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AN ECONOMIST'S REFLECTIONS ON THE REVENUE ACT OF 1951

WALTER W. HELLER*

THE ECONOMIST, no less than the legal practitioner, finds the individual income tax provisions the most interesting aspect of the Revenue Act of 1951. Therefore, after briefly reviewing the revenue impact of the Act as a whole, this commentary will focus mainly on the income tax provisions. It will try to appraise briefly the equity and economic rationality of Congress' action, especially in terms of the charge that Congress has pushed us to, or over, the brink of bearable taxation.

Revenue Impact

Seen in one light, the 1951 Act is the capstone of an heroic tax effort by which Congress in less than 18 months added $15 billion (at 1951 income levels) to the annual flow of federal tax revenues—all but $1 billion of that amount representing increases in taxes on individual and corporate incomes. The Revenue Act of 1951 accounted for $5.4 billion, the Revenue Act of 1950, $5.8 billion, and the Excess Profits Tax Act of 1950, $3.5 billion.[1]

Seen in another light, the 1951 Act sounded the death knell to our pay-as-we-go national budgetary policy. In effect, the Congress last year and the Administration this year have succumbed to deficit financing to meet our defense needs. In the face of a budget deficit of perhaps $10 billion and a cash deficit of perhaps $5 billion during the current calendar year (even after taking into account budget cuts being made by Congress), Congress has balked at further tax increases, and the President has not pressed for action on even the mild tax recommendations in his January Budget Message.[2]

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1. For a succinct statement of the revenue effects and tax rate and base changes in the three acts, see U. S. Treasury Department, *Annual Report for the Fiscal Year 1951,* U. S. Government Printing Office, 1952, pp. 44-52.

2. The chief differences between the conventional budget and the cash-consolidated budget are that the latter includes trust fund operations and treats interest on the public debt on a cash basis while the conventional budget excludes trust funds and treats interest on an accrual basis. Payments into the trust funds currently exceed disbursements by about $4.5 billion annually. The cash-consolidated budget is presented each year in one of the special analyses in the budget documents. See, for example, Special Analysis A, "Receipts from

The 1951 action also signalled the end of the brief tax honeymoon that existed between the Administration and Congress after Korea. The 1950 Revenue Act met, almost to the letter, the requests of the Administration. The Excess Profits Tax Act delivered $3.5 billion of the $4 billion requested. In 1951, while still using Treasury recommendations as a point of departure, Congress enacted only $5.4 billion against a requested $10.7 billion.[3] Moreover, the composition of the tax increase in the Act differed substantially from the recommendations. Congress enacted less than one-fourth[4] of the recommended excise tax increase of $3.2 billion, only three-fifths of the Treasury proposal of a $4.2 billion increase in individual income taxes, and two-thirds of the $3.2 billion increase proposed for corporation taxes.[5]

Congress in fact enacted slightly over $6 billion of tax increases but offset them in part with various tax concessions totalling about $700 million annually. Individual income taxpayers will gain over $300 million a year from the assortment of reliefs and reductions discussed by Mr. O'Byrne in the preceding article.[6] For example, special treatment of capital gains on sales of personal residences will save taxpayers about $110 million a year; liberalizing of family partnership provisions, $100 million; extension of roughly half of the benefits of income splitting to qualifying heads of households, $44 million; extension of capital gains treatment to breeding livestock, coal royalties, and growing crops sold with a farm, perhaps $30 million. Corporations were given $100 million of additional excess profits tax relief. The roughly $80 million of added allowances under percentage depletion and mining development costs also accrues largely to corporations. Last but hardly least are the losses to the Treasury of $100 million by repeal of the electrical energy tax and another $100 million by other excise tax reductions.[7]

None of the foregoing concessions was initiated by the Admin-

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and Payments to the Public" in *The Budget of the United States Government for the Fiscal Year 1953*, U. S. Government Printing Office, 1952, p. 1142.

3. Although President Truman originally foresaw a budget deficit of $16.5 billion to be covered by additional taxes, the slackening of the pace of the defense effort steadily shrank the prospective deficit. As a result, the anticipated "second bite" of the 1951 tax program failed to materialize.

