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Problems to Keep in Mind When It Comes to Tax Reform

William Fellner

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THE THEME AND THE GENERAL LINE OF ARGUMENT

It would be difficult for any economist to clarify in his own mind the problems involved in the debate about tax reform without assimilating a number of contributions concerned with the small size of the individual income tax base when compared with broader concepts of income.[1] Convinced though I feel of the importance of the materials analyzed in these contributions and of the quality of the analyses contained in them, I also feel convinced of the impracticality of one of the main suggestions they carry. This is the suggestion that a fruitful effort could be made to achieve a major broadening of the individual income tax base in order to reduce significantly the average effective tax rate in relation to taxable income. From this suggestion it would follow that, alternatively, broadening the tax base would be a promising method of acquiring a significant amount of additional revenue for fiscal programs that would otherwise be too costly if the effective tax rates on income remained unchanged.

I greatly appreciate the time Mr. Emil Sunley of the U.S. Treasury Department took in reading this paper and giving me his comments. Among my AEI colleagues, Rudolph Penner kindly read this paper and made valuable suggestions. No one except the author is, of course, responsible for the appraisals and views expressed in the paper.

[1]See Joseph A. Pechman, *Federal Tax Policy*, 3rd edition (Washington, D.C.: Brookings Institution, 1977), and also several earlier contributions of this author to which references will be found in the writings cited in this footnote. These contributions include Joseph A. Pechman and Benjamin A. Okner, *Individual Income Tax Erosion by Income Classes* (Washington, D.C.: Brookings Institution, 1972). Further, see Richard Goode, *The Individual Income Tax* (Washington, D.C.: Brookings Institution, 1976); and U.S. Department of the Treasury under the direction of David F. Bradford, *Blueprints for Basic Tax Reform* (Washington, D.C.: U.S. Department of the Treasury, January 1977) henceforth to be referred to as *Blueprints*.

The present paper will be concerned with the reasons for the impracticality of such a conception. As I see it, pressing a program to broaden the tax base as far as possible against forthcoming resistance would be likely to lead to very minor victories for the program's advocates, with spotty results that would prompt widespread disapproval. It remains a fact that changes are needed in the tax structure that would cost the Treasury some revenue, as compared with the status quo; but the resulting problems are by no means insoluble, and it would be a mistake to make the required reforms dependent on a corresponding broadening of the income tax base.

Details of the argument will be found in the following sections, but the details are of some complexity, and, before we run the risk of getting lost in them, something should be said about the basic characteristics of the problem.

The view that there is a large potential payoff in broadening the tax base—in making the concept of taxable income much more comprehensive—derives, I think, from a conception that can be described in the following three steps.

(1) A broad base, such as that of the value-added tax, would have great advantages, and it would be highly desirable to construct a base of comparable breadth. Significantly reduced tax rates would then yield the same revenue as is now yielded by much higher rates. Alternatively, reforms involving a revenue loss to the Treasury could be made compatible with the same average tax burden on the taxable income.

(2) The value-added tax itself would, however, be acceptable at best as one ingredient in a tax system in which the graduated income tax plays a large role. This is because there exists no practical method by which progressivity could be adequately introduced into the value-added tax.

(3) Hence the problem is mainly that of constructing a comprehensive tax base for a tax that does have the desired progressivity feature—the individual income tax.

What to me seems unrealistic about this conception is that it attributes a unique status to progressivity among the traits tilting the political decision-making process toward the income tax. For understandable reasons, progressivity does not in reality have this unique status in the minds of the political decision makers or of those on whose support they depend. The property of the income tax which rightly or wrongly makes it appear so attractive to participants in the political process is that it can take account of a large number of special circumstances and allow them to influence the tax burden on any given income. The size of the taxpayer's income, which under progressive taxation is included among the determinants of the tax burden per unit of income, is one of the special circumstances intended to influence the burden imposed on any given income, but it is merely *one* of these special circumstances. Concern with a large number of other circumstances results in the narrowing of the tax base through provisions permitting exclusions and deductions from broadly defined income, and a significantly broadened tax base would, of course, result from the elimination or significant reduction of these exclusions or deductions. But, while it would be an overstatement to suggest that without these exclusions and deductions the income tax would be like Hamlet without the prince of Denmark, it certainly would be like Hamlet without several of its principal characters. It would have lost a large part of its intended meaning.

Nevertheless, problems of importance undoubtedly do arise in connection with exclusions and deductions. This is not because the resulting system is "inefficient" by the standards of the pure theory of resource allocation. That should astonish no one. Once we take a preference for progressive income taxes for granted, we must also take inefficiency by those standards for granted, because even a nonprogressive income tax is inefficient, and a progressive tax system is that *a fortiori*. The political community may accept these "inefficiencies" because without them the system could not be made sufficiently equitable in a hard-to-define and yet politically relevant sense. Moreover, in the real world, any system would show inefficiencies, quite aside from the characteristics of its fiscal apparatus, and the political process may disclose a preference for one set of inefficiencies over another. What really matters for the appraisal of the exclusions and deductions is whether by and large they achieve what they are intended to achieve. These provisions make up a complicated network in which some elements may indeed perform very differently from the way they were intended to perform, so much so that revising the provisions becomes a matter of importance.

Consequently, it is important to keep an open mind about these provisions and to scrutinize the list periodically. As will be argued in this paper, it is quite likely that some desirable changes in the exclusion and deduction provisions would have tax-base broadening effects, but these would be the by-product of effects that are desirable on other grounds and the by-product accruing in the form of base-broadening would be of minor quantitative significance. Also, the most peculiar item on the list—the deductibility of interest paid for purposes other than earning taxable income—represents an unusual method of subsidizing home-ownership and the housing market. This provision can probably not be changed much in the predictable future because the political process probably cannot be reshaped to remove much of this particular subsidy.

The items making up the difference between income in the broader sense and the individual income tax base do deserve to be looked into carefully, but it would be unpromising to try to reduce the average effective income tax rate significantly by eliminating the exclusions and deductions. To repeat, the political process has shown a preference for the income tax largely because it enables policy makers to build these provisions into the tax system. Some of us researchers may have a personal belief in this or that exclusion or deduction and a dislike of others, but this in itself cannot be expected to command much public interest.

If any major revenue loss results from reforms, it would be equally unpromising to try to offset them by cutting out a significant portion of the network of exclusions and deductions. Yet some of the needed tax reforms would indeed be associated with a reduction in revenue. In the following sections, it will be argued that these reforms could be put into effect in such a way that the resulting revenue loss should pose no major problems. More specifically, (1) under a reasonable demand-management policy, correcting the individual income tax structure, including the capital-gains tax provisions, for the unjustifiable tax-raising effect of inflation would not be very costly to the Treasury; (2) the correction of corporate taxes for inflation could be phased in gradually by a method taking account of taxpayers' preferences; and (3) ending the double taxation of dividends would probably justify some degree of reduction of the revenue loss from other tax-alleviating provisions, and a partial offset of this sort would reduce somewhat the net revenue loss, which would also be reduced by the growth-promoting effect of ending the double taxation. Elaborations on these propositions will be found in the sections that follow.

