THE PROPOSAL TO REDUCE HIGH SURTAXES

I. THE CASE FOR REDUCTION

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The question of progressive rates for income taxes, particularly what the upper limits of the progression shall be, is one of the most controversial in the whole field of public finance. The earlier discussions were over the question of justice in taxation —whether taxes should be based on ability to pay or on benefits received. Ability to pay is now generally accepted as the just basis for taxation. The discussion has now taken a new turn. Other than fiscal considerations are brought in. Those with high incomes, the argument runs, should pay at higher rates not only because they have more ability, but also because by this process the inequalities in the distribution of wealth will be somewhat lessened.

There are many people who object to the use of taxation for any purpose other than the raising of revenue. One need not agree with them and yet may doubt whether high surtax rates are the best way to bring about greater equality of income. Those who propose such use of taxation for purposes of reform usually assume that the only effect will be the one desired. However, it appears evident that in the effort to equalize wealth by heavy surtaxes we have seriously hampered economic recovery by lessening the funds available for investment in equity capital.

The plan of the paper is simple. We shall first indicate the changes which have taken place in the normal and surtax rates of the federal income tax and then shall attempt to show that the undesirable effects of the high surtaxes are great enough to make it advisable to lower them.

In brief, the argument is that high surtaxes along with certain other features of our system of taxation are an important factor in checking recovery by hampering investment in equity or risk capital. This does not mean that the cutting down of the high surtaxes would by itself bring an investment in equity capital. There are other conditions which have to be considered, but it would remove one of the hampering factors.

We turn now to the history of the income tax rates. The income tax is divided into two parts: the normal tax which must be paid on all the taxable income and the

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surtaxes which are additional taxes paid on various segments of high income, the rate increasing as the segments represent higher and higher income. The total tax is made up of the sum of the two. The rates of both normal and surtax have varied greatly. Ordinarily there is but one normal rate, but in a few of the laws there was a slight gradation for lower incomes before the full normal rate was charged. Perhaps the most satisfactory way to indicate varying weight of the total tax is to give the full normal tax, the lowest and highest surtaxes and the amount of income to which they apply. This information is given in the table which follows.

INCOME TAX RATES

(Income in thousands of dollars)

Year	*Full Normal Tax*	*Lowest Surtax*	*Highest Surtax*
1913	1%	1% on 20-50	6% over 50
1916	2%	1% on 20-40	13% over 2,000
1917	4%	1% on 5- 7.5	63% over 2,000
1918	12%	1% on 5- 6	65% over 1,000
1922	8%	1% on 6-10	50% over 200
1924	6%	1% on 10-14	40% over 500
1925	5%	1% on 10-14	20% over 100
1932	8%	1% on 6-10	55% over 1,000
1934	4%	4% on 4- 6	59% over 1,000
1935	4%	4% on 4- 6	75% over 5,000

As is seen in the table the surtaxes have varied in four ways, the starting rate, the income to which it applies, the highest surtax and the income to which it applies. The present law has the highest starting rate, 4%, applying to the lowest income, $4,000, and reaches the highest maximum rate, 75%, of all of the laws.

The history of high surtaxes, in brief, is that they started out as very slight taxes, but were raised to great heights during the World War. The argument was primarily a fiscal one, based on the theory that taxes should be levied in accordance with ability to pay. The war required vast sums of money and those with large incomes should contribute according to their ability. The surtaxes were reduced substantially after a discussion in which Mr. Andrew Mellon, then Secretary of the Treasury, took an important part. Many refused to take the arguments of the Secretary seriously; they thought that his great wealth disqualified him from treating the subject objectively. However the reduction took place. The present high surtaxes date from the depression. They reached their present height in three stages. The argument was a double one—the argument from ability and the contention that the taxes were desirable in themselves since they cut down the inequality of wealth of people of the nation.

This effort to lessen inequality is advanced in the interest of the low income groups, and most people sympathize with the aim of raising the standard of living of the lower income groups. The argument for the reduction of the surtaxes involves two steps. The first is that full recovery of economic activity and the possibility of raising standards of living depends on the resumption of new capital expenditures in a considerable volume. Most economists would agree that it is a fair conclusion from our previous history that high total national income and increasing standards of living have come in periods of increasing capital investment. The next step is that high surtaxes along with other features of our tax system hinder the flow of capital into industry, particularly in the form of equity capital. The conclusion is that the surtaxes should be lowered.