4. The wagering tax is here excluded. Against estimates of $400 million annually by Congressional experts and $300 million by the Treasury, actual collections in the first seven months totaled only $3.5 millions according to The Wall Street Journal, June 4, 1952.

5. U. S. Treasury, *op. cit. supra* note 1, at 470, 501.

6. 36 Minn. L. Rev. 832, 834 *et seq.* (1952).

7. These revenue loss estimates were derived from exhibits in U. S. Treasury, *op. cit. supra* note 1, at 477, 501-507.

istration, and several were explicity denounced by President Truman in signing the bill.[8] A fairly close historical parallel is not hard to find. After cooperating rather harmoniously with the Administration in 1940 and 1941 and after enacting a large tax increase in 1942 in spite of growing differences with the Administration, Congress balked almost completely in 1943. It gave President Roosevelt little more than a fifth of the $10.5 billion tax increase he had sought and at the same time granted extensive tax concessions. He reacted with an unprecedented veto, catigating Congress for "providing relief not for the needy but for the greedy," but his veto was overridden.[9]

Economic Limits to Taxation

Reactions of Congressional leaders, Presidential aspirants, and the taxpaying public to the Revenue Act of 1951—or, more accurately, to the total tax burden as increased by that Act—strongly suggest that the political limit of taxation has been reached, short of total war. Both Chairman Doughton of the House Ways and Means Committee and Chairman George of the Senate Finance Committee are among those who have indicated that the 1951 legislation is about as far as we can go, short of war. Most of these judgments rely heavily on the argument that further taxation will have unfortunate if not disastrous economic consequences.[10] This position appears to be untenable.

Among economists, Colin Clark of Australia is the most widely cited exponent of the position that taxes beyond a certain point become self-defeating. He suggests that when taxes rise above roughly 25 per cent of the national income, they defeat themselves by impairing production and causing inflation.[11] Since total taxes in the United States now exceed 30 per cent of national income, and since many influential opponents of higher taxes have endorsed

8. In the "Statement by the President, October 20, 1951, upon signing H.R. 4473, the Revenue Act of 1951," he said: "Furthermore, this legislation does little to close the loopholes in present tax laws, and in some respects provides additional means by which wealthy individuals can escape paying their proper share of the national tax load through such devices as excessively liberal 'capital gains' provisions, family partnerships, and excessive depletion allowances on oil and gas and certain minerals properties."

9. "Message from the President of the United States returning without approval the bill (H.R. 3687) entitled 'An act to provide revenue, and for other purposes,'" February 22, 1944.

10. See, for example, the article by Senator Walter F. George in Look Magazine, January 29, 1952.

11. The best-known statement of this thesis is in Clark's brief article, *The Danger Point in Taxes,* Harper's Magazine, December, 1950, pp. 67-69.

Clark's thesis, its validity has become a significant issue in federal tax policy.

Apart from citing a variety of statistics which are supposed to, but do not in fact, establish his thesis,[12] Clark argues that 25 per cent is the tax threshhold to inflation because that level, (1) business, financial, and political leaders "transfer their allegiance" to inflation; (2) employers' resistance to wasteful expenditures and wage increases weakens; and (3) incentives to work and invest are badly impaired. Implicitly, he is saying that further tax increases reduce the output of goods and services *more* than they reduce the flow of purchasing power seeking to buy those goods.

Nothing in recent U. S. output, consumption, and price statistics appears to bear Clark's thesis out. The consumers' price index, after rising from 170 at the time of Korea to 184 eight months later, has held virtually steady since February, 1951. Gross national product, meanwhile, moved up from $287.4 billion in the third quarter of 1950 to $328.2 billion in the third quarter of 1951, and has since risen by more than $10 billion during the period of relative price stability. Meanwhile, consumer expenditures fell from the high of $209 billion early in 1951, and have only recently regained this level.[13] In other words, the Revenue Act of 1951 and the other tax increases since Korea may rather be said (a) *not* to have prevented rapid growth in productivity of the American economy and (b) to *have* helped curb consumer spending and check inflation.