Before this general section is concluded, attention should be called to certain problems that will not be elaborated upon further in this paper.

Moderating the top-bracket income tax rate of 70 percent would be a clearly reasonable measure causing negligible revenue loss, if any. This change, as well as others briefly mentioned above and discussed in some detail in the following pages, are needed for strengthening incentives to engage in productive activities, including investment. Given the characteristics of the political process, however, a viable package would presumably have to include components recognized as having a "direct" benefit specifically to the low-income groups, rather than merely the substantial indirect benefits they receive from the improved performance of the economy. Shifting the present mix of exemptions and tax credits somewhat toward tax credits would clearly add such a component to the package, given an unchanging revenue loss to the Treasury. This should be kept in mind, even if, as will be argued in this paper, exemptions express much more nearly an acceptable principle than do tax credits—except when the credits are intended to remove from the federal system a tax burden imposed on the taxpayer by other authorities. However, making concessions at the expense of this principle would do less harm than would adding to the progressivity of the tax system as a whole by moving from present methods of social security financing to financing out of the general revenue. This latter move would create the pressures for greater generosity that always develop among the beneficiaries when the false impression of a free ride is given.

WHAT TO EXPECT OF EFFORTS TO BROADEN THE BASE OF THE INDIVIDUAL INCOME TAX

Defining the "Gaps." For 1976 the Bureau of Economic Analysis (BEA) of the Department of Commerce estimates the personal income (PI) of the United States at $1,375.4 billion. For the same year Treasury experts gave a preliminary estimate of about $680 billion of the income subject to the federal individual income tax (henceforth: taxable income or TI).[2] The TI is the "tax base" for the federal individual income tax. The difference between the PI and the TI is about $700 billion, somewhat more than one-half of the PI. The federal revenue from the individual income tax is estimated at $145.3 billion for that year,[3] that is, at 21.4 percent of the TI. In relation to the PI, it amounts to 10.6 percent.

In professional work it has repeatedly been suggested that the average effective tax rate of between 21 and 22 percent could be reduced significantly by broadening the tax base, that is, by enlarging the TI, though it has not been proposed that the broadening effort could or should be carried all the way to the PI. Economists estimating the size of comprehensive tax bases differ in the additions they make to the present base, and therefore in what they regard as the total "tax expenditure" (revenue loss for the federal government) developing from the reduced size of the TI as compared with some definition of the "com-

[2]This number results from rounding the present best guess of experts, which is a shade higher than the estimate found for the TI in the *Blueprints* (see footnote 1).

[3]This is the latest official estimate, expressed on the National Income Accounts basis. The estimate is somewhat higher than that found in the *Blueprints*. Moreover, recent estimates made for the unified budget suggest that even this figure may be somewhat too low.

prehensive" tax base. But just because each expert's concept of the comprehensive base is different, it seems useful to ask what major categories of items fill the gap between the PI and the presently taxable income. After all, the concept of the PI has not been constructed with controversial tax problems in mind, and increasing the comprehensiveness of the base may be viewed as a matter of narrowing this gap.

In the first place, for 1976 there is an estimated gap of about *$300 billion* between the PI and the "adjusted gross income" (AGI). The AGI is that income concept used by the fiscal authority from which merely the exemptions, the standard deduction, and the itemized deductions need to be removed to arrive at the TI. Secondly, there is a nearly *$400 billion* gap between the AGI and the TI, this being the gap made up of the exemptions and of all deductions. Let us look at these two gaps separately.

The PI-AGI Gap: Net and Gross. For 1976 the Treasury experts estimated the AGI at about $1,070 billion.[4] As was seen, the BEA estimates the PI of the year at $1,375.4 billion, suggesting a PI-AGI gap of about $300 billion as mentioned above. This, the first of our two gaps, results from (1) a *gross gap* somewhat exceeding $400 billion, which is made up of items included in the PI but excluded from the AGI, and (2) partially offsetting items, adding up to about $100 billion, which even at present are included in the AGI but not in the PI. The net PI-AGI gap of about $300 billion can be narrowed either by reducing the items making up the gross gap somewhat exceeding $400 billion or by increasing the items making up the partially offsetting $100 billion.

Of the gross gap of $400 billion, nearly $200 billion are transfer payments, mostly governmental, and tax-free military allowances; about $70 billion consist of non-wage components of broadly defined "labor" income (fringe benefits not reflected in any current money flow to the wage earner); and an estimated $60 billion are other incomes not realized as current money income, including imputed interest and also imputed rent on owner-occupied houses.[5] At this point we may postpone any discussion of the tax-free status of the $200 billion transfers, taking this exclusion temporarily for granted. The other items described above—$70 billion and $60 billion, adding up to about $130 billion—are clearly very poor candidates for withdrawal or reduction of the exclusion privilege. The remaining $70 billion in the $400 billion

[4]This number results from rounding the present best guess of Treasury experts which is a shade higher than the estimate found for the AGI in the *Blueprints*.

[5]These numbers are derived from the estimates published in the National Income Accounts statistics, with some "filling-in of gaps" on my part.

gross gap (400 minus the sum of 200 and 130) contains some equally poor candidates, such as sick pay, moving expenses, property income earned by nonprofit organizations, and several others, but it also includes items we shall consider "potential candidates" for abolition or reduction of the exclusion privilege. Assume that one-half of the $70 billion is so considered. Even the complete abolition of the exclusion privilege for $35 billion would increase the TI by no more than about 5 percent. Indeed, the proportionate increase would in any event have to be somewhat smaller, because some of the increase in the AGI would be offset by more of the permissible exemptions and standard deduction becoming effective in reducing the TI as compared with the AGI.

Realistically we should take it for granted that a concentrated effort to obtain legislation along such lines would lead to distinctly less than a 5 percent increase in the tax base. Further, whatever the merits of including into the tax base any of the potential candidates referred to above, they would have a substantial offsetting effect on the negative side of the social balance sheet. In many cases, no strong statement could even be made on any *net* advantage. For example, among our potential candidates for withdrawal are the tax-exemption of interest on state and municipal securities. This measure would increase the TI by less than 1 percent if it is limited, as it should be in this context, to interest going to individuals, and increased pressure for federal grants would almost certainly result. Also, unless the change applied exclusively to future borrowings of the lower-level governments, there would be a shock in the bond market, caused by the significant losses imposed on holders who had acquired securities at high prices in the era of tax-exemptions. To take another of our potential candidates, disallowing all business expenses incurred by individual income recipients would probably raise the TI by between 1.5 and 2 percent, but this measure would strongly discriminate against specific types of occupation. By reforms of this sort, some of very doubtful value, the sum of the items included in the PI but not in the TI could, of course, be reduced, but the increase in the TI that could be achieved by this method without changing the tax-free treatment of transfer payments would be quite a bit less than 5 percent.

