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Income Taxes and Our National Economy

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The topic that I have been asked to discuss with you is "Income Taxes and Our National Economy." I should like to review with you in a general way some of the philosophy underlying our present tax structure and to consider what a factor the tax structure is in modern business life.

In order to understand where we are, sometimes it is necessary to look at where we have been. The income tax in its present form is not so very old, going back only to 1913.

Prior to that time, there was an income tax for a fairly brief period at the time of the Civil War and a corporation excise tax was enacted in 1909 which was in the nature of an income tax. Prior to 1913—at the end of the nineteenth century—there was also an attempt to enact an income tax. This tax was, however, declared unconstitutional in the rather famous case of *Pollock* vs. *Farmers Loan & Trust Company.*

THEORIES AND EARLIER PRACTICE

The question of what basis for taxation is fair and equitable is one to which theorists have given thought for a long time. One line of thought held that taxes should be apportioned according to the benefit that the taxpayer would expect to derive from governmental services. Another line of thought, which gave rise to the income tax, was that taxes should be apportioned according to so-called ability to pay. This concept considered that ability to pay increased more than proportionately in relation to the increase in income. Accordingly, a graduated income tax would be an appropriate form of taxation.

There was and is also economic thought to the effect that an income tax is one that is difficult to pass on. In other words, when there is competition between entities subject to varying rates of tax, those subject to the higher rates will have to absorb the excess taxes in order successfully to compete with those taxed at the lower rates.

GRADUATED TAX

The Sixteenth Amendment, which gave Congress authority to tax incomes from whatever source derived and without apportionment, was adopted to eliminate the constitutional problem posed by the *Farmers Loan & Trust Company* case.

TAXATION FOR REVENUE ONLY

It should be recognized that the tax originally contemplated was astonishingly low by present standards. The 1913 Act imposed a tax of 1 per cent on net income in excess of exemptions amounting to $4,000 for a married man, with an additional tax of 1 per cent on the amount of net income in excess of $20,000 over exemptions, graduated up to a total tax of 7 percent on net income in excess of $500,000.

In the congressional discussions at that time it is understood one of the opponents stated that the proposed tax might be used to impose heavy burdens on the people. One of the chief proponents, however, is said to have stated that if he thought the American people would ever allow the tax to rise as high as 10 per cent he would resign from public life.

Following the outbreak of World War I, rates were rapidly increased. Under the Revenue Act of 1918, combined normal and surtaxes on individuals rose as high as 77 per cent on net income in excess of $1 million. These rates were substantially reduced during the 1920s and the maximum combined rate on individuals under the Revenue Act of 1928 was 25 per cent on net income in excess of $100,000. However, the low rates of the original Revenue Act were not to be restored.

Obviously, the higher rate schedule made it increasingly important to define the income subject to tax and to consider the equity of various claims for special treatment. The courts have held that the income subject to tax under the Sixteenth Amendment is the gross income, although gross receipts must be reduced by capital invested in items sold, but not by other expenses of doing business. Deductions are a matter of legislative grace.

Congress has always attempted, however, to levy the tax on net income, but early Acts did not provide for some of the deductions that would be considered essential today. For example, in the original Revenue Act, no provision was made for depletion and by this is meant not only percentage depletion but cost depletion as well.

Although the principle of the graduated income tax was introduced in 1913, vigorously expanded with the revenue needs of World War I, and only partially contracted thereafter, it is probably correct to say that the philosophy prior to the 1930s could be expressed in the term "taxation for revenue only." In other words, the government would incur only its necessary expenses but these expenses would be apportioned among the taxpayers in accordance with the principle of ability to pay.

REDISTRIBUTION OF WEALTH

In the 1930s a new concept was introduced, namely, the concept of redistributing wealth through taxation. This concept gave another and more steeply graduated boost to tax rates. With the additional revenue requirements of World War II and the Korean War, together with the cold war in which we are now engaged, we come up to date in the rate structure.

As the rate structure of the 1930s had already come close to the point of confiscation in the top brackets, most of the additional revenue for military expenditures necessarily had to come from lower brackets. As of today, of course, we have high tax rates on all brackets, reaching 91 per cent for taxable incomes over $200,000.

In addition to taxes on individuals, there is, of course the corporate tax of 30 per cent on the first $25,000 and 52 per cent on any excess over that amount. This tax should probably be regarded as purely for revenue purposes. It is hard to justify in terms of any tax theory. It results in a double tax on income realized through corporations and has no relation to ability to pay, because the stockholders of the larger corporations may, and often do, include widows, orphans, and individuals in very low income brackets.

INFLUENCE OF TAX POLICIES

Obviously, taxes such as those presently imposed represent one of the major considerations of any transaction that might be reached by the tax.

