- TAX REFORM -

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One of the firm rules of the Athenaeum Society has been the prohibition of papers dealing with religion and partisan politics. Observance of this rule is unquestionably one of the reasons that the Athenaeum has flourished for three quarters of a century. Observance has also, without doubt, kept many provocative and interesting subjects from coming under the discerning scrutiny of the Society. It is a noteworthy occasion when a political topic is raised about which everyone agrees for it is a suitable subject for discussion by the Athenaeum. The subject of this paper is such a topic - Tax Reform. Everyone of every political persuasion from radical to reactionary is convinced that he pays too much in taxes and further, that everyone else pays too little. Thus, with the exception of one significant group, everyone agrees that taxes should be reformed. The one group which does not agree consists of legislators. Their reasons for objecting to tax reforms will be obvious as this paper proceeds.

Before looking at tax reform, however, we ought to make sure that we really understand taxes. First, then, a definition: Taxes are an involuntary payment imposed by the state upon subjects of that state to be used for purposes which the state considers desirable. The state may be democratic or totalitarian; the citizens may have much or little

say in determining the programs which the taxes are levied to support.

Taxes are a product of civilization. They do not exist in primitive societies. Such societies dispose of their economic output differently. Primitive people are usually organized into tribes or clans under the leadership of a chief or head-man who takes charge of the economic output of the group by assigning tasks, distributing goods to the members, and enforcing the traditions of the society. Elizabeth Marshall Thomas, an anthropologist and an expert on the Bushmen has described their method of sharing the kill after a hunt: "It seems very unequal when you watch Bushmen divide the kill, yet it is their system, and in the end no person eats more than any other. That day Ukwane (the headman) gave Gai still another piece because Gai was his relative....No one doubted that he would share his large amount with others, and they were not wrong, of course; he did."

Although such an arbitrary and autocratic system could be unfair, a wise chief undoubtedly followed tradition and certain rough rules of equity. Nevertheless it is also reasonable to think that some individual or group of particular strength might get an unfair share.

As society became more civilized and complicated and states succeeded tribes, the way in which the sovereign or the state excercised power changed. Although everything in theory might still belong to the king, in practice the

individual satisfied the king by payment of a tithe or tax of one/fifth or one/tenth of his income. Such payments had the sanction of religion. In theocracies such as the Biblical Hebrews, the tax was actually collected by the priests.

The majority of men have always recognized the right of the state to claim part of their wealth for social purposes, the term "social" meaning those things which the state must do that the individual cannot. Coexistent with this attitude, however, is the belief that all possible taxes should be avoided.

Taxes have always been based on the most important economic asset of a society. In primitive times taxes were based on income, in the sense that all the products of the community were subject to disposition by the headman. For centuries the economic base of taxation was land. Actually land has continued to be a tax base in modern times long after it has declined in relative importance. In modern industrial societies incomes are the economic tax base.

One base of taxation which has kept its importance from earliest times is inheritances. The state has always claimed the right to tax the property of a decedent passing to his heirs. Probably in primitive societies the property of a decedent was confiscated or stolen unless the heirs were strong enough to prevent it. Social peace and order required that all property have an owner. The state protected the peaceful possession by the heirs in return for a share of the property.

Under the feudal system of the Middle Ages all property once again in theory belonged to the king and was

held by a series of holders bound together by a complicated hierarchy of feudal obligations. The death of one of these holders meant that the property reverted to the king or some superior in rank who was free to bestow it on anyone he saw fit. Romantic fiction is filled with stories of wicked guardians and helpless wards and of landless noblemen turned outlaw in the manner of Robin Hood. In experience this seems to have happened rather infrequently because of social disapproval. A succession tax satisfied the needs of the overlord for revenue and upheld his right to dispose of the property while confirming the heirs of the decedent in their claim to the property. Modern states still levy succession taxes although the legal, social, and economic justification has changed. Now these taxes are imposed to reduce the size of estates and thereby reduce the economic and social power which accrues to wealth. It is an economic fact that the rich get richer in spite of indifference to or even mismanagement of their assets unless the state acts to reduce their wealth. The history of many countries shows what calamities may befall a nation in which an excessive maldistribution of wealth exists.

The succession tax is an example of a tax where the incidence of taxation may be accurately determined. This is not true of many taxes. Incidence refers to the taxpayer who actually pays the tax, these whose wealth is actually reduced by payment of the tax.

The significance of incidence is illustrated by

a famous anecdote told about Colbert, finance minister to one of the Louis' of France, who was asked by the king to explain taxation.

