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GROWTH AND FEDERAL INCOME TAXES

RICHARD V. CARPENTER †

*Remota justitia, quid sunt regna nisi magna latrocinia.*¹

PROPER tax policy should seek a more or less mobile balance between the competing interests of such contrasting groups as earners and investors, consumers and producers, rich and poor, and citizens and government. We say *mobile* because such balance will shift—if ever so slightly—with every development in the social economy. Ideally the balance should be determined by economic and ethical factors directed toward the general welfare. In actuality, of course, it will be fixed in large part by the relative political powers of the sectors of society which are affected. We can identify at least three principal approaches in this country to the question of tax policy, each characterized by the preference it would bestow on one sector of society over another. To enumerate them briefly, one approach favors lower-income families whose incomes may be expected to be spent in large part on consumer goods,² another tends to favor entrepreneurs and the business and investment classes,³ while a third is disinclined to favor any class of taxpayers but, instead, advocates increasing the proportion of gross national income appropriated for the socialized activities of the state.⁴

The supporters of the three respective approaches all presumably would agree on the desirability of one goal—

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¹ Attributed to St. Augustine. Freely translated: "Absent justice, government is nothing more than large scale racketeering."

² AMERICANS FOR DEMOCRATIC ACTION, GUIDE TO POLITICS, 1954, at 14 (Howe & Schlesinger ed.).

³ COMMITTEE FOR ECONOMIC DEVELOPMENT, GROWTH AND TAXES, STEPS FOR 1961.

⁴ GALBRAITH, THE AFFLUENT SOCIETY (1958).

industrial growth. They disagree on means. The rate of economic growth became a prime political issue in the last presidential campaign. Over a long period of time the growth of the American economy is said to have averaged 3 per cent per year and certainly this growth has heretofore yielded unprecedented prosperity for our country. During the past few years, however, this rate is said to have slowed to about 2.5 per cent per year or less and authorities generally agree that this is inadequate for the general welfare. Walter W. Heller, reputed to be the favorite economist for the present administration, advances the premises that our labor force rises by 1.5 per cent per year and normally the average output per man increases 2 per cent per year. From these premises he concludes that we must improve our annual growth rate to at least 3.5 per cent just to hold our own—let alone to achieve desired new goals.⁵ As a matter of fact he may be overly conservative in his figures inasmuch as population experts plausibly predict that our labor force will increase much more rapidly during the 1960's than heretofore. The children representing the so-called "population explosion" of wartime and early post-war years will for the first time be seeking jobs. Since the war our over-all population has been increasing more rapidly than our labor force, but now we may expect the labor force to increase at a faster rate than our population.

In any event, it is interesting to compare Heller's figures with the economic growth rates which he cites for other industrial nations: Germany, Japan and Italy whose rates are said to exceed 5 per cent; Holland and Switzerland exceeding 4 per cent; and Sweden exceeding 3 per cent. We may have some mental reservations about the precise accuracy of these estimated figures, but they still furnish some basis for tentative comparison. Practically all other industrial countries of the free world (except the United Kingdom) outstrip us in the rate of industrial expansion. In appraising these comparative figures some persons take

⁵ Life, March 10, 1961, p. 24.

solace in the fact that our growth rate is expressed in percentages of a gross national production which is already the highest in the world, whereas other countries start from substantially lower levels. It is disturbing, however, to see their growth rates continuing at high rates even as their industries expand,⁶ whereas ours appears to be slowing down. Obviously the increasing prosperity and brightening prospects of the nations of the European Community and of Japan are the most hopeful portents on the horizon of foreign affairs. The United States may take some credit for having initiated this prosperity in the first instance by adopting the Marshall Plan during the Truman administration. But the pace of advance of these nations also highlights by contrast the deceleration of our own progress. This is what should cause us concern. It challenges us to improve our own rate of industrial growth in order to maintain our high standard of living and, more important, to avoid increasing unemployment.

The question is how can taxes be apportioned and imposed so as to stimulate industrial growth or, perhaps more accurately, to hold the economy back the least. Suppose we imagine our industrial economy as a troika drawn by three horses representing, respectively, the small-income and working class (consumers), business and the big-income class (investors), and last but not least, the government. Proponents of the first tax approach described in our opening paragraph contend that if we feed and pamper the first horse, all will be well. They point to the overcapacity existing in certain industries and conclude that the weak spot in our economy lies in underconsumption. If we divert more disposable income into the hands of consumers by increasing wages and/or decreasing their taxes, they will spend it on consumer goods and the rest of the economy will take care of itself. The second horse will pull harder to keep up with the first (supply rising to meet demand), and the efforts of the first two will ease

⁶ This is true despite cyclical variations. During 1962 there appears to have been some hesitation in the growth rate of some countries in the European community.

the load and give a "second wind" to the third horse (increased production will broaden the tax base and produce more tax income). In this happy view the troika will soon be galloping out of the woods and leaving the wolves far behind.

Proponents of the second tax approach, on the other hand, believe it is the second horse whose undernourishment and stumbling gait threatens the progress of the troika. They point to the fact that for many years the first and third horses have been getting an ever-increasing share of the available oats (accompanied by spiraling prices and, more recently, by shrinking profit margins).⁷ In our current economy, consumer spending is the one factor which has most consistently remained at all-time highs and has continued upward. It therefore hardly seems reasonable to blame underconsumption for our lagging growth and high unemployment. On the contrary our weakness seems to lie in lagging capital investment for the improvement and expansion of our industrial plant, explained by the cloudy outlook for profits.

Proponents for the third tax approach, of course, back the third horse of the troika. Professor John K. Galbraith has published a best-selling defense of their position, curiously based on moralistic condemnation of the vulgarities of money-spending status seekers in an affluent society.⁸ Professor Galbraith is a clever and witty pamphleteer who believes that material wealth in our society has already so far outstripped our rational wants that we should no longer seek to expand productivity for the private sector of society. He speaks of "the thralldom of a myth"—the myth "that production by its overpowering importance and its ineluctable difficulty, is the central problem of our lives." He would avoid the complexity of inducing growth by encouraging unpredictable individuals to spend money for consumer goods or for modernizing and expanding productive facilities. In lieu thereof he would leave to the wise and

⁷ First National City Bank, Monthly Economic Letter, April 1962, pp. 39-42.