BUSINESS LIFE

In economic theory, as previously mentioned, it is sometimes thought that an income tax will not affect business transactions but will have to be absorbed by the party on whom imposed. But where most of the business in any line is done in corporate form and corporations are subject to a fairly uniform and high rate of tax, it seems reasonable to assume that some part, if not all, of this tax gets built into the price structure.

It may also be noted that in the case of the individual income tax the greatest amount of the actual revenue is provided by the tax at the lowest rate. Tax in the highest brackets produces a comparatively small amount of revenue because of the comparatively small amount of income reached. Apparently it is felt, however, that whatever the economic disadvantages of the rate structure, it serves to make the whole tax politically more palatable to the generality of taxpayers.

Whatever may be the effect of the tax structure on ordinary manufacturing and selling transactions, it seems clear that many transactions are in special categories.

FUNCTIONING OF THE ECONOMY

For example, the sale of property, such as real estate or stock that has been held for investment for some time, may result in very substantial gains. These gains are often within the power of the holder to incur or not to incur, more or less at will. Obviously, a high rate of tax constitutes a major impediment to the normal functioning of the economy. Furthermore, the gains realized may be largely illusory because of the inflationary element and may also be entirely out of line with the individual's normal income, and thus with his ability to pay. Substantial recognition has, of course, been given to these factors through the provision of special tax rates for capital gains. Nevertheless, there is a substantial question concerning whether this tax, even though much less than the ordinary tax, may not be impairing the functioning of the economic system. It has often been noted that the security markets of the last few years have been rather thin, a situation that may tend to produce rather wide fluctuations in price on a relatively small volume of transactions. The condition is often attributed in substantial measure to the fact that individuals with large paper profits have been reluctant to realize them and thereby incur tax.

A similar situation has existed in the real estate market. Some measure of relief was provided several years ago in the case of an individual who had unrealized appreciation on his own home, when Congress permitted the deferment of any capital gain to the extent that the proceeds were promptly reinvested in a new home. This relief is not available to holders of other types of real estate. The holder of investment real estate, however, can dispose of his property without incurring the capital gains tax if he exchanges it for other real estate similarly held for investment. In recent years this situation, as you know, has given rise to a fairly substantial volume of exchange transactions. In some areas real estate people have organized more or less formal exchanges for the purpose of facilitating these transactions.

DEPRECIATION *vs.* INFLATION

Another area in which the present high tax rates, particularly when combined with the inflation of the last several years, have influenced the economy, is in the matter of depreciation. All property used in business, such as buildings or machinery and equipment, will ultimately wear out and become useless through physical decay if it has not long prior to that time become useless through obsolescence. Obviously, the cost of such property has to be recovered before the taxpayer can properly be said to have realized any income. This fact has always received theoretical recognition and taxpayers have been entitled to recover the dollar amount of their investment over the estimated useful life. Where the value of the dollar was shrinking, however, a deduction measured in terms of dollars spent a number of years ago does not provide a recovery of the real values invested. In some countries where inflation has been more extreme than here I understand that recognition has been given to this principle to the extent of allowing depreciation based on replacement cost. Although there has been some belief that this type of depreciation should also be allowed here, apparently the degree of inflation has not yet been sufficiently extreme to bring this change about. Relief of a sort was provided by the 1954 Code, however, when it allowed accelerated depreciation—either declining balance or sum-of-the-years' digits. These concepts continue to measure depreciation in terms of original cost and thus do not give direct recognition to the erosive effects of inflation on the investment. However, by allowing the taxpayer to recover a greater part of his investment in the earlier years, these methods give some measure of relief because a greater portion of the investment is recovered taxwise before too many years of inflation have set in.

BUSINESS STIMULATION

Because of the pervading importance of taxes to all of us, Congress has also seen fit to use tax policy as a means of control and, in some cases, through a measure of tax relief, as a means of stimulating certain areas of the economy. This, of course, represents some departure from the original idea of apportioning the necessary tax burden in accordance with some philosophical concept such as ability to pay. Thus, the accelerated depreciation referred to earlier was undoubtedly prompted more by the thought that it would stimulate business than by the idea that it would be fair in relation to the effect of inflation. For example, the Senate Finance Committee made this statement with respect to liberalized depreciation:

> More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of American economy liberalized depreciation policy should assist modernization and expansion of industrial capacity with resulting economic growth, increased production and a higher standard of living.
>
> Small business, and farmers particularly, have a vital stake in a more liberal and constructive depreciation policy. They are especially dependent on their current earnings or short-term loans to obtain funds for expansion. The faster recovery of capital investment provided by this Bill will permit them to secure short-term loans which would otherwise not be available.