Colbert replied, "Sire, the art of taxation is to pluck the goose so as to obtain the greatest amount of feathers for the smallest amount of hissing." No one complains about a tax which he is unaware of paying.

Legislators know about the principle of incidence instinctively and use it frequently. In the tax systems of the United States this principle explains why corporate taxes are so popular. The fact of the matter is, corporations do not pay taxes; they collect them. The incidence of corporate taxes is always shifted to someone else. The parties in the know make all the correct noises. The populist legislator castigates the giant corporations and proudly supports tax relief for the little man. The conservative law-maker waxes eloquent about another curb on the free-enterprise system. Corporate management shows the proper indignation and implores all the stockholders to write their congressmen. What has actually happened? If elasticity of demand permits, the corporation will raise the price of its products, thus passing its tax on to its customers. If the corporation cannot pass the tax along to its customers, then it passes it to its stockholders by restricting the dividends they might have received.

Ultimately a corporate tax will be paid by the public at large if the tax reduces the capital investing ability of the corporation and thereby reduces its output of goods and

services. This summary description of the situation is sufficient to explain why politicians have and always will manipulate the corporate tax rate. It is far and away the best way that a politician can hide from his constituents the fact that he has raised their taxes and lowered their standard of living.

Closely related to the principle of incidence is the principle of remoteness of the taxing authority. This means that taxes are more easily imposed and collected if they are imposed by a political entity remote from the taxpayers. For example, in Kentucky, as our locsl officials are quick to explain, taxes are imposed by the state from the capitol in Frankfort, which remits to local governments their part of the take. This is a more efficient way of raising revenue, and it allows local officials to devote their time to assuring the people that they are as unalterably opposed to planning, zoning and other forms of socialism as they are to abortion and blackbirds.

Likewise the state of Kentucky depends upon the Federal government to collect some of its taxes to ge remitted through revenue sharing or grants.

Politicians give lip service to the idea of bringing the government closer to the people, but it is the last thing that they really want when it comes to taxes. To the local politician, Federal Revenue Sharing is the best thing imaginable because be can bestow benefits on the voters without having to raise their taxes.

If the former two principles have to do with reducing the "hissing", then the next principle has to do with "plucking the goose". This is the principle of progressivity. It is an article of faith in modern industrial democracies that income taxes and death taxes should be progressive; that is, as taxable income or wealth increases the tax increases at a faster rate. It is also a fact, almost unknown, that there is no general agreement among economists and tax experts on the theoretical economic rationale for progressivity.

The first argument for progressive taxation was advanced by Adam Smith in 1776 in his book "Wealth of Nations". Smith said, "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."

This argument was developed into the equity theory of progressivity: that the state benefits the wealthy more than the poor and fairness dictates that they accordingly pay more taxes. Other economists argue from the utilitarian economics of Bentham and Mill and the hedonistic theories of Pigou. They maintain that different people are all equally efficient " pleasure machines" and that there is decreasing marginal utility associated with increasing incomes. That is, the pleasure provided by each additional increment of income is less than that provided by the previous increment.

Thus the larger the income the smaller the sacrifice in giving it up in the form of taxes. A person, thus, with a high income must pay at a higher rate in order to treat him as fairly as the person with the lower income and thus equalize the sacrifice of each.

The third school holds that the equity and marginal utility hypotheses can never be tested. It rests its case for progressivity on the pragmatic grounds that experience shows that society is more stable when disparities in income and wealth are reduced and that progressive taxes are efficient levelers.

What other principles of taxation should we review? There is the principle of horizontal equity, which, stated simply, means that people with like incomes should pay a like tax. This is the principle on which the non-taxability of municipal bond interest is usually attacked. There is the principle of certainty which means that taxpayers should be in no doubt about the amount of tax they should pay. There is the principle of convenience which means that taxes should be collected from the taxpayer so as to disrupt his affairs as little as possible. Also, the tax collection system should be as efficient as possible. Finally, tax rates should be as low as possible. All of these principles were explained by Adam Smith in "Wealth of Nations" and have not been improved upon since.

Raising money for the government, however, is not the only purpose of the tax system. We must consider the role of taxes in advancing public policy. This is the origin of the "loophole", which may be defined as any provision of the tax code which benefits someone I don't like.

Taxes obviously remove money from the pockets of the citizens. By adjusting deductions, credits for money spent for various purposes, and including or excluding certain items of income, the government can direct the flow of spending into preferred areas of the economy. Congress has at different times stimulated private housing, capital investment, charitable giving, oil and gas exploration, and encouraged matrimony over the single life, to mention only a few areas.