⁸ GALBRAITH, *op. cit. supra* note 4.

good philosophers who run our government the choice of spending money for public buildings and monuments, education and art, public parks and highways and other non-productive purposes—possibly for prestige excursions to the moon. The program calls to mind the tongue-in-cheek (we hope) fable recounted somewhere by Lord Keynes. Once upon a time a depression-ridden nation went to war and found that war revitalized its economy with prices high and all men employed and happy. Then came peace and the cabinet members of the government gloomily met to face the prospect of renewed depression. The cabinet, however, hit on a brilliant solution by deciding to continue its mammoth purchases of munitions which the people could fire happily and harmlessly into space in a continuous Fourth of July celebration. Upon this public disposal of excess production the national economy continued in high gear and everybody lived happily ever after.

The problem, however, is not simply one of dividing the national wealth among the sectors of society to see that money gets into circulation quickly. It is a question also of encouraging stronger incentives to create more wealth—namely, to stimulate economic growth. Certainly the nation must spend a good portion of its income on consumer goods. This is essential for its well-being and enjoyment of life. But our economy, including our industrial capacity, is also geared to production of capital goods for new development and expansion—the bone and brawn of economic growth. When demand falters for capital goods we naturally must expect some excess capacity to show up in our industrial plant. Under such circumstances it smacks of folly to seek to cure the imbalance by government policies which further jeopardize the producers' prospect of profits. Yet such jeopardy seems implicit in policies purporting to stimulate consumer buying by means of massive government expenditures for nonproductive purposes or of encouraging wage increases which are not economically justified. In the one case producers' profits are threatened by high taxes, in the other by high costs. It is fallacious (and possibly intellectually dishonest) to seek to justify wage increases on the ground of labor's increased productivity when the

latter results solely from industry's increased investment in more efficient machinery. In such case any wage hike should rightly be subject to industry's prior claim for a profit increase proportionate to its increased investment.

Consumption contributes to economic growth only indirectly by stimulating the improvement and expansion of industry to produce more and better goods to meet the demand. Even demand, however, will fail to stimulate production and supply when the government artificially creates that demand under conditions which do not afford adequate profit incentives for productive investment. Business may sometimes lose confidence that simple price increases are feasible to offset higher taxes and costs. They may fear price increases will invite retaliatory legislation or administrative action or they may worry about pricing themselves above the reach of those customers who live on relatively fixed incomes. Certainly today they have good reason to foresee strengthening competition from foreign industries operating in political climates more favorable to private enterprise and profit. Yet we know the expectation of profits is a *sine qua non* for industrial growth in a free economy. The United States Department of Commerce has come to recognize the range and margin of corporate profits as leading indicators forecasting expansion and contraction in business cycles.⁹ The National Bureau of Economic Research soberly states: "Active and prospective profits play a vital role in the generation of business cycles. By providing the incentives as well as the wherewithal for investment, by generating optimism or pessimism about the business outlook, by stimulating expansion or forcing retrenchment, profits (or losses) occupy a strategic position in a private enterprise economy."¹⁰

Nonproductive public disbursements paid by deficit financing or by money siphoned off in the form of high taxes may, in the long run, be overshadowed by the volume

⁹ Business Cycle Developments, Sept. 1962, at 18-29 (Series 16, 18 & 22 in Chart 1 and Tables 1 & 2).

¹⁰ 1 NATIONAL BUREAU OF ECONOMIC RESEARCH, BUSINESS CYCLE INDICATORS 67 (1961).

of private investment which it effectively deters. In any event such nonproductive public disbursements will stimulate the economy only as long as they continue to be made. Once they are cut off the economy will be worse than ever. In combatting recession the difference between government spending for pyramids and sphinxes, on the one hand, and profit-motivated expenditures for industrial expansion, on the other, can be compared to the difference between paying \$1,000 to an indigent man over six-months time to chip rocks for your garden wall by sledge and chisel, and by paying him the same amount to buy automatic stone-cutting and polishing tools. In the first instance you will still have an indigent man on your hands at the end of the six months. In the second case the man should no longer be indigent—he will have tools which he can use with profit. Of course, in the first case, you would end up with a wall in your garden just as Egypt has its sphinx and pyramids, but walls and pyramids are inert objects which contribute little to the dynamics of an economic system. It is not the corn we eat nor even the corn we pile up in overflowing granaries which makes for economic growth; the only corn which grows is the corn we plant in the ground. If we can improve the strain by hybridization, so much the better. Similarly, the seed of our economy is the money we plough into the creation, expansion and improvement of facilities to produce more and better goods.

This long introduction brings us abruptly to the avowed subject of this paper—the effect of tax policies on our economic growth. Many factors undoubtedly have contributed to the sluggishness of our growth—practically all of them operating through their depressant effect on the prospect of profits. In this paper we propose to direct our remarks principally to the peculiarities of our tax structure—that being the factor for which our government has the most direct responsibility. On two counts our federal tax laws may be blamed for discouraging and slowing business growth—the excessive double bite which income taxes take from corporate income and again from such income when distributed to shareholders in the form of dividends, and

second, the prolonged time required under our tax policies for a taxpayer to recoup a capital investment tax-free through the allowance of depreciation deductions against taxable income. On July 11, 1962 the Treasury issued regulations substantially liberalizing its long standing depreciation policies¹¹ but even with these much needed changes our depreciation allowances still remain the least liberal in the free world.

TAX RATES AND DOUBLE TAXATION

The federal income tax rate on each \$100 of an industrial corporation is generally \$52. If the corporation then distributed to a stockholder as a dividend the \$48 which it retained after taxes, the stockholder in turn would be taxed thereon in accordance with his top tax bracket. Thus an individual with an income of \$16,000 who received such a \$48 dividend would be compelled to pay 50 per cent thereof to the government in the form of personal income tax. Under these circumstances the United States government would be collecting 76 per cent of all industrial profits while the stockholders, who theoretically are the ultimate owners of the industrial enterprise under our system of "private enterprise", would be entitled to only 24 per cent. Moreover, this result would be reached without considering the impact of federal excise taxes and of state and local taxes.