As was mentioned above, the "net" PI-AGI gap of $300 billion could be reduced not only by disallowing the exclusion from the AGI of items included in the PI, but also by adding to the AGI additional items that are not in the PI, that is, by making additions to the $100 billion worth of non-PI items already in the AGI. At present the bulk of this $100 billion consists of employee contributions to social security, of taxable annuities and pensions, and of one-half of the realized long-term capital gains.

Some proposals for adding to this $100 billion include "new" items, rather than merely enlarging present types of additions of non-PI items to the AGI. These occasionally proposed "new" additions to the AGI include currently unrealized accruals of savings held by institutions for the future benefit of individual income recipients. Gradually accumulating life insurance savings represent the most prominent item of this kind that has occasionally been proposed for inclusion. It seems very unlikely that the inclusion of unrealized accruals would be considered seriously by policy makers, but if it were, then the addition of accumulating life insurance savings could increase the TI by about 2 percent.

The main proposal made for addition to the AGI of an item not in the PI relates not to new items but to the enlargement of an item that already forms part of the $100 billion non-PI component of the AGI. The reform in question would increase the tax base by including 100 percent, instead of merely one-half, of the realized long-term capital gains into the TI. If the gains were not corrected for inflation this might conceivably raise the TI by about 3 percent.[6] But, with good reason, the reform would be considered highly objectionable if corrections for inflation were omitted and if nominal gains corresponding to practically zero or to negative real gains were taxed at an even higher rate than now. With correction for inflation the increase in TI would be much smaller. In fact, even the taxation of the real gains at the full income tax rate would have a number of harmful effects, since taxing unrealized gains runs into prohibitive difficulties and increasing the disadvantages of realization would have an adverse effect on mobility in the assets markets. Also, the higher the rate of taxation of capital gains, the more it would be necessary to make allowances for the fact that a large part of the gains had developed over a period of many years. In view of all this, the argument for the full taxation of capital gains does not stand up well at all.

Another reform envisaged by some has nothing to do with either the gross or the net PI-AGI gap. This is the inclusion of net corporate savings into the shareholders' AGI, along with the abolition of the corporate income tax. This question will be discussed later in this paper. Here it merely should be pointed out that while this method of integrating corporate with individual taxation would, of course, increase the base for individual taxation, it would not achieve the objective of reducing effective rates on a broadened tax base without a loss of revenue. The change would eliminate the corporate tax base and

[6]This guess is based on the estimate in *The Budget of the United States Government Fiscal Year 1978, Special Analysis*, p. 130, where an estimate is given of the revenue loss resulting from the application of a lower tax rate to realized capital gains than to ordinary income.

would increase the individual tax base only by roughly one-half of the eliminated corporate base.

In the foregoing discussion, we have, for the time being, left aside possible changes in the treatment of transfer payments. With this omission, the conclusion has been that very little broadening of the tax base could be accomplished by reducing the net gap between the PI and AGI. The first look at the problem—a look at items included in the PI but not in the AGI—suggested the possibility of broadening the base by distinctly less than 5 percent; and then by looking at items not in the PI that could possibly be further added to the AGI, we stretched the result upward to some extent, recognizing that much of the conjectured broadening operation would involve sacrifice of other reasonable objectives. If at such a sacrifice a reduction of the net gap between the PI and the AGI were used to broaden the tax base, the TI might perhaps be increased by between 5 and 10 percent, and the average effective rate could be reduced, without revenue loss, from the present 21.6 percent to, say, the 19.5 to 20.5 percent range. The small size of the payoff so expressed implies, of course, that the payoff of the base-broadening effort would also be small when the objective is not to reduce the average effective rate but to finance new fiscal programs that cause revenue losses.

Transfer Payments. It follows that a substantial broadening of the individual income tax base could in all probability be achieved only by one of two methods. One is the abolition of the tax-exempt status of transfer payments, particularly of government transfers, and of thereby reducing the gross as well as the net gap between the PI and the AGI. The other method is a significant reduction of the gap between the AGI and the TI, that is, of exemptions and of the deductions.

As for the transfers and the items representing the AGI-TI gap, we have seen that in 1976 nontaxable transfer payments and military allowances amounted to about $200 billion; the AGI-TI gap, consisting of exemptions (about $150 billion), the standard deduction ($115 billion), and the itemized deductions ($130 billion), added up to about $400 billion.[7] Including in the tax base $600 billion—the sum of $200 billion and $400 billion—would raise the TI by about 90 percent. Such a broadening of the tax base would indeed make it possible to reduce the average effective tax rate on the TI significantly without appreciable loss of revenue. But nothing of the sort could be seriously contemplated.

[7]The figure for exemptions and for the standard deduction are taken from *Blueprints*, p. 149, and the figure for the itemized deduction is the present tentative estimate of Treasury experts. I have rounded off the figures.

Starting with the nontaxable transfer payments, we note that probably more than two-thirds of these are made by the government, at three governmental levels. The nontaxable private transfer payments—including fellowships, scholarships, and supports resulting from charity—would mostly be regarded as deserving protection from taxation, and even if included in the AGI they would be largely protected by exemptions and the standard deduction. The donors are taxed anyway to the extent that the gifts are merely deductible in the derivation of the TI but are not credited against tax liabilities. Any proposal for stiffer taxation would presumably relate to the tax treatment of donors, not recipients.

Turning to the government transfer payments, most of which are nontaxable, taxing these with allowance for exemptions and the standard deductions would be equivalent to reducing the entitlements by the amount of the tax. It has occasionally been stressed that the beneficiaries of some of the major transfer items, particularly of social security income and of unemployment compensation, are not limited to the low-income groups. This would suggest that subjecting these transfers to the income tax would serve income-distributional objectives. However, if policy makers wanted to improve the after-tax position of the low-income classes by using the yield of increased taxes on the higher groups—a method that has not proved very effective anyway—then reducing the government transfer payments going to the upper-middle and upper income classes would be a particularly awkward way of trying for this result. For the sake of getting at the share of the middle and higher groups in roughly $150 billion worth of nontaxable government transfers—a "pot" in which social security weighs heavily—the government would have to start sending out checks in reduced amounts to a good many recipients who had paid their social security contributions in the past. Furthermore, these beneficiaries were taxed on their personal contributions to social security—one of the items included even at present in the AGI and the TI, though not in the PI—so that, if it were decided to tax the benefits, an allowance would have to be made for the fact that some proportion of the benefits represent a repayment of amounts on which taxes were already collected in the past. These considerations do not apply in the same form to government transfers other than social security, but broadening the tax base by taxing such transfers would generally be a very inefficient method of trying to improve the after-tax income position of any noteworthy section of the population.