All of these actions have been roundly condemned by some highly vocal groups as unjustifiable loopholes favoring unworthy special interests. The incentives given to home ownership are said to encourage energy wasteful private dwellings rather than energy efficient multi-family housing or to favor the middle class over the poor. The oil depletion allowance is the favorite loophole of the Liberals but the Woman's Liberation Movement is now equaling the Liberals in stridency protesting the differences in the code between married couples and single persons, who are largely women.

Unquestionably the problems of loopholes will continue regardless of any efforts to reform the tax system as long as Congress uses the tax system to direct investment and spending because these questions involve value judgments on which some people disagree.

And Congress will continue to use the tax system to promote public policies because it is efficient.

For the economy an even broader question of public policy is this: Should the tax system encourage consumption or investment? A strong economy must have capital formation if the standard of living of the entire population is to advance. This is an economic fact based upon the principle known as the Law of Diminishing Returns. This law explains why output will fall if one factor of production is held constant even though another factor is increased . Thus a rising population living off a fixed inventory of natural resources will see its standard of living fall without the multiplier effect of capital investment . The tax system can either facilitate or make difficult the process of capital formation.

In the light of all these principles let us examine the proposed tax reforms which Congress will be asked to pass.

It is thought that the Administration will propose a cut in tax rates for all individuals. Congress will agree soon and publicly on this point if only because tax cuts are sure-fire ways to reelection.

It will be recommended that capital gains on sale of assets be taxed as ordinary income instead of at preferential rates. The argument will be advanced that the difference between ordinary income and capital gains induces efforts to convert ordinary income into capital gains which "produce

little or no social value but are productive of ample private gain", to quote Treasury Secretary Blumenthal. Leaving aside the question of whether or not there is something wrong with trying to achieve "ample private gains" , the Secretary's argument is deceptively incomplete. An equally strong case can be made for the proposition that taxes should be eliminated on capital gains entirely. Capital investments are assets that yield a flow of income over time. Thus the present worth of an asset is the discounted value of the expected flow of income. When expectations change about the value of this expected flow, the value of the capital investment changes. It is upon this change that the tax is levied, but only when the asset is sold. Thus when changes in capital values are taxed, it means that the income from capital is taxed twice - once when it is expected and once when it is realized. By contrast, the income from labor is taxed only once, when it is realized in the form of wages. Far from being any bonanza, capital gains taxes penalize the return to capital; and here the incidence of taxation problem returns to haunt us, for by penalizing a high rate of capital investment which is critical in increasing productivity and employment, the burden of the capital gains tax falls, in the final analysis, most heavily on labor. Not only is the principal of equity violated as to one class of citizens, property-owners, but the national interest suffers. From the pragmatic, political point of view taxation of capital gains will reduce the "hissing" . It will be beyond the power of Congress to

explain a subtle argument such as this to the average citizen even if Congress understands it. Judging from the Senators and representatives from Kentucky it is extremely doubtful that Congress will understand.

However, since capital formation is currently recognized to be urgent, something must be done to encourage it. The seriousness of the problem is indicated by the fact that capital formation in the United States is at the lowest rate of any industrialized nation, a condition which is not new but has prevailed for the past few years. Some authorities estimate that as much as $20 billion annually could be withdrawn from the flow of investible funds by taxing capital gains at ordinary income tax rates. What Reform takes away it must somehow return.

The reform that is expected to do this is called "integration" of corporate and individual income. It is designed to eliminate the so-called "double tax" on corporate dividends. The idea is to tax stockholders with their proportionate part of corporate income, somewhat as partners are taxed with partnership income. At least three different ways have been proposed to accomplish this, none of which is satisfactory on either theoretical or practical grounds. This subject is too involved to consider in this brief paper.

I cannot believe that integration will be enacted. What legislator in his right mind would vote for it? If it should be passed Congress will lose a favorite whipping boy, but more important, it would lose its ability to shift the incidence of taxation by manipulating corporate tax rates.

I n summary then, it appears that in tax reform as in most other human endeavors, the more things change, the more they remain the same. Loopholes, exemptions, exclusions, and preferences are every Congressman's stock in trade and none wants to see his inventory wiped out. After reform has been enacted the members of this Society will still agree that each one of them pays too much in taxes, and further that everyone else pays too little. But here, I believe, is where I came in.

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