In the 1954 Code, Congress did permit some minimal relief from this burden of double taxation—namely, taxation on profits in the hands of the corporation and then again on the same profits in the hands of stockholders to whom they are distributed in the form of dividends. Section 116 was drafted to permit the individual stockholder to exclude from his gross income the first \$50 in dividends which he received in any tax year. This exclusion may be popular with a relatively large number of voters who happen to own only a few shares of stock, but it has insignificant

¹¹ Rev. Proc. 62-21, 1962 INT. REV. BULL. No. 30, at 5.

effect on larger investors whose investment decisions bear strongly on the industrial growth rate of the country. In addition, Congress allows shareholders a credit against their personal income tax measured by 4 per cent of dividends included in their gross income. Thus a shareholder receiving \$100 in dividends (over and above the \$50 exclusion) would have a credit of \$4 which he could apply against his tax bill whether his top bracket was 20 per cent or 91 per cent. Minimal as has been the relief afforded by this 4 per cent dividend tax credit, the present treasury officials have actually advocated its repeal.

In contrast with this harsh insistence by our officials on double taxation of dividends, other governments have gone a long way to reduce such double taxation and some have completely eliminated it. Both Belgium and Italy completely exempt shareholders from the standard income tax on dividends to the extent the corporation has paid such tax on the same income. The United Kingdom relieves a corporation of the standard income tax on the portion of profits which it distributes to shareholders—although the corporation is required to withhold such tax and pay it on account of the respective shareholders. Germany taxes distributed corporate profits at the maximum rate of 15 per cent as opposed to the maximum 51 per cent rate imposed on undistributed profits. Canada grants to shareholders a 20 per cent tax credit on the amount of dividends received from a Canadian corporation. These provisions are described in greater detail in Schedule A appended to this article.

POLICIES GOVERNING DEPRECIATION DEDUCTIONS

To determine actual net income, according to elementary principles of accounting, one must deduct from gross income, among other things, a reasonable amount representing the wear, tear and obsolescence of physical property which has been used in the production of the income. Traditionally the Treasury has permitted taxpayers to recover tax-free the historical costs of such physical assets by allowing them depreciation deductions spread over the estimated useful

life of the assets. Up until July 11, 1962 the only official formal guide in this country for estimating the lives of various classes of property was *Bulletin F* which had been last revised in 1942. On July 11, 1962 the Internal Revenue Service at long last replaced *Bulletin F* with *Revenue Procedure 62-21*¹² which gives us greatly simplified and liberalized guide lines for depreciation. It is a substantial improvement over the bulletin which it replaced but it is questionable whether it has gone far enough. *Bulletin F* complicated tax accounting unduly by requiring the detailed calculation of depreciation on a vast number of explicit categories of depreciable property. The new regulation reduces these categories to about seventy-five broad classes of assets. For most taxpayers it is expected that three or four guidelines will cover all their depreciable assets. This is all to the good.

An even worse feature of *Bulletin F* has been that it attributed overlong lives to the various categories of depreciable assets. True, it purported to allow taxpayers to calculate their depreciation deductions in accordance with their individual replacement practices, and apparently many big taxpayers, better represented by tax accountants and attorneys, have managed to benefit by this provision. Some of these taxpayers, in fact, now complain that the new procedure offers them no advantage. By and large, however, government tax men have been loath to depart from the letter of *Bulletin F* and very likely most taxpayers have been writing off their depreciable assets no faster than indicated by *Bulletin F*. The guidelines under the new regulation should relieve this situation, at least temporarily, by establishing shorter norms for estimating the useful life of depreciable assets. To give a single example: *Bulletin F* gave composite lives ranging from fifteen to twenty-five years on machinery and equipment in the metal products industries, which would result in straight-line depreciation rates of 6-2/3 per cent to 4 per cent per annum. In contrast the new guidelines accord an estimated twelve-year life to

¹² *Ibid.*

production machinery and equipment for fabricated metal products, thus indicating a proper depreciation rate of $8\frac{1}{2}$ per cent on a straight-line basis. Nevertheless the new regulation may conceal a joker. A taxpayer may use the new guidelines as a matter of right and without question by the Revenue Service for only an initial period of three years. At the end of the trial period the taxpayer must justify his depreciation rate by proof that such rate is in accord with his replacement practice. He can meet the burden of such proof by means of a complicated formula based on reserve ratios—viz., ratios of the depreciation reserve for assets in various guideline classes to the original cost or other tax basis of such assets. The purpose and normal effect of liberalized depreciation is to stimulate industrial investment and replacement. The government insists in taking back the liberalized benefits from a taxpayer in each instance unless the taxpayer can show he has kept up a satisfactory rate of replacement. Our government leaves nothing to chance. It continues to ride taxpayers with a short rein and a curb bit.

The real issue in this problem turns on whether depreciation deductions should be tied so closely to the actual useful life of the depreciable assets, and if so tied, then whether deductions should be spread evenly over the life of the asset on a straight-line basis or, in the alternative, should be accelerated by allowing early deductions in proportionately greater amounts. After all, it is common experience that a newly purchased asset (*e.g.*, a motor car) is subject to a greater loss in market value in the first year of ownership than in later years. Congress gave its own answer to the latter part of this question when it enacted Section 167(b) of the 1954 Code which permits some acceleration of deductions for depreciation in the early years of the estimated life of a physical asset. Thus the declining-balance method permits the use of a depreciation rate not exceeding twice the depreciation rate which would be allowable under the straight-line method. For example, in the case of an asset costing \$100 with a life of 12 years imputed to it under the new guidelines, the annual depreciation rate under the straight-line method

would be $8\frac{1}{2}$ per cent or \$8.50 each year for 12 years. Under the declining-balance method the taxpayer would be allowed to double the depreciation rate to 17 per cent but such doubled rate could be taken each year only on the declining balance of the asset's historical cost (or other tax basis) after deduction of previous depreciation charges. Thus in the first year the taxpayer could deduct 17 per cent of \$100 or \$17, in the second year 17 per cent of \$83 or \$14.10, in the third year 17 per cent of \$68.90 or \$11.70 and so on. In the first three years a taxpayer could thus charge off an aggregate of 42.8 per cent of the machine's cost.