Apparently, recent tax increases have not shifted allegiances to inflation, nor is it easy to visualize how this would come about in any event. This leaves for examination Clark's arguments about the effects of taxes on business spending policies and on economic incentives.

Prior to Korea, the basic corporation tax rate was 38 per cent; action in 1950 raised this to 47 per cent and added a 30 per cent excess profits tax, with the proviso that the combined maximum effective rate was not to exceed 62 per cent. The 1951 Act raised the

12. A brief critical examination of the historical data which Clark cites in support of his thesis is contained in the writer's testimony before the Congressional Joint Committee on the Economic Report in *Hearings on the Report of the President,* Joint Committee on the Economic Report, 82d Cong., 2d Sess., January-February, 1952, pp. 315-325. A more comprehensive appraisal of Clark's statistics is presented by Joseph A. Pechman and Thomas Mayer in an article to be published in the Review of Economics and Statistics, Harvard University.

13. Data are taken from the monthly *Economic Indicators,* May, 1952, Prepared for the Joint Committee on the Economic Report by the Council of Economic Advisers, U. S. Government Printing Office, 1952, pp. 2, 3. Dollar figures are given in terms of annual rates.

basic rate to 52 per cent and the maximum effective rate to 70 per cent. At present, then, the top rates on corporate income are as follows: 52 per cent for corporations without excess profits; 82 per cent for those with excess profits until the combined tax reaches 70 per cent of net income, beyond which the rate holds at 70 per cent.

On individual incomes, the pre-Korea bracket rates were, illustratively, 16.6 per cent on the first $2,000 of surtax net income, 44 per cent on the $16,000 to $18,000 bracket, 66 per cent on the $50,000 to $60,000 bracket, and 82.1 per cent on incomes over $200,000. Today the corresponding rates are 22.2 per cent, 56 per cent, 77 per cent, and 92 per cent.[14] The maximum effective rate has risen from 77 to 88 per cent.

Do such rates as these stimulate wasteful business spending? Clark's answer, and indeed, the customary answer, is "yes," on the ground that out of each additional dollar spent, for example, by a corporation, the government foots 52 or 70 or 82 cents of the bill. Undoubtedly, when a business man can make "nest-feathering" expenditures today on maintenance, improvements, and advertising which cost him only 30 cents or 18 cents on the dollar but which promise to increase his profits in the future when taxes leave him, say, 50 or 60 cents on the dollar, he will be stimulated to spend. But for the types of expenditures which promise no future income—the "loose-living" expenditures of high expense accounts and the like—the argument is more difficult to fathom. Such outlays promise little more than a bloated expenditure structure which will in due time weaken the competitive position of those who indulge in them. Moreover, is it not plausible that businessmen, rather than trying to find ways to spend more dollars on the theory that the government pays 82 or 70 per cent of any added cost may instead focus their atention on the 18 or 30 cents that remains from each dollar? If so, their effort might well be concentrated on earning as many of these dollars as possible to maintain profits after taxes at satisfactory levels.

Turning to the incentive argument, where the individual income tax rates come more directly into play, one finds the essential questions to be: how does the individual react to rates of 22.2,

14. The rate given operate fully only for single persons; because of income splitting, married couples filing joint returns pay lower bracket rates, in effect, on surtax net incomes above $2,000. For example, between $16,000 and $18,000, their marginal rate is now 38 per cent rather than 56 per cent. At $50,000 to $52,000, it is 66 per cent instead of 77 per cent.

56, and 77 per cent on his additional income, and how many persons pay at the various marginal rates?

From one point of view, the higher the marginal rate of tax, the greater is the stimulus to reduce one's work and increase one's leisure and, perhaps more important, to substitute untaxed for taxed work wherever possible. For example, the taxpayer may gain by painting his house or keeping a garden rather than putting in overtime on his job since the overtime is taxable, while the work for himself is not. Whether he substitutes leisure for work, or less efficient for more efficient work, in either case, the economy suffers a loss in total output (though this is not the same as saying that the sum total of human happiness has necessarily been lessened).