As for government transfer payments other than social security, many of them are limited to low-income recipients, and thus not relevant to the problem we are now considering. But this is not true of unemployment compensation. Quite aside from how we may want to appraise distributional effects, a strong case can be made for reducing the disincentive effect of tax-free unemployment compensation on secondary wage earners. As has been argued repeatedly by Martin Feldstein, the problem of disincentive effects develops mainly where, jointly with a primary wage earner, a secondary earner is subject to a bracket rate that reduces appreciably the attractiveness of the after-tax wage income as compared with tax-free unemployment compensation.[8] This leads to the suggestion that a useful purpose would be served by including unemployment compensation in the AGI. The argument is valid on its own grounds, but it has nothing to do with major tax-base broadening efforts. Even in the trough year of the recent recession (1975), unemployment compensation accounted for no more than about 10 percent of the government transfers. The case for taxing transfer payments with the objective of achieving a noteworthy broadening of the tax base is weak, to say the least. At the same time the political difficulties standing in the way of such a program would be very large.

The AGI-TI Gap. We now turn to the gap between the AGI and the TI. Broadening the tax base by abolishing exemptions and the standard deduction, or by appreciably reducing these, would be a decision clearly running counter to widely accepted value judgments. These particular provisions, which now exempt a filing unit's income up to some limit, could be changed to lead to steeper progression along the income scale, and substituting tax credits for exemptions would be a way of achieving this. However, changes in tax graduation could be introduced directly rather than in this roundabout fashion; if they are not introduced directly, it is presumably because, considering the complex consequences of progression, a steepening of the graduation is not considered a particularly promising means of improving the standard of living of the bulk of the population. Also, something like a principle is involved in the proposition that up to some income level defined by the exemptions and the standard deduction, the taxpayer merely places himself in condition to earn a taxable income; no comparable principle is reflected in a procedure by which a tax liability is first computed by a prescribed formula and then part of the liabilities are cancelled through credits. Basically, a tax credit is justified only if the legislators wish to abstain from superimposing the tax liability in question upon another tax obligation of the same amount—not if they

[8]For a recent statement of his position, see Martin Feldstein, "Social Insurance," in Colin D. Campbell, ed., *Income Redistribution* (Washington, D.C.: American Enterprise Institute, 1977).

merely want to leave some small or moderate amount of income untaxed. Nevertheless, we have gradually come to use tax credits to some extent as substitutes for an increase in exemptions, and the point to be made here is that measures of this sort aim at the distribution of tax burden rather than at a reduction of average effective tax rates by tax-base broadening. Observations on this point were made at the end of the introductory section of this paper.

Itemized deductions pose a somewhat different problem. In 1976 well over one-third of these deductions—almost $50 billion out of about $130 billion—consisted of taxes paid to state and local governments.[9] It would be difficult to deny that the superimposition of state and local upon federal taxes calls for recognizing in the tax provisions that to become a federal taxpayer a person must meet the costs imposed upon him by a state and a locality.

State and local income taxes clearly represent such a cost. Also, the reconciliation of considerations expressing themselves in the federal tax structure has very little meaning if the structure can be changed signficantly by state and local taxation. As concerns state and local income taxes, this line of argument viewed in isolation would favor crediting them against the federal income tax liabilities, while the present deductibility from income provides lesser relief to all taxpayers. It also distributes the partial relief differently—refunding a relatively higher proportion of the state and local taxes to the upper than to the lower brackets. Yet full tax credits would create the belief that the imposition of income taxes is a "free lunch" for the state and local governments, and that would have very serious disadvantages. Hence, deductibility from income in the federal returns may not be a bad compromise.

It is much less clear in what part of the federal tax structure allowance should be made for nonbusiness state and local taxes other than income taxes. Making allowances for these other taxes by deductibility from income in the computation of the federal income tax is clearly arbitrary, and some experts have expressed the view that no federal relief whatever should be given for these taxes. Yet if the state and local income taxes were fully credited against the federal income tax liabilities, and the other nonbusiness taxes levied by the lower-level governments were not even deductible from income, the total loss to the federal government would be increased appreciably as compared with the status quo. In 1976 this revenue loss would have amounted to about $50 billion. Under the present provisions the federal deductions from the AGI for all state and local taxes amounted to somewhat less

[9]The figures I am using for the itemized deductions and their breakdown are based on tentative estimates of Treasury experts.

than $50 billion, and only a moderate proportion of this amount could have been the tax loss developing for the federal government through deductibility. The total tax intake of the state and local governments is estimated at about $200 billion for the year, and, while the techniques by which deductions led to a $50 billion reduction of the federal taxable income on this account may deserve reexamination, it could hardly be argued that the $50 billion compensating reduction was oversized in the aggregate.

Leaving aside the state and local taxes, the other itemized deductions expressed themselves in 1976 in a removal from the tax base of about $80 billion to $85 billion. These deductions consisted mostly of interest paid (about $40 billion), of charitable, educational, and religious contributions (about $20 billion), and of medical costs ($15 billion).[10] In terms of any general principle, the least defensible item on the list is the deductibility of interest payments on debts incurred by taxpayers showing no taxable revenue from investment undertaken with the borrowed funds. At the same time, this item of deduction, or at least the bulk of it, is presumably untouchable for political reasons. Well over one-half—probably about 60 percent—is mortgage interest on residential buildings, and the deductibility of interest on consumer credit also clearly belongs in the hard-to-justify as well as the politically hard-to-touch category. Withdrawal of the interest-deductibility on such debts would raise the TI by about 5 percent, but in all probability we must disregard this method of broadening the tax base. The deductibility provisions in question represent essentially a subsidy, and it is very difficult to imagine that they could be removed, given anything like the present play of political forces.

On the itemized deductions other than state and local taxes and interest, policy makers would scarcely consider more than minor surgery. Nor could a strong case be established for the abolition of the favored tax treatment of income components spent on charitable, educational, and religious gifts or on meeting large medical costs. Yet some allowance should probably be made for the potential yield of minor surgery on these deductibility provisions. It seems, for example, that raising the floor above which medical expenses are deductible from the present 3 percent to 4 percent of the taxpayer's AGI might raise the TI by as much as 1 percent, or even slightly more.

A Meager Payoff. Before considering the itemized deduction, we suggested that a concentrated effort at reducing the net gap between the PI and the TI might lead to a broadening of the tax base (enlarge-

[10]See footnote 8.

ment of the TI) of 5 to 10 percent. We added that few people would have strong convictions that all the adjustments needed for such a result are desirable, and some would feel strong skepticism about the existence of any positive net advantage of such a set of adjustments. This same statement can be repeated after taking a look at the itemized deductions, though the emphasis should now be placed on the upper range of the potential tax-base broadening—10 percent of the TI.