If we compared even these liberalized depreciation practices with those of foreign countries, we would see that in the first three years France would probably permit a taxpayer to charge off 75.57 per cent on most machines, West Germany 57.8 per cent and substantially more if the machine were a so-called "basic industry," and Sweden about 71 per cent. Due to many variances in the depreciation practices of different countries it is dangerous to try to oversimplify comparisons; Schedule B appended hereto describes in some detail the depreciation policies of leading foreign industrial countries. By and large, foreign governments are far more liberal to taxpayers in this area than is our own government. Sweden's experimentation with depreciation policies is particularly interesting because of its reputation as a "socialist state" committed to a planned economy. From 1938 to 1955 Sweden permitted taxpayers to write off and deduct their capital costs whenever they saw fit—even to the extreme of allowing deduction of 100 per cent of the cost in the year of acquisition of assets. This "free depreciation" policy was recommended by a 1936 tax committee when Sweden, concerned with the depression of the 1930's, sought devices to limit or forestall future depressions. It was believed that high depreciation deductions in good years and low depreciation charges in bad years would tend to stabilize industrial earnings. In post-war years the policy was found to contribute to inflation because it overstimulated capital investment. In

1955 Sweden therefore modified its policy to that described in Schedule B.¹³

Why should Congress limit accelerated depreciation on the declining-balance method to *double* the straight-line rate? Why not triple? And why should taxpayers be required to justify their depreciation rates even when they are within the norms of the guidelines set out in the new regulation? Certainly it would simplify taxpayers' accounting procedures if they were permitted to compute their depreciation in accordance with the guidelines without any labored and involved calculation of reserve ratios. Even if a taxpayer's depreciation deductions might sometimes exceed the amount justified by his replacement practices, the net result would be merely a minor additional acceleration of write-offs. In no case over the long run would it give a taxpayer aggregate deductions in excess of what he had actually paid for his depreciable assets.

In discussing the great size of the government's tax take from corporate profits, we saw that the government is the major participant in every enterprise of consequence. The entrepreneurs put up the capital and take the risk while the government gets the lion's share of the profits, if any, without risk. If two men enter into a speculative enterprise but one of them alone puts up all the required capital, we see the reason and justice of requiring the repayment of the capital before distributing the profits. Applying the same principle to depreciation policies a good argument could be made in equity to permit a taxpayer to recover his investment in depreciable assets before letting the government siphon off the greater part of the profits in the form of taxes.

Hard-headed economics, moreover, also indicates the desirability of accelerating depreciation write-offs. Capital investment is inevitably a calculated risk. A taxpayer cannot know with certainty whether he will profit from a capital investment or will lose part or all of the money

¹³ HARVARD UNIVERSITY, 1959 HARVARD TAX SERIES, TAXATION IN SWEDEN 86 (1959).

he invests. Existing portents may seem to support his business judgment as to the near term, but his sense of risk will normally increase progressively as he is forced to look further and further into the future for the ultimate payoff on his investment. Under the circumstances any acceleration of depreciation deductions seems eminently suited to enhance the confidence of a prospective investor, to spur investment and to stimulate industrial growth. After all, we must bear in mind that such acceleration does not result in tax avoidance but only in tax deferment. In the meanwhile it gives taxpayers a greater cash flow out of which to pay for continued modernization and expansion. This would go a long way to offset the hardship of the past twenty years when slow write-offs have been inadequate to protect against rising costs (namely, for replacing the property when it is finally discarded) caused by inflation incident to war and crisis, as well as the slow inflation which seems deliberately built into some of our government policies.

A final argument in favor of liberalizing our depreciation policies is that they should be brought more in line with the policies of other industrial countries with whom we are in competition. Otherwise our business works under a substantial competitive disadvantage.

INVESTMENT TAX CREDIT

For two years the current administration has been pushing the idea of mitigating our harsh depreciation policies by means of an investment tax credit measured by a fixed percentage of new industrial investment. The taxpayer would be allowed to apply this credit against his taxes for the year in which he makes an industrial investment. It was not a new idea since England, Belgium and the Netherlands have been using various analogous types of investment allowances or deductions in addition to regular depreciation deductions.¹⁴ The new tax law of 1962, finally enacted by

¹⁴ See Schedule B.

Congress and signed by the President on October 16, does now provide for an investment tax credit fixed at seven per cent of new industrial investment. By its terms a taxpayer investing \$100 in new property will (subject to defined limitations) receive a credit of \$7 which he can apply against his tax bill, but at the same time the tax basis of the new property, against which he must compute his depreciation deductions in subsequent years, must be correspondingly reduced from \$100 to \$93. The overall consequence of this reduction in tax basis will be a reduction of \$7 in the aggregate depreciation deductions spread over the life of the property and a corresponding increase in his taxes equal to 52% of \$7 or \$3.64. The net benefit to the taxpayer of the much heralded investment tax credit is therefore not 7% but only 3.36%. In view of the fanfare with which this tax credit has been introduced it seems to be another case where the mountain has labored only to bring forth a mouse. Concern for the treasury deficit is commendably prudent but it seems ominous that this prudence should be exercised at the expense of taxpaying industry by a Congress which has been feeding Leviathan with the largest appropriations in the history of our country.

MORE COMPARISONS WITH FOREIGN TAX SYSTEMS

Our tax structure is so designed that it probably drags on industrial investment and growth more than do the tax systems of other countries. This is true even though the over-all taxes of other countries may often absorb a greater percentage of the gross national product than do the taxes of our country. *Business Week* recently published the following comparative table showing, with respect to each country, the percentage of gross national product taken in 1959 by all taxes of whatever kind—national, state and local, direct and indirect:¹⁵

¹⁵ *Business Week*, Aug. 25, 1962, p. 53, compiled from United Nations and United States Treasury sources. The British National Institute published a similar comparative table for 1959 using somewhat different figures which do not, however, change the relative position of the United States as the eleventh most heavily taxed nation in the world. *Foreign Tax Weekly Bull.* No. 48, April 26, 1961, p. 5.