DEPLETION

The dual problem of equity and stimulation of what is believed to be a desirable economic activity enters also into the matter of depletion and the natural-resources industries. As mentioned previously, there was no provision for depletion in the original Revenue Act, a situation obviously most unfair to natural-resource companies. This condition was soon corrected but additional problems of a practical and equitable nature were immediately faced. Cost depletion analogous to depreciation would permit recovering the actual investment in the property over the available reserves. The actual available reserves are not known, however, until the property is exhausted and therefore a reasonably good estimate may or may not be available in any given situation. Furthermore, the minerals owned by a natural-resource company are in a certain sense its capital. It can therefore be argued that treatment analogous to capital gains treatment is proper.

These considerations, together with recognition of the extra risk inherent in exploration and the desirability of stimulating the exploitation of natural resources, have led to various measures of special treatment for natural-resource companies. Perhaps the most important of these is percentage depletion, which allows an arbitrary deduction of a certain percentage of the value of the mineral product—the familiar 27½ per cent in the case of oil and gas.

Because successful oil exploration may result in gains that may be retained to a somewhat larger extent than gains from some merchandising or manufacturing operations, there has undoubtedly been a considerable interest in this form of investment. More capital has undoubtedly been made available for exploration than would have otherwise, and to this extent, the purpose of stimulating the exploitation of natural resources has in some measure been achieved.

BUSINESS COMBINATIONS

Still another area in which the tax structure has had a major effect on our business life is in the matter of business combinations.

If, as often happens, an individual or a small group succeeds in building up a business in corporate form to the point where the stock is worth substantially more than the original investment, the owners face some important tax problems which may be very serious. If the stock is sold, or the business is liquidated, the stockholders will, of course, incur heavy taxes. If, however, they continue to hold the stock until the time of their deaths, they may face other and possibly more serious tax problems. Although our topic of discussion relates to income taxes, we are all aware of the existence of the estate tax, which also imposes a heavy burden on individuals in high brackets. Incidentally, the federal estate tax is a matter that should probably be of interest to more people than are aware of the extent of its effects. Any estate of more than $60,000 must file a return and may, under some circumstances, have to pay the tax. As the estate for this purpose includes the face value of insurance, the fair market value on any real estate held, such as a home, and personal property such as an automobile or furniture, as well as stocks, bonds, and other investments, the number of persons potentially subject to tax is larger than is usually realized.

But to return to the problem of the stockholder of the closely held corporation: We may assume that he could be in a fairly high estate-tax bracket; at the same time, most of his estate may be tied up in the stock of his company for which there may be no ready market. Some measure of relief has been provided in certain situations wherein the estate tax may be payable in instalments or where the company may redeem a sufficient amount of stock to pay the taxes. These provisions are not always applicable, however, nor do they necessarily solve the stockholder's entire liquidity problem.

One of the solutions that may commend itself to the stockholder of this type of corporation is a merger with a larger, publicly held corporation. There is no immediate tax on the exchange of stock if proper precautions are observed. Upon the death of the stockholder his estate is, of course, still subject to tax. However, the estate now holds stock for which there is a more or less ready market and it may be much less difficult to raise the necessary tax money.

We are all aware of the large number of mergers that have taken place in recent years. While the tax reasons are not the only ones and may not be the most important in any given situation, they have obviously added considerable impetus to this trend.

REAL ESTATE

In the real estate field tax policy has, as you know, favored home ownership through the allowance of deductions for real estate taxes and mortgage interest paid.

Possible opportunities for tax saving, combined with the growth in property values of the last several years, have also tended to be favorable to real estate investments for income purposes. This situation has developed because tax depreciation is allowable based on the factors of physical deterioration and obsolescence. In the case of many well-conceived real estate investments, however, growth of the underlying values has offset this factor. The result has been that the investor could recover in cash a part of his investment tax-free while enjoying offsetting appreciation which kept his economic interests intact. If the appreciation is realized, it would be taxed at capital gains rates. These matters are, I am sure, very familiar to all of you but take a by-no-means unimportant place in any discussion of the effect of taxation on the national economy.

CAPITAL FORMATION

Perhaps the most important consequence of taxation is its effect on capital formation. Capital must, of course, be formed out of savings, and savings are possible only after at least certain minimum requirements have been met. If taxation absorbs, as it does, a very high percentage of the excess, it undoubtedly acts as a serious impediment to the creation of new capital investment. The graduation factor in the tax rate tends to accentuate the situation because it absorbs with particular severity the income of middle and higher bracket individuals, which income would otherwise be most readily available for investment of a risk-taking character. And, of course, the taking of risks is made less attractive by reason of the high proportion of any gains that will be claimed by the government in the event of success.

CONCLUSION

In conclusion, when such a high proportion of income is taken by taxation, the effect on the economy is necessarily great. As citizens we have, of course, the same opportunity as others to influence the over-all level of taxation. As business men and consultants to business men we have to live with the tax structure as it exists. Nevertheless we can endeavor to channel our efforts and the efforts and investments of those we serve into lines that will be most productive of after-tax income which, of course, is the real income.