A relevant question arising in connection with these calculations relates to the proportion in which, say, a 10 percent increase in the TI would have increased the 1976 revenue from the personal income tax at given tax rates. This depends, of course, on which of the many provisions concerning exclusions and deductions would have been modified and on how much these provisions would have been changed. We would have to know whose TI would have risen and by how much. The answer is not that at constant tax rates the 1976 personal income tax revenue would necessarily have risen by about 10 percent. But if this should have turned out to be a good approximation of the correct answer, the 1976 tax revenue would probably have been about $15 billion higher than was the case. A hard-won victory of advocates of base broadening and loophole closing could conceivably lead to an analogous outcome in future years, with adjustment of the figures to the scale of the economy; yet pressing the issue to the point described by these figures would almost certainly result in changes that would be considered harmful by many reasonable observers.

As was said in the introduction, the argument developed in this paper does not invalidate the view that the individual items encountered on the way from the PI to the AGI and from the AGI to the TI need to be examined for their effects on efficiency and equity—essentially for how well or poorly they perform the functions they are believed to perform. Economists should indeed keep reminding the public of the peculiar subsidization procedure hidden behind interest-deductibility. The deductibility of nonbusiness state and local taxes other than income taxes from the federal income tax base does raise conceptual problems that may call for reexamination, even if by reasonable criteria the total deductions for the state and local tax burden represent only a modest fraction of that burden. An important problem is raised by the disincentive effect of tax-free unemployment compensation on beneficiaries with family incomes subject to marginal tax rates in the middle or higher ranges, and there are surely other problems of this sort that are worth examining. But a concern with such problems is not focused well at all by making it part of an effort to achieve a significant increase in the tax base. That effort is unpromising, and trying to force the matter as far as it could conceivably be forced would lead to decisions of very questionable quality.

Nor should tax-base broadening efforts be linked to some of the needed changes in the tax system to which we now turn. This is unnecessary and undesirable, though these changes would become associated with some amount of revenue loss.

SOME CRUCIAL PROBLEMS OF TAX REFORM

We can now turn to reforms that would be needed to remove distortions of the tax structure resulting from what will here be called *overtaxation*. By this I do not mean the imposition on specific taxpayers of a tax burden which they individually or others consider excessive by subjective standards—practically the whole taxpaying population is overtaxed by those elusive standards in most countries. Overtaxation here is used in two specific senses: (1) an extra burden resulting from the tax-raising effect of economic processes on which it would have been indefensible to rely consciously, but which nevertheless raise the tax burden in relation to incomes, as a by-product; and (2) any excess burden that develops when legal provisions levy a federal tax on a taxpayer's income which the federal government had previously taxed when that income was already his but not yet paid out to him.

Our tax structure has at least two features that should be changed because they lead to overtaxation in one of the senses just explained. One such feature—failure of the tax structure to be indexed—results in what may be called inflationary overtaxation, because whenever the price level rises the tax burden is raised in relation to real incomes without legislative action. The other feature—the taxation by the federal government first of corporate profits as a whole, including their dividend components, and then also of their dividend components separately—captures for taxation a substantial amount of income twice in succession.

The preceding section was concerned primarily not with specific reform proposals but with the difficulties standing in the way of a significant broadening of the income tax base. Figures for the year 1976—the latest year for which at least tentative data are available ex post—were used for illustration. The problems of reform discussed in this section, however, acquire substance only if they are focused on the future, as if they were put into effect now for the coming years. The orders of magnitude used for illustration will be chosen accordingly, even if this requires guesswork. First the problem of inflationary overtaxation will be considered.

Overtaxation as a Result of Inflation. The distortion resulting from inflation develops in the area of the individual income tax, as well as of the corporate income tax. As concerns the graduated individual income tax, a taxpayer whose nominal income rises in the course of an inflationary process is made subject to a higher effective tax rate because part of his higher nominal income falls in a higher tax bracket, though his real income remains unchanged. When real incomes also rise—though in an inflationary period the rise would be less than that of the nominal incomes—the inflationary upward push in the tax brackets becomes superimposed on the upward push resulting from the rise in real incomes.

Practically the whole inflationary distortion could be eliminated by raising automatically, in proportion to the rise in the general price level, the exemption limits, the tax credits, the standard deduction, and the lower and the upper limit of each successive tax bracket. This method of "tax indexation" would practically eliminate the inflation-caused "real" increase in the individual income tax revenue—that is, the increase in the current-dollar tax liability over and above the proportionate increase corresponding to the inflation rate, and hence to the proportionate increase in nominal incomes. This extra increase in revenue, caused by the upward push in the bracket structure, was estimated in 1975 at about 6 percent for 10 percent inflation, and it is likely to be roughly 3 percent for a 5 percent inflation rate.[11] In other words, at this latter inflation rate, the individual income tax revenue would rise by about 8 percent instead of by 5 percent for any given level of real income, that is, for a 5 percent increase in nominal incomes. In 1978, inflation may well turn out to be developing at a rate of about 5 percent.

In my appraisal, our policy makers have no valid excuse for not having introduced such a correction for the inflationary distortion of the individual income tax structure. The excuse occasionally voiced is that Congress has periodically reduced taxes and that the aggregate amount of these reductions has in fact taken care of the inflationary overtaxation. Even in terms of crude aggregate, the validity of this assertion depends on how far back we go. The assertion is not valid even in these crude aggregative terms if, for example, we start in 1965 when inflation started to become a problem. Over the past twelve years the periodic tax reductions have by no means completely offset the

[11]See William Fellner in collaboration with Kenneth W. Clarkson and John H. Moore, *Correcting Taxes for Inflation* (Washington, D.C.: American Enterprise Institute, 1975). The reader will find a good many valuable studies on this problem and on related ones in Henry J. Aaron, ed., *Inflation and the Income Tax* (Washington, D.C.: Brookings Institution, 1976).

inflationary distortions in terms of the aggregates. Quite aside from results observable on the aggregative level, the distribution of the tax cuts by income classes has been very different from that which would have offset the inflation-caused upward push in the bracket structure for the individual groups.

The effect on individual income classes was analyzed in an earlier study for the 1975 tax adjustments,[12] but the same effect stands out even more clearly when the 1977 tax reduction is taken as an illustration. The 1977 tax cut, applicable to the full fiscal year 1977 but with the change in withholding going into effect only on July 1, 1977, consists of a significant increase in the standard deduction for married couples, along with a minor reduction for single individuals. This is said to benefit almost exclusively the groups up to $20,000 AGI, with negligible benefit going to the groups above that level but with no harm suffered by them. Yet in reality the inflation-caused upward push in the bracket structure will raise the tax rates for all income groups that are said neither to benefit nor to suffer from the new legislation; indeed, for the average taxpaying unit, this push will start having a harmful net effect somewhere in the range between $15,000 and $20,000, at a point where the inflationary push into higher brackets starts weighing more heavily than the advantages of the increase in the standard deduction. For single individuals the break-even point will, of course, come at a lower level. This is no way to undo the inflationary tax distortion, even if it so happens that for 1977 viewed in isolation the aggregate individual income tax cut may turn out to be roughly the equivalent of the aggregate inflationary overtaxation.