<i>Country</i>	<i>Share of GNP taken by national, state and local taxes</i>
1. West Germany	34.0%
2. France	33.3%
3. Austria	33.1%
4. Finland	32.1%
5. Norway	31.8%
6. Luxembourg (1958)	30.0%
7. Sweden	29.7%
8. Italy	29.2%
9. Netherlands	29.1%
10. Britain	28.9%
11. United States	26.7%
12. Canada	24.3%
13. Belgium	23.1%
14. Australia	22.0%
15. Japan	19.0%
16. Switzerland	14.4%

The above figures tend to obscure the tax picture of the various countries. To begin with, the taxes on which the comparison is based include payroll and social security taxes which generally run higher in foreign countries. Yet when these "taxes" are paid by employers they should more properly be classed as labor costs since they pay for employee benefits, and they scarcely begin to close the wide gap between low labor costs abroad and high American wages. Moreover, to the extent the employees pay such social security taxes, the payments are not so much "taxes" to support the government as premiums to pay for personal insurance benefits in favor of the payors. The *Business Week* article cites figures for the year 1958¹⁶ showing that 29 per cent of the total tax collections at all levels of government in Germany and France, respectively, consisted of social security charges. For Italy the corresponding percentage was 35.5 per cent; for the Netherlands 26 per

¹⁶ From data published by the British National Institute.

cent; for Austria 22 per cent; and for the United Kingdom 13 per cent. In contrast with these figures the corresponding percentage in the United States was 14 per cent. If we adjusted the figures for such countries in the foregoing comparative table by excluding the effect of the social security taxes, we see that the share of gross national production taken by taxes would be reduced approximately as follows: West Germany—34 per cent reduced to 24 per cent, France—33.3 per cent to 23 per cent, Italy—29.2 per cent to 19 per cent, Netherlands—29.1 per cent to 21.5 per cent, Austria—33.1 per cent to 26 per cent, Britain—28.9 per cent to 25.1 per cent and the United States—26.7 per cent to 23 per cent. These adjustments help to put the picture in focus.

We are not entirely sure as to all the factors which went into the calculation of Gross National Product for purposes of the above comparative table, and whether it took into account all expenditures for services and the like. For that reason it may be significant to consider also the percentage of national income which is represented by the total taxes collected by federal, state and all local governments in the United States. For 1959 this percentage amounted to 24.9 per cent of national income and for 1960 27.1 per cent. In addition to taxes, moreover, the governments in the United States also annually receive huge additional revenues from such sources as current charges, postal service, highways, natural resources, hospitals, housing, transportation, interest and insurance trusts. The percentage of national income represented by all government revenues of all governments in the United States (excluding duplicative transactions) amounted to 33.5 per cent in 1959 and 37 per cent in 1960.¹⁷ Unfortunately we do not have comparable figures for foreign countries. "National Income" for the purpose of the above computation is defined as "the aggregate earnings of labor and property

¹⁷ Computed from data taken from U.S. BUREAU OF CENSUS, DEP'T OF COMMERCE, SUMMARY OF GOVERNMENTAL FINANCES IN 1959 (1960) and U.S. BUREAU OF CENSUS, DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS, BUSINESS STATISTICS 1, 197 (1961).

which arise from the current production of goods and services by the nation's economy." We also point out the substantial jump in the percentages represented by the taxes and government revenues in the United States for 1960 over the year 1959. This jump would presumably affect the relative position of the United States in the above comparative table if it were to be recalculated for the year 1960 and perhaps for subsequent years.

Probably the most significant difference between the American tax structure and that of other leading industrial nations is our disproportionate reliance on income tax as a source of revenue. According to reported figures, income taxes produce about a third of total *national* tax receipts for leading European countries whereas it produces about four-fifths of federal tax income in the United States.¹⁸ Other nations rely more heavily on excise taxes such as sales and turn-over taxes, license and franchise taxes and the like. According to figures cited in *Business Week*,¹⁹ taxes characterized as income and wealth taxes averaged 30 per cent of all tax collections at all levels of government in representative European countries but constituted 41 per cent of total tax collections by federal, state and local governments in the United States. Likewise the European average percentage represented by indirect taxes such as sales and excise taxes amounted to 47 per cent compared to 35 per cent for the United States.

Europeans claim their tax systems give their governments greater fiscal stability in times of economic slump whereas our advocates counter that our system acts automatically as an economic stabilizer by restraining booms through the process of increasing taxes and government surpluses and by stimulating investment during recessions through the process of decreasing taxes and resulting government deficits. Unfortunately, in practice it has not always worked out that way. During booms the tax take has

¹⁸ Chicago Tribune, July 22, 1962, part 2, p. 1; see also Table of Central Government Taxes on Income and Capital in First National City Bank, Monthly Economic Letter, Sept. 1961, p. 100.

¹⁹ Business Week, *supra* note 15, at 54.

certainly increased but by operation of Parkinson's Law, government expenditures have unfailingly risen to meet income and sometimes even to exceed it. In times of recession Parkinson's Law does not work in reverse to bring expenditures down to reduced income, although certainly the high level of spending engendered by good times has always served to increase the deficit during recession. We do not doubt that there are times and circumstances when government deficits are useful and necessary but we question the good sense of any man (regardless of his official or academic standing and regardless of his eloquence) who would make a virtue of deficits per se at practically all times and under all circumstances. In any event the reduction in tax payments due simply to reduced profits during a recession is scarcely the kind of tax reduction best designed to spur investment. Moreover, the stimulant injected into the economy by government deficits is more often than not derived from inflation of the money supply (viz., bank deposits) since such deficits are financed by the sale or pledge of government bonds to the Federal Reserve Bank system in exchange for created deposits rather than by the sale to investors who pay therefore out of their savings. Over the long run such inflation may be expected to show up in higher prices for goods and shrinking value for money. This procedure can become the cruelest kind of capital levy which a government can impose on the unsophisticated sector of its citizens.

