, "NIMBY" objections to the construction of low-income housing, building codes and occupancy restrictions based on middle-class notions of adequacy, trade-union practices in defense of "turf," and in some areas outright racketeering. On the general principle that the inefficiency produced by a deviation from the optimum tends to vary as the square of the deviation, bad as the baneful effect of the income tax discrimination would be if it were the only factor at work, it becomes much worse when piled on top of these other distortionary factors working in the same direction. Reducing the income tax discrimination against renters thus deserves the vigorous support of all those genuinely concerned for the provision of affordable housing for low-income groups.

Homeowners' political clout is probably strong enough to repel a frontal attack on this discrimination by including imputed rent in the income tax base. A possible alternative would be to allow renters a deduction for an equivalent part of their rental payments. Some administrative difficulty may be encountered in determining what part of the rent represents interest on the value of the premises (and property taxes in the event these remain deductible to owner-occupants) and what corresponds to nondeductible payments for maintenance, utilities, or other services and amenities. However, even a very rough determination would be far better than no allowance at all. The main disadvantage is that, as compared with taxing imputed rent, this would result in a smaller tax base, requiring higher marginal rates and producing greater distortionary and disincentive effects in other respects, if the revenue is to be maintained. Even so, the severity of the adverse effects of the discrimination against renters would make this well worthwhile.

IX. Income from Leisure

While direct evaluation of income from leisure would be too subjective a matter to be a proper basis for taxation, there are ways in which gainful employment increases the cost of living for which some allowance should be made for the sake of equity among families with differing numbers of employed members, as well as to mitigate slightly the disincentive effect of an income tax on labor-force participation. Among the specific items to be allowed for may be listed commuting expenses, the added costs of suitable clothing and meals away from home, and reduced opportunities for bargain-hunting and do-it-yourself activities. If \$10,000 is thought of as the level of earnings at which it is reasonable to assume full-time work, a suitable formula might be a deduction from income of 40 percent of the first \$10,000 of earnings of each individual, plus possibly 20 percent of the next \$5,000, to avoid too sharp a break at an essentially arbitrary point.

REFERENCE

Vickrey, William S., *Agenda for Progressive Taxation*, New York: Ronald, 1947.