Opponents of indexation have argued that Congress has the right to change the tax structure toward greater progressivity. This is clearly true, but equally clearly it does not add soundness to a practice that alleges to offset a technically hard-to-uncover inflationary effect in such a way that professional research is needed to estimate the net benefit going to some groups and the harm done to others. Assume for a moment that for 1977 the inflationary distortion would have been eliminated by the simple indexation device described above and that, by the undeniable right of Congress to change the tax structure, the inflation-corrected provisions (rather than the distorted ones) would have been modified. It is very difficult to imagine that in such a logically clear and understandable procedure tax rates would have been raised for all groups above roughly $15,000.

More generally, as Herbert Stein has put it, Congress is usually very reluctant to raise tax rates to any major group unless some specific

[12]See Fellner et al., *Correcting Taxes for Inflation*.

explanation is found for such a measure.[13] Yet the net effect of inflation, on the one hand, and of the 1975 and the 1977 tax cuts, on the other, has been an increase in the tax rates of large groups, along with cuts in the low-income regions. Without the smoke screen surrounding this increase, the increase could almost certainly not have occurred. Essentially the same argument can be expressed by pointing out that, whereas the practices of the past have been described as leading to an allocation of the "fiscal dividend" to tax cuts on the one hand, and to additional fiscal expenditures on the other, there have in fact been no tax cuts in the aggregate for more than a decade. This is because the tax cuts given to lower income groups have been offset or outweighed by unlegislated inflationary tax increases for groups in the middle and the higher ranges.

The ability of the authorities to achieve such an outcome has hinged on the fact that on no occasion was it necessary for them to "decide" to raise taxes. They could just allow tax increases to develop as a result of inflation, and then could say that all they were doing was to reduce taxes, mostly for the lower income groups and sometimes only for them. Thus they ended up channeling more resources into the public sector than they could have done if it had been necessary to introduce the tax changes explicitly and to defend programs based on tax increases for major parts of the population. Even those who like this result should recognize that nothing can be said for a practice that hides a very essential part of a continuing process in this fashion.

Nor is this simply a matter of bygones. After all, even under the best of all policies (for which one can only hope) it will take several years to reduce inflation to insignificance; and the danger of renewed upward movements of the price level will not have disappeared at that time.

As for 1978, the indefensible "revenue gain" caused by the inflationary upward push in the bracket structure may be estimated at an amount on the order of \$6 billion.[14] Since capital gains realized by individuals are also subject to what is defined as the individual income tax, an addition needs to be made to this \$6 billion. We should add roughly \$2 to \$3 billion—probably the higher figure—for the indefensible revenue gain from using the historical cost-price of assets for the

[13]See Herbert Stein, "Spending and Getting," in William Fellner, ed., *Contemporary Economic Problems 1977* (Washington, D.C.: American Enterprise Institute, 1977).

[14]This results from the assumption that without indexation the federal income tax will yield somewhat more than \$180 billion in fiscal 1978. With inflation at, say, roughly 5 percent, we should estimate the revenue gain in question (and hence the revenue loss involved in forgoing the gain) at about 3 percent of the yield of the income tax. See Fellner et al., *Correcting Taxes for Inflation*.

computation of capital gains and hence taxing nominal gains, though the real gains are sure to be smaller and may well be real losses.[15] In other words, including capital-gains taxes, the revenue loss involved in correcting the individual income tax structure for inflation would be likely to come out at not much less than $10 billion for 1978.

We now turn to the corporate income tax. The progressivity feature of this tax, and hence the corresponding bracket-push phenomenon, are of relatively minor importance. Here, the main reason why inflation has a distorting effect is similar to that arising in connection with capital gains taxes. When enterprises replace used-up inventories, a large proportion of them—the inventories valued by the first-in-first-out (FIFO) method—are revalued upward each time as a result of price inflation. The same is true of the currently used up and replaced part of plant and equipment because the tax code requires that depreciation be charged at historical cost. These revaluations of a physically unchanging capital stock become included in the reported and taxable profits of the enterprises. In 1976 these revaluations, reflecting merely inflation but nevertheless entering into the taxable profits, probably amounted to between $35 and $40 billion.[16] This is about 25 percent of the reported corporate profits of roughly $150 billion.

However, the tax distortion is not measured properly by relating the entire $35 to $40 billion to the corporate profits. As will be explained presently, to the extent that the investments were financed by borrowing, with interest deductible, the fictitious inflationary component of the gains went to the direct or indirect creditors and were taxable to them rather than to the borrowing corporation. The reported corporate profits include only that component of the fictitious inflationary revaluation gains which corresponds to the equity-financed part of the

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[15] As for 1976, a reasonable guess of the yield of the capital gains tax levied on individuals would put this yield at somewhat more than $5 billion. Any projection of such a figure to 1978 is obviously very shaky. Much of the gain taxed in the present circumstances is merely a reflection of inflation.

The foregoing estimate of the 1976 yield implies, of course, the present statute, according to which 50 percent of the realized long-term capital gains enters into the tax base. We pointed out earlier the adverse effect on the mobility of assets which would develop from the full taxation of all realized capital gains *even after correction for inflation.*

[16] For 1976 the inventory valuation adjustment and the capital consumption allowance of the BEA add up to about $30 billion. The latter of the two adjustments implies straight-line depreciation. While the BEA has reasons to proceed in this fashion for constructing the National Income Accounts, we have no reason to undo the consequences of accelerated depreciation for our purposes. In the text it will be explained why in the present context it would be unjustified to pair a correction for inflation with a shift from accelerated to straight-line depreciation. Without undoing the consequences of accelerated depreciation, the BEA adjustments would probably amount to between $5 billion and $10 billion more than the roughly $30 billion adjustment actually made.

investments. In view of this, the inflationary revaluations have probably increased the tax base of the corporations in 1976 by between $20 and $25 billion, that is, by more than one-half of the $35 to $40 billion but not by this full amount, and undoing this distortion would have caused a revenue loss of about $9 billion.[17] On the assumption that by 1978 this revenue loss will have risen to about $10 billion, and that this needs to be added to the close to $10 billion loss derived above for the individual income tax including capital gains, the total revenue loss involved in correcting for inflation could be close to $20 billion in 1978. The total cost could even exceed this amount by a small margin if provisions were included for undoing at least part of the overtaxation of creditors (a problem that, for various reasons, cannot be handled in a truly systematic fashion). We shall put the revenue loss involved in inflation correction at $20 billion for 1978, about one-half of which is accounted for by the corporate income tax.