From another point of view, there may be a good reason for doing just the reverse, namely, for converting leisure into work. If higher taxes cut down the income to which the individual has been accustomed or which he aims to achieve, he may work just that much harder to restore his income. He may work longer hours at his job or do more things for himself around the house. In either case, the higher taxes—given a fully employed economy as we have today—lead to a gain in output (though not necessarily in happiness).

Unfortunately, no firm evidence exists to establish which effect predominates—the negative "substitution effect" which is a function of marginal rates of tax or the positive "income effect" which is a function of average rates of tax. To be sure, a study made at the Harvard Graduate School of Business Administration concludes that "for the most part, with considerable exceptions, businessmen are currently working as hard under high tax rates as they did under low tax rates. . . ."[15] But for the great mass of wage and salary earners, we have little more in the way of evidence than assertions that absenteeism, unwillingness to work overtime, reluctance to change jobs, and the like can be laid at the door of the income tax. Before accepting these assertions, one should examine the distribution of taxpayers by tax brackets. Figures presented by the Treasury at the hearings on the 1951 Act show that the incomes of 44.9 million out of the 51.7 million individual income taxpayers do not reach beyond the first surtax bracket,[16] in other words, are taxable at a marginal rate of only 22.2 per cent. Taxes which leave workers over 75 cents out of each additional dollar of earnings are

15. Sanders, Effects of Taxation on Incentives, 25 (1951).
16. *Revenue Revision of 1951,* Hearings before the Committee on Ways and Means, House of Representatives, 82d Cong., 1st Sess., Part 1, p. 25.

not likely to discourage their work significantly and may even stimulate additional work to replace lost income.[17]

In brief, then, although income taxes at present rates undoubtedly have adverse effects on incentives, there are substantial offsetting favorable effects. How much farther taxes can be pushed before the adverse effects become prohibitively great is a matter of judgment, though it seems reasonable to conclude that we are not yet close to the economic limits of taxation in general and income taxation in particular.

Equity Considerations

The most serious misgivings concerning further reliance on the individual income arise, in my opinion, in the area of social justice. Longstanding imperfections of the tax base and tax administration have on one hand been magnified by higher rates and lower exemptions and have on the other hand been compounded by a phantasmagoria, as Mr. O'Byrne would put it, of new inroads on the base and progressivity of the tax. The Revenue Act of 1951 is merely the most recent offender in the series of actions which have undermined the theoretical fairness of this tax.

For example, when Congress reclassified several income items as capital gains, it was merely taking a further step in what is perhaps the most striking development of tax avoidance in the past ten years. It began in 1942 with the lowering of the ceiling rate on capital gains to 25 per cent, the shortening of the holding period to 6 months, and the reclassification of certain business assets as "capital assets." It continued in 1943 and 1950 with the conferring of capital gains treatment on timber and stock options. At the ceiling rate of 26 per cent (after a token increase of one per cent in the 1951 Act), the capital gains treatment is a powerful tax avoidance magnet for incomes which would otherwise be taxable at rates of 70, 80, or even 90 per cent.

Another device which the Act paid its respects to is the splitting of large incomes into small pieces. By easing taxpayer access to family partnership treatment, and by giving semi-splitting to heads of households, it also transferred a substantial amount of income

17. Of course, income taxes are not the only ones which cut into the worker's incentive. Any tax, including sales and excise taxes, which cuts down the size of the bundle of goods which the worker can buy with a given amount of additional income will have similar effects to those discussed here in terms of the income tax. If it is true, however, that the closer the relationship between the tax and the reward for the effort expended, the sharper the impact on that effort, then the influence of other taxes on incentives will be weaker than that of the income tax.

from higher into lower brackets. Quite apart from the objections on equity grounds that these provisions violate equity by treating differently persons who are in essentially the same economic circumstances, they violate progressivity, maintaining its form but sapping its substance.