GENERAL DISCUSSION

The deterrent effect of taxation on economic growth can sometimes depend more on the character of the tax than on its over all amount. Taxation in the form of income tax commends itself because it seems to measure the amount of tax by the ability to pay. On the other hand, income tax hits directly at business profits which constitute the incentive and mainspring of economic growth. Consequently at high rate levels no other tax form can be so discouraging to business initiative and enterprise. An investor or corporate manager can be expected to initiate

or expand an enterprise only when he foresees attractive profits. In his calculations he will project ordinary excise taxes (such as the sales and turn-over taxes so common in Europe) as fixed items of cost similar to wages and rents. Prospective revenues in excess of such costs will represent the profits which his imagination will balloon in proportion to his optimism. On the other hand, he can never outdistance income taxes. They will ever stay with him to dilute profits and to maintain a constant deflationary pressure on his hopes. More than half the benefit of any cost cut he may effect through ingenuity, efficiency or new investment will be lost to him through a corresponding increase in income taxes. One must be twice as optimistic to venture capital in the face of a fifty-two per cent income tax rate as without such tax. Professor Dan Throop Smith once wrote:

The nature of a country's tax structure may be of considerably more importance than the aggregate level of the tax burden. I am sure that with a reasonable amount of ingenuity we could devise a tax system which would throttle economic growth and development though it took only 10 per cent of a country's national income. I am also sure that, with reasonable ingenuity, we could devise a tax structure which would go appreciably beyond the oft-mentioned figure of 25 per cent of national income without being significantly repressive or inflationary.

. . .

A destructive tax system would, of course, place especially high burdens on the gains from risk investments, with light taxes on relatively riskless uses of capital. . . . It would also have high marginal rates on incomes.²⁰

Certainly no one could suspect that our tax system has been deliberately structured to throttle economic growth. It has tended to grow like Topsy, pulled and pruned one way or another by political forces which may be ascendant at one time or another. By and large such forces have not been impressed by the importance of encouraging profits, particularly the profits of big business. For thirty years in this country there have been too many bureaucrats, writers

²⁰ Smith, *Introduction to Tax Institute, The Limits of Taxable Capacity* 3-4 (1952).

and teachers of influence who purport to downgrade the profit motive as something rather vulgar and selfish—a curious attitude due, perhaps, in some part to snobbery, in part to a psychological lack of empathy on the part of men in professions motivated in greater degree by satisfactions other than financial gain, and in part by pure envy. It is the same spirit which frequently finds expression in terms of Fabian Socialism or state capitalism. We suspect that it has contributed considerably to the imbalance of our tax structure in its pressure on private business and enterprise.

High income taxes might not hinder investment and industrial growth if only American businesses were involved and all competitors bore the same burden—for in that case profits might still be protected by the simple means of adjusting prices upward to offset the taxes as elements of cost. This protection of profit margins would also make it easier to finance capital expansion even in the face of illiberal depreciation deductions. This was the situation for many years after World War II while foreign industry was still in the process of rehabilitation. Now, however, European and Japanese industries are back on stream and competing strongly with American industry, both in foreign markets and here at home. They have the competitive advantage of more liberal income tax and depreciation policies of their governments which makes it more difficult for our industry to protect its profit by shifting the excessive burden to the ultimate consumer in the form of increased prices. Yet we must face the fact that men generally will invest only when they can hope for reasonable compensation for the use and risk of their money. All the appeals in the world to socialist theory or human benevolence will not alter this mainspring of human conduct. As someone succinctly expressed it: great profits, great growth—small profits, small growth—no profits, no growth.

It is unfortunate that any lightening of the tax burden on business is apt to be criticized by the demagogue and mistaken by the ignorant as a gratuitous handout to the rich and “the vested interests.” This has probably caused

many a Congressman and many a government official to steer his course by short range political considerations rather than the long range economic welfare of the country. In this context, too, the economic welfare of the country is in accord with the general welfare or the common good. We wish this could be more fully realized in the coming struggle for thoroughgoing reform of our tax structure.²¹

²¹ It is beyond the limited scope of this paper to discuss at length the question of government deficits which might be increased by any reduction of the tax burden on business profits. We might suggest, however, the following lines of argument: (a) Government deficits caused by tax reductions designed to induce and enable business to grow and improve itself represent better economic policy than do deficits created by government's increased spending for doles and nonproductive purposes.

(b) The best way to solve the problem of government deficits is not by clinging to an uneconomic tax structure but rather by beginning to phase out our fantastic six billion dollar farm program or by trying to cut down the waste on dubious projects in our foreign aid program.

(c) Moreover the economy, if stimulated by tax reform as expected, would eventually provide a broader tax base and hence, over the long run, lower tax rates might not reduce total tax collections as much as some people fear.

SCHEDULE A

COMPARISON OF NATIONAL TAX SYSTEMS OF VARIOUS COUNTRIES AS THEY BEAR ON CORPORATE PROFITS AND DIVIDENDS

	<i>Normal Corporate Tax Rate</i>	<i>Tax Credit Allowed Share- holders on Dividends</i>	<i>Maximum Marginal Tax Rate on Individuals</i>
United States	52.0%	4%	91.0%
Canada	47.0%	20%	80.0%
Netherlands ¹	43.0%	Note ¹	72.5%
Luxemburg ¹	40.0%	Note ¹	54.0%
Sweden ²	40.0% ²	0	65.0%
Australia	37.5%	0	66.67%
Norway	34.0%	0	55.0%

NOTES :—

¹ Both the Netherlands and Luxemburg also withhold and pay an additional 15 per cent tax on dividends declared and paid to shareholders and the shareholders in turn receive a credit against their own taxes for the tax so withheld and paid for their account.

² Sweden permits the deduction from taxable income of an amount equal to 40 per cent of business income for reserves to stabilize economic activity. Forty per cent of these reserves must be invested with the central bank for use as permitted, depending on the level of economic activity and employment. The corporation may use the balance of the reserves as it sees fit.

Other countries with more complicated differentials are dealt with separately below:

West Germany:

<u>Undistributed Corporate Income Normal Tax Rate</u>	<u>Distributed Corporate Income Corporate Tax Rate</u>	<u>Maximum Marginal Tax Rate on Individuals</u>
51%	15%	53%

The sensational reduction in tax rate on the portion of corporate income which is distributed to shareholders eliminates most of the double taxation on dividends. A corporation also withholds and pays to the State a 25 per cent tax on dividends declared and paid to shareholders and the shareholders in turn receive a tax credit for the tax so withheld and paid for their account.