The foregoing reasoning is based on the assumption that in 1976 the overtaxation of corporations amounted to about $9 billion, because their reported profits were inflated by about $20 billion, which is more than half of the $35 to $40 billion inflationary revaluation of the corporate capital stock. This in turn implies that the correct way of accounting for debt financing is to disallow to corporations the inflation correction on the debt-financed part of their investment, that is, on less than one-half of their investments. The reason is that the corporations are deducting interest costs in their tax returns and any gain from debt-financing that remains over and above interest cost is *to them* a real gain, not a fictitious inflationary revaluation gain.[18]

[17]The relevant problem here relates to the equity-financed and the debt-financed proportion of investment in plant and equipment and in inventories. Hence the bulk of the problem arises in connection with the nonfinancial assets of the nonfinancial corporations. Any estimate of the equity-financed proportion of these assets has implications on whether the financial assets and liabilities of the nonfinancial corporations are first netted out, with the result that the net financial liabilities plus equity are interpreted as "financing" the nonfinancial assets, or whether the gross financial liabilities plus equity are interpreted as "financing" the financial as well as the nonfinancial assets. In either case, some of the details of the calculations depend on further assumptions. However, it seems a reasonable conclusion from the data that the equity-financed proportion is more than one-half for the nonfinancial corporate sector—the range being slightly more than one-half to nearly three-quarters, depending on the assumptions, with a strong presumption that the upper end requires "forcing" the assumptions in that direction. The estimate of the orders of magnitude in the text implies a roughly 60 percent share of equity-financing in the total.

[18]In the event of debt-financing with interest cost deductible by the borrower, any inflationary revaluation of fixed capital and inventories becomes a real gain to the borrower, because the books of the borrower show such a current-dollar gain only if he pays less interest than the equivalent of inflation. In this case, the gain becomes "real" to him at the expense of the lender. The question may be raised, however, whether this real

Some experts have expressed the view that it is not enough to disallow the inflation correction on debt-financed investment because the borrowing corporation should be interpreted as having made a taxable real gain on the reduction of the real value of its outstanding debt. I consider this view unconvincing because the "real gain" so defined is an unrealized accrual based on very arbitrary methods of valuation. The "real gain" under consideration is the equivalent (expressed in terms of dollars of base-period purchasing power) of a nominal upward revaluation of the entire debt-financed plant and equipment in proportion to the general inflation rate, with the nominal value of the debt unchanged. This is the kind of real gain that is sometimes said to develop from a reduction of the real value of the outstanding debt with unchanging real value of the physical capital. But the proposition that the nominal value of the entire plant and equipment of a corporation is raised in proportion to the inflation rate observed from one year to the next is wholly arbitrary. Taxes should not be levied on an increase in net worth so "estimated" (or implied), as indeed they should generally not be levied on invariably vague estimates of unrealized accruals.[19] Hence, while I am postulating disallowance of the inflation correction on borrowed capital, I would find it unjustifiable to levy a tax on any real gain viewed as developing from the reduction of the real value of the outstanding debt.

In the discussion concerning the need to correct the corporate income tax for inflation, it has occasionally been maintained that specific stimuli to investment—mainly the investment tax credit and accelerated depreciation—have offset the adverse consequence of the inflationary overtaxation of corporations. This is unconvincing. It is arguable that to some extent these tax-alleviating measures have offset the investment-penalizing provisions that went into effect well before 1965, that is, before inflation became a serious problem. This is arguable because as compared with the 1950s, the corporate income tax has

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gain of the borrower should be viewed as *realized* (hence taxable) real gain or as an *unrealized* (hence untaxable) real gain. The text assumes that a real gain developing from the revaluation of used-up and replaced fixed capital and inventories should be regarded as realized and hence taxable. The reason is that while our practices in taxation correctly imply that any estimated upward revaluation of the capital stock represents unrealized gains insofar as the stock is not currently used up (replaced), our tax practices also imply that gains on currently replaced fixed capital and FIFO inventories are *realized* and hence taxable gains. This is presumably because the using-up and replacing operation is interpreted as involving "realization." In any event, it is much less arbitrary to assign a value to components of the capital stock that were currently purchased in a market during the accounting period than to the bulk of the capital stock that does not turn over during the period.

[19]See also footnote 18.

been reduced appreciably in relation to reported profits, and this may be interpreted as meaning that the investment tax credit (in effect most of the time since 1962) and the liberalization of write-off rules (since about 1954) have served as at least partial offsets of such long-standing handicaps to investment as, for example, the double taxation of dividends. But it cannot be argued convincingly that the investment tax credit or any other tax-alleviating measure has served as an effective offset to the tax-raising effect of the post-1965 inflation. The federal corporate income tax bears just about the same proportion to the fictitiously inflated reported profits now as it had borne to the preinflationary (thus "sound") reported profits of 1965. This proportion was 37.6 percent in 1976 as compared with 38.4 percent in 1965; including state and local taxes it was 43.5 percent in 1976 as compared with 41.4 percent in 1965. In relation to inflation-corrected profits the corporate tax burden has clearly risen significantly since the time when inflation began to have noteworthy consequences. With correction of the profits for inflation the federal corporate income tax alone now absorbs close to 45 percent of the profits and, in addition, the dividend-component of the profits is taxed separately.

The Double Taxation of the Dividend Component of Profits. The overtaxation expressing itself in taxing the dividend-component of corporate profits twice leads to (1) nonneutrality of tax treatment for corporate in comparison with noncorporate enterprise, and (2) it places a penalty on self-financing (equity-financing) relative to the debt-financing of corporate enterprise. Given the orders of magnitude in the American economy, the second of these two consequences is of much greater importance. Equity-financing is penalized as compared with debt-financing, and we should recognize that there are limits to which corporations are and should be willing to engage in debt-financing. From this it follows that the double taxation dividends impose a penalty on corporate investment in general.

Of the ways in which the double taxation in question could be eliminated three deserve to be discussed below. It will be suggested that the third method stands up best.

(1) Abolishing the corporate income tax and adding the undistributed profits to the TI of shareholders, some of whom had held their shares only for a short period during the year, would be very difficult administratively. Also, subsequent auditing may change the amount of the undistributed profits retroactively. On the other hand, this method of eliminating double taxation is often credited with the advantage of doing away with the corporation as an independent tax unit and of thus expressing the fact that the corporation is merely a legal entity

doing business for the individuals owning it. Hence the method is sometimes regarded as a desirable means of integrating corporate taxation with the taxation of individuals. But it is very questionable whether in reality any such objective could be achieved by this method, because in one way or another the corporation would have to provide the shareholders with the funds required for paying the tax on undistributed profits—and the various shareholders belong in different tax brackets. All ways of overcoming the difficulty would have substantial disadvantages, and it is unclear what the least unsatisfactory way would be. The probable effect would be an increase of the dividend component of the corporate profits in proportions that would depend significantly on the bracket rates of the individual income tax structure and would consequently vary significantly whenever the bracket rates are changed.