Overly generous or inappropriate exclusions, deductions and exemptions are another means of escape from income tax liabilities. Some may be necessary in the interests of simplification, e.g., the granting of full-year exemptions for part-year dependency and the exclusion of a dependent's income (raised from $500 to $600 in 1951). Others, like the special treatment of income of members of the Armed Forces and the deduction for medical expenses, both liberalized by the 1951 Act, are defended on grounds of social policy. The granting of additional exemption to the aged and blind in 1948 was also so defended. Apart from the usual objections to using the tax mechanism as the instrument for granting subsidies, aggravated by the fact that the benefits of exclusions, deductions or exemptions rise with income under progressive rates, Professor Surrey has suggested that if Congress succumbs to each plausible case made for extra exemption (e.g., for physically handicapped persons), "[s]uch a course is bound to result in the income tax exemption sections' resembling the benefit provisions of an accident insurance policy."[18]

In many ways, opening the percentage depletion gates to let in a long procession of additional minerals was the 1951 Act's crassest assault on principles of equity in taxation. In the face of the Administration's renewed plea to narrow this $750-million-a-year loophole, Congress broadened its coverage materially.

Even without attempting a complete catalogue of defects in the income tax,[19] one cannot avoid at least brief reference to the serious problem of evasion and underreporting of individual incomes. In many ways, this is the worst breach of all in the equity of the income tax because it leads to striking and unintended tax differentials among various sources of income. A much higher percentage of liabilities is actually collected on wages and salaries than on interest and dividends because of the withholding provisions. Yet, the Senate in 1951 struck down a provision of the House

18. Surrey, *Federal Taxation of the Family—the Revenue Act of 1948*, 61 Harv. L. Rev. 1097, 1103 (1948).

19. A more comprehensive discussion of these defects is presented in the writer's *Limitations of the Federal Net Income Tax*, 7 The Journal of Finance, 185-202 (1952).

bill which would have collected $250 million more a year[20] from interest and dividends by means of an ingenius system developed by the Treasury Department.[21] Mainly to save dividend and interest payors the modest compliance costs involved and to avoid certain problems relating to savings bonds and small savings accounts, Congress thus foregoes a quarter billion dollars of tax-evaded revenue.

It is in their differential impact that the special concessions and defects of the income tax give the greatest cause for concern. A recent study gives orders of magnitude that are little short of appalling. A comparison of U. S. Department of Commerce income estimates with the amounts actually reported on income tax returns filed for 1944, 1945, and 1946 showed that while 86 per cent of total income and 95 per cent of civilian wages and salaries were accounted for on the returns, other sources of income fell far short:[22] only two-thirds of "interest, dividends, and fiduciary income appeared; likewise, only two-thirds of farm and other business and professional income was covered;[23] rent, excluding roomer-boarder income, was little more than two-fifths reported. Even if one grants that part of the gap between Commerce and tax return data results from overestimates of the former, the underreporting indicated is still a compelling cause for administrative and Congressional action.

Conclusion

In condemning the defects of the income tax—and Congress for worsening some and refusing to remove others—I do not mean to imply that this tax is no longer the best instrument of social and economic policy that the field of taxation has to offer. Nor do I

20. U. S. Treasury, *op. cit. supra* note 1, at 475.

21. Using dividends as an illustration, the system may be summarized as follows: the corporation would withhold a flat 20 per cent of its total dividend payments and forward the resulting amount to the Treasury without making any breakdown by individual stockholders and without providing any withholding receipts to those stockholders. The latter, in filling out their income tax returns, would report the actual amount of dividends received, compute one-fourth of this amount and (a) add it to their taxable income and (b) take credit for this amount as withheld tax.

22. Selma F. Goldsmith, "Appraisal of Basic Data Available for Constructing Income Size Distributions." Part VI in 13 *Studies, Conference on Research in Income and Wealth,* National Bureau of Economic Research, 301-4 (1951).

23. For 1945, the one year for which the farm and non-farm elements were separated, the startling result was that "only 36 per cent of farm income was reported on tax returns . . . as against 87 per cent of non-farm entrepreneurial income."

overlook the courage of Congress in enacting $14 billion of additional taxes on individual and corporate incomes within 18 months after Korea. But the growing disparities and special concessions which now mar the individual income tax threaten its right to the position of "backbone of our tax system." While no final judgment can be made without knowledge of the alternatives open at any given time, this brief analysis strongly suggests first, that much of the current concern and lament over the *level* of taxation should be redirected to its *structure* and, second, that the individual income tax base should be improved and restored before proceeding with further changes in rates and exemptions.