France:

<u>Undistributed Corporate Income Tax Rate</u>	<u>Distributed Corporate Income Corporate or Withholding Rates</u>	<u>Tax Rates on Individual Shareholders</u>
Corporation Tax 50%	50%
Temporary Com- plementary Tax (renewed 1962) 6% ¹	6% ¹	Note ¹
Progressive Indi- vidual Income Tax	18% ² (withheld for account of shareholders)	65% (maximum marginal rate offset in part by the tax withheld) ²

¹ The complementary tax is supposed to be a temporary tax but was renewed in 1962 at the rate of 6 per cent (reduced from 8 per cent). Individuals are normally subject to this tax on income derived from business but are exempt therefrom on dividends paid from income on which the corporation has already paid the tax. The amount of complementary tax is itself deductible from income in the year in which it is paid.

² Normally the withholding tax is 24 per cent but it is reduced by the amount of complementary tax paid by the corporation.

United Kingdom:

<u>Undistributed Corporate Income Tax Rate</u>	<u>Distributed Corporate Income Corporate Tax Rate</u>	<u>Tax Rates on Individual Shareholders</u>
Standard Income Tax 38.75%	38.75% (withheld for account of shareholders)	38.75% (completely offset as to dividends by credit for the withholding tax)
	No tax on corporation as such	
Profits Tax 15%	15%	None

Progressive Surtax
on individual in-
comes over
\$5600.

0

0

50%
Maximum Marginal
Rate

A shareholder must include in his statement of income the full pre-tax amount of a dividend, including the amount of standard income tax withheld thereon for his account. The standard tax when paid, however, is itself deductible in computing taxable income for the period in which payment is made. Thus, over a period of years of fairly constant income this would reduce the average effective standard income tax rate from 38.75 per cent to approximately 28 per cent (viz., 28 equals 38.75 per cent of (100-28)).

Belgium:

<i>Undistributed Corporate Income Maximum Tax Rate</i>	<i>Distributed Corporate Income Corporate Tax Rate</i>	<i>Tax Rate on Individual Shareholders</i>
Professional Tax on Industrial & Business Profits ¹ 40%	0	0 (as to dividends)
National Crisis Tax 0	20%	0 (as to dividends)
Withholding Tax 0	30% (for account of shareholders)
Dividend Tax 		30% (completely offset by credit for withholding tax)
Personal Progres- sive Complement- ary Tax 		30% Maximum Marginal Rate

¹ Income Tax rates in Belgium vary in accordance with the source of income. Rates here given relate only to that class of income characterized as industrial and business profits. We do not include an additional 2 per cent Temporary Exceptional Tax which in 1961 was imposed on corporate income (whether or not distributed) but is due to expire at the end of 1962.

There are two notable peculiarities of the Belgium system: (a) the professional tax is itself deductible in computing taxable income for the period in which payment is made. Thus, as we saw in computing taxable income in the United Kingdom, this serves to reduce the average effective professional tax rate over a period of years from 40 per cent to approximately 28.5 per cent (viz., 28.5 equals 40 per cent of (100-28.5)). (b) Also

the effective combined rate of the national crisis tax and withholding tax, measured against the amount of corporate profits required to generate a dividend, is not 50 per cent but approximately 45.3 per cent. For example, if a corporation declared a gross dividend of 100 it would distribute 70 to the shareholders, would withhold a tax of 30 and would pay an additional National Crisis Tax of 20. The National Crisis Tax, being paid out of undistributed profits, would itself be subject to the 40 per cent professional tax amounting to 8. Thus, out of pre-tax corporate income of about 128, a corporation could distribute a net dividend of 70 and pay taxes of about 58. The ratio of 58 to 128 approximates 45.3 per cent. The dividend of 70 so distributed would be received by the shareholder tax-free except for the Progressive Complementary Tax.

Italy:

<i>Corporate Income Normal Tax Rates</i>		<i>Maximum Marginal Tax Rates on Individual Shareholders</i>
Standard Tax	20%	0 (as to dividends)
Excess Profits Tax	15% ¹
Complementary Progressive Tax	50% (The maximum rate is reached only on the amount of individual income over \$806,000.)

¹ The corporation excess profits tax is imposed on that amount of corporate income, after deduction of the standard tax, which exceeds 6 per cent of capital and surplus of the corporation.

One might also note that the Italian Standard Tax and also the Belgian Professional Tax are the same for corporate and for individual taxpayers, and are imposed at fixed rates depending upon the particular type of income. Shareholders are exempt from such taxes on dividends distributed by corporations which have paid such taxes on the income distributed. In European nomenclature these taxes are referred to as "objective" taxes since their rates depend on the classification of the object (the income) taxed rather than the subject (the taxpayer) taxed. In the above schedule for both of said countries we have assumed the corporate income was derived from ordinary commercial activities not including revenue from real estate, bonds or stocks.

Data for this Schedule has been compiled from various sources including: Foreign Tax Service of Foreign Tax Law Association, Inc.; "The Belgian System of Taxation," Ministry of Economic Affairs and Energy, (December 1961) particularly Part II's comparative study of direct taxes in various countries; Michigan Legal Studies on the European Common Market (1960) v. 2, pp. 349-420; and miscellaneous documents.

SCHEDULE B

DEPRECIATION POLICIES OF CERTAIN FOREIGN COUNTRIES

United Kingdom:

Basic depreciation rates, developed in consultation with various trade associations, have been set at $7\frac{1}{2}$ per cent, 10 per cent, $12\frac{1}{2}$ per cent and 20 per cent for various categories of industrial machinery and equipment. Applied on a declining-balance basis, they are increased by one-fourth to effective rates of $9\frac{3}{8}$ per cent, $12\frac{1}{2}$ per cent, $15\frac{5}{8}$ per cent and 25 per cent of the declining balance. Individual taxpayers may be able to justify higher rates.