(2) Extending the exclusion of dividend income in the individual tax returns from the present nominal amount of $100 to all dividend income would eliminate double taxation by a different method, by one that would be very simple administratively. This method would in all probability reduce dividend payments relative to undistributed profits because much smaller pre-tax incomes of the dividend recipients would correspond to any given after-tax dividend income. Here, too, the effect would depend significantly on the bracket rates, which have in fact varied from period to period.

(3) The third method, administratively an equally simple method of eliminating double taxation, would in all probability create an incentive to increase dividend payments and to make a somewhat larger proportion of all investments subject to the scrutiny of comparative market appraisals. This method would leave all dividends taxable to the recipients and would make dividends deductible in the corporate tax returns when taxable profits are derived from the given reported pre-tax corporate profits. The reported pre-tax profits would not be affected by this deduction. The reported taxable profits would decrease, and the after-tax profits would increase; the increase would become greater with a rising dividend payout ratio, but incentives that might develop for raising that ratio would probably not be influenced much by changes in the bracket rates of the individual income tax. For example, a lowering of the bracket rates would, on the one hand, enable the corporations to pay less in dividends without reducing the after-tax income of the shareholders, but diminishing the dividend payment ratio of profit would, on the other hand, have the unwelcome consequence of lowering the after-tax profits of the corporations. In the corporate accounts, interest and dividends would be treated symmetrically, except for a difference that reflects the true nature of these

transactions. The difference would be that interest payments, representing a deductible cost in arriving at the reported pre-tax profits, would continue to diminish these profits on a correspondingly smaller amount of equity, while dividend payments would merely be deductible on the way from the reported pre-tax profits to taxable profits without diminishing the reported pre-tax profits on a correspondingly larger amount of equity.

The balance of considerations favors the third method of eliminating the double taxation. With dividends deductible in this fashion, the 1978 revenue loss would be in the $10 to $15 billion range, depending on whether we do or do not calculate as if correction for inflation had already taken place.

Of the three foregoing methods of ending the double taxation of dividends, it is true only of the first that it establishes tax neutrality between corporate and noncorporate investment regardless how the present corporate tax rate compares with the relevant tax rates to which the owners are subject. The second and the third method create corporate-noncorporate tax neutrality only to the extent that the tax rates are the same for the corporation as for its shareholders (owners). But we have seen that the advantage which the first method has in this regard would be acquired at a substantial cost. As concerns the more important problem of tax neutrality for equity-financing as compared with debt-financing, this would be restored by all three methods in the relevant sense of the term *neutrality*.

Why the Net Revenue Loss Would Be Smaller. In the foregoing pages we considered changes that could cause a revenue loss of up to about $30 billion in terms of normal 1978 magnitudes. The $30 billion is made up of close to $10 billion for the individual income tax, including capital gains; about $10 billion for the correction of corporate taxes for inflation; and about $10 billion for the elimination of the double taxation of the dividend-component of corporate profits. However, there is good reason to assume that the $10 billion revenue loss resulting from the inflation correction of business taxes would not develop in a single year but would (or could easily be made to) become "phased in" gradually. Furthermore, a fair part of the $10 billion revenue loss associated with the ending of double taxation would represent no net loss.

The correction of corporate taxes for inflation would result in a reduction not only of the taxable profits of the corporations but also of the pre-tax and the after-tax profits they may report to their shareholders on a given amount of equity. A sudden, significant reduction of reported profits—in differing proportions for different corporations—might cause a shock in the security markets. Such a change would also call for adjustments in those corporate obligations that depend on stock performance or earnings per share. The slowness and incompleteness of the shift from the FIFO to the LIFO method of inventory accounting strongly suggests resistance in the corporate sector to shifts involving a significant reduction of reported profits. Hence if the correction for inflation were made optional over a period of several years, and if completion were mandatory by the end of the period, a gradual phasing-in of the change would thereby probably be ensured.

There would be no similar tendency on the part of business to slow the revenue consequences of the elimination of the double taxation of dividends. This reform would not reduce reported pre-tax profits but would merely permit dividend payments to be deducted in deriving taxable profits, and it would increase after-tax profits. However, given this solution, a case would develop for somewhat reducing the tax concessions involved in specific provisions (for example, in the investment tax credit) by which the tax burden on given reported profits is eased at present. As was argued above, correction for inflation would not establish such a case because the tax-alleviating measures now in effect were introduced as stimuli to investment well before inflation added essentially fictitious components of major size to the taxable profits. Since 1965, when inflation really started, the joint effect of investment tax credit and accelerated depreciation on the one hand, and of inflation on the other, has been a significant rise of the tax burden in relation to inflation-corrected profits. Yet the record of the pre-1965 period does suggest that liberalized write-off rules and, from 1962 on, the investment tax credit, have worked effectively counter to the overtaxation involved in the then already prevailing practice of taxing the dividend component of profits twice. The tax burden relative to true profits did decline at that time, even if it started rising again from 1965 on. The revenue loss caused by the elimination of the double taxation of dividends could be partially offset by a reduction of the revenue loss now arising from measures intended to alleviate the tax burden. Moreover, the elimination of double taxation would strengthen investment activity and growth trends, and thus would produce a fiscal dividend of its own. It would be reasonably safe to count on this latter effect if the reduction of other tax-alleviating measures were made to represent merely a partial offset.

If for the individual income tax, including capital gains, inflation correction were adopted at one stroke, but if for corporate taxes, it were phased in gradually, and if the present business-tax alleviating measures were somewhat reduced when the double taxation of dividends was brought to an end, the revenue loss involved in the needed reforms would cause no serious problem. Quite aside from these reforms, determination to moderate the trend in fiscal expenditures would, of course, be needed to work toward a balanced budget along our future normal growth path, and thus to prevent government dissavings from diminishing the private savings available for productivity-raising investment.

Under a reasonable policy the reforms discussed here would place no excessive claims on the fiscal revenue yield of continued cyclical recovery and of subsequent normal growth. As was said in the preceding sections, revising the exclusions and deductions in the individual income structure that do not achieve their intended purpose could also contribute to collecting the revenue needed for the reforms discussed in this paper. But while some of these revisions could well have such a by-product, it would not be of large quantitative significance. At any rate, the emphasis would be misplaced if the results of the revision efforts in question were linked to the reforms needed to make the economy function more satisfactorily.

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William Fellner, a resident scholar with the American Enterprise Institute, is Sterling professor of economics emeritus at Yale University, a former member of the Council of Economic Advisers, and a past president of the American Economic Association.

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