The most liberal features of the British depreciation policies, however, are the so-called Initial Allowance and Investment Allowance which are allowed for the first year of an asset's life in addition to the normal annual deduction described in the first paragraph above. The Initial Allowance is an extra amount of depreciation charged against the cost of the asset like other depreciation deductions so that the total depreciation allowed during the lifetime of the asset is not increased. However, the Investment Allowance is an extraordinary deduction allowed as an incentive bonus for investment in useful forms of industry. It is not charged against the cost of the asset. The rates therefor are as follows:

	<i>Industrial Buildings</i>	<i>Machinery & Plant</i>	<i>Mines, Oil Wells, etc.</i>	<i>Scientific Research</i>
Initial Allowance	5%	10%	20%	60%
Investment Allowance	10%	20%	20%	20%

France:

France appears to be liberal in its estimate of the "useful life of an asset" over which it permits depreciation deductions to be spread on a straight-line basis. Thus ordinary machinery is given a regular straight-line depreciation rate of 15 per cent based on a useful life of $6\frac{2}{3}$ years and heavy machinery (such as steel mill equipment) one of 10 per cent based on a useful life of ten years. A double deduction, however, is allowed the first year on an asset whose useful life exceeds five years. On top of this an additional initial depreciation allowance of 10 per cent is permitted on equipment purchased as part of a modernization program. Under this system a machine with a regular straight-line depreciation rate of 15 per cent would get 37 per cent of cost written off the first year (10 per cent initial allowance plus double the 13.5 per cent allowed on the balance of cost spread over $6\frac{2}{3}$ years) and approximately 11.19 per cent in each of the succeeding $5\frac{2}{3}$ years.

As an alternative to taking advantage of the double deduction and the initial allowance outlined above, France permits accelerated depreciation on a declining-balance method, whereby straight-line rates may be increased $1\frac{1}{2}$ times for property with a life of three or four years, doubled for a life of five or six years, and raised by $2\frac{1}{2}$ times for lives of more than six years. Under this alternative method the machine described above would be depreciated for the first three years at the respective rates of 37.5 per cent, approximately 23.4 per cent, and approximately 14.63 per cent, or an aggregate of 75.57 per cent compared with 59.39 per cent under the first method.

Also, under certain conditions, France permits the revaluation of property to compensate for past inflations in establishing a basis for depreciation. This provision may be of decreasing importance in the future if France succeeds in maintaining the fiscal stability established under General DeGaulle.

West Germany:

The German rule is to permit straight-line depreciation deductions on property over its normal useful life to the firm owning it, taking into account potential obsolescence. Thus the actual rate and life period are matters of individual negotiation for each business. A basic depreciation rate of 10 per cent is said to be common for straight-line depreciation of machinery. Under a declining-balance method this may be increased $2\frac{1}{2}$ times provided that it may not exceed an annual rate of 25 per cent. Depreciation rates may be increased by private negotiation in case of double or triple-shift operation. Accelerated depreciation deductions are permitted in certain instances, *e.g.*, in "basic industries" such as coal, iron, mining, steel and hydro-electric, taxpayers are permitted to write off 50 per cent of the cost of movable assets, and 30 per cent of the cost of fixed assets in the first five years of their life, in addition to their regular straight-line deductions.

Belgium:

Depreciation rates on a straight-line basis are subject to negotiation in individual cases with a view to spreading the deductions over the useful life of the depreciable property but with a margin of safety to cover accidental loss and potential obsolescence. The following rates have been customary on new assets: Industrial buildings and offices—3 to 5 per cent; specialized buildings (*e.g.*, chemical or brewing)—10 to 15 per cent; explosives factories—10 to 30 per cent; fixed plant—10 to 12 per cent or more; movable plant—20 to 25 per cent; loose tools—33 to 100 per cent.

A declining-balance method is permitted but is said to be little used. Also in some instances accelerated depreciation of $33\frac{1}{3}$ per cent annually has been allowed by reason of "a particular economic situation."

A temporary law which has been extended through 1963 permits the deduction from taxable business income of 30 per cent of the profits which are invested in new industrial plants, land or other assets or in the substantial expansion of existing industrial plant. This deduction must be spread over three years at the annual rate of 10 per cent. If profits in any year are insufficient to absorb the permitted deduction it may be carried forward for five years.

Netherlands:

Straight-line depreciation is permitted in accordance with good commercial practice. The conventional rate on machinery is said to be 10 per cent and on buildings $1\frac{1}{2}$ to 3 per cent. An additional initial deduction for depreciation is allowed in the first year amounting to 6 per cent on office equipment, motor cars and buildings other than factory buildings, and up to a maximum of $8\frac{1}{3}$ per cent on other assets.

The Netherlands also grants an investment allowance aggregating 20 per cent of cost of industrial capital assets, deductible from income at the rate of 4 per cent per year for the first five years after investment. This investment allowance is not chargeable against the depreciation basis of the property involved.

Italy:

Straight-line depreciation is permitted over the estimated useful life of depreciable property. In practice the tax authorities set straight-line rates varying from 3 per cent to 20 per cent per year. Italy permits accelerated depreciation by a unique formula which shortens the depreciation

life by 40 per cent and then permits the depreciation quota normally allotted to the end period so eliminated, to be added to the normal depreciation deductions for the first four years. Thus a machine with a given ten-year life could be depreciated over six years at the following annual rates: 20, 20, 20, 20, 10 and 10 per cents.

Luxemburg:

Luxemburg permits depreciation on the basis of historical cost to the taxpayer, with some adjustment for inflationary appreciation of values, over the estimated useful life of the depreciable property. It takes a liberal view of the work life of property with generous regard for potential obsolescence. Its tax budgets have customarily permitted an initial investment allowance to be deducted from taxable income, equal to 20 per cent of the cost of new investments in certain kinds of property subject to maximum limitations, *e. g.*, the 1960 budget limited such deduction to twenty-four million francs (about \$483,000) for any year.

Sweden:

Today Sweden permits depreciation deductions against all depreciable assets (other than buildings) at an annual rate of 20 per cent of historical cost, thus compatible with an assumed five-year useful life. In the alternative it permits an accelerated 30 per cent depreciation rate on the declining-balance of the depreciable assets, subject to adjustment for any gains realized on a sale of depreciable assets. In any year when the latter method does not yield the taxpayer as favorable a position as the first, the taxpayer may elect to take depreciation by reducing his book value of depreciable assets to cost less straight-line depreciation at the annual rate of 20 per cent.

As to buildings, Sweden permits straight-line depreciation on the basis of estimated useful lives more in accord with custom and tax practice elsewhere.

Reference here should also be made to Schedule A regarding the extraordinary 40 per cent deduction which Sweden permits corporations to take against income for reserves to stabilize economic activity.

Data for this Schedule has been compiled from various sources including: Foreign Tax Service of Foreign Tax Law Association, Inc.; Monthly Letter, First National City Bank, September 1960; Ch. II, "Income Tax Differentials," Tax Institute (1958), and miscellaneous documents.