It should be stated again, with all the emphasis possible, that the problem of restoring the flow of funds to the capital market is a very complicated one which cannot be solved by any one proposal. All that is claimed is that the high surtaxes have been a hindrance preventing the flow of capital into industry. And so should be lowered. After the reduction of the surtax rates in 1925 the capital market had an extremely active period. But we are not arguing that if the surtaxes were reduced now we would have a recurrence of the activity of the late 1920's. The reduction of the surtaxes is recommended as the removal of a hindrance not as a "sure cure" for our troubles.

As is always the case, it will be necessary to consider some of the topics assigned to the other authors. Thus the problem of the high surtaxes, particularly in its effect on the capital market, is inextricably bound up with the existence of tax-exempt securities and the regulations about capital gains and losses.

We shall now show how the investments in industry particularly in the form of equity capital are hindered by the high surtaxes.

The first step in the argument has to do with the manner in which our taxing system tends to force investments into government securities rather than into industrial securities. But first there are two conceptions which we must distinguish, tax evasion and tax avoidance. Tax evasion means that a person does not pay the taxes the law requires, conduct which, of course, is illegal. Tax avoidance means that a person shifts the form of his property so that he will pay less taxes, conduct which is perfectly legal. It is foolish to be exasperated that people do not choose the form of investment which will cause them to pay the highest taxes.

The most direct influence of high surtaxes in checking equity investment is illustrated in the case of Henry Ford, as given by Mr. Mellon.[1] The high surtaxes cut down the amount of funds Mr. Ford had available for plant expansion.

The more serious situation at present has to do not with the amount of money available for investment but with the direction of the investment. So far, there has been no shortage of funds for investment but they have been invested more in government securities than in industrial securities. And the part which has gone into industrial securities has been in the form of bonds more frequently than in the form of stocks. The problem of tax exempt securities is treated in another part of this symposium.[2] However we must mention it here as complicating the problem of high surtaxes. There is a line of Supreme Court decisions going back to Marshall which holds that the federal government cannot tax the instrumentalities of the state governments and that the state governments cannot tax the instrumentalities of the

[1] MELLON, TAXATION: THE PEOPLE'S BUSINESS (1924) 97. [2] *Infra* pp. 217-242.

federal government, thus the income from state and municipal bonds is exempt from the federal income tax. The first case was a clear one. Maryland was attempting to hamper the activities of the Bank of the United States by taxing its branch. But to an economist it seems strange that it should be concluded that if the federal government taxed the income from state bonds at the same rate as other income was taxed it was in some way hampering the activities of the states. At any rate we have these bonds which are free from federal income tax. The high surtaxes and the existence of tax-free bonds means that the money which should go into equity capital investment in industry is forced not only into bond investment but into government bonds and industry does not get it in any form.

COMPARISON OF TAXABLE AND TAX-EXEMPT INVESTMENTS FOR THOSE WITH INCOMES OF VARIOUS SIZES[1]

If Taxable Income Is:	Municipal Bonds Bearing: 1½%	2%	2½%	3%
	Are equivalent to taxable securities with a % yield of:			
$ 10,000 to $ 12,000	1.69	2.25	2.81	3.37
12,000 to 14,000	1.71	2.27	2.84	3.41
14,000 to 16,000	1.73	2.30	2.87	3.45
16,000 to 18,000	1.77	2.35	2.94	3.53
18,000 to 20,000	1.81	2.41	3.01	3.61
20,000 to 22,000	1.85	2.47	3.09	3.70
22,000 to 26,000	1.90	2.53	3.16	3.80
26,000 to 32,000	1.95	2.60	3.25	3.90
32,000 to 38,000	2.00	2.67	3.33	4.00
38,000 to 44,000	2.09	2.78	3.47	4.17
44,000 to 50,000	2.18	2.90	3.62	4.35
50,000 to 56,000	2.31	3.08	3.85	4.62
56,000 to 62,000	2.46	3.28	4.10	4.92
62,000 to 68,000	2.63	3.51	4.39	5.26
68,000 to 74,000	2.83	3.78	4.72	5.66
74,000 to 80,000	3.06	4.08	5.10	6.12
80,000 to 90,000	3.33	4.45	5.56	6.66
90,000 to 100,000	3.66	4.88	6.10	7.32
100,000 to 150,000	3.95	5.26	6.58	7.90
150,000 to 200,000	4.17	5.56	6.95	8.33
200,000 to 250,000	4.41	5.89	7.35	8.82
250,000 to 300,000	4.69	6.25	7.81	9.38
300,000 to 400,000	5.00	6.67	8.33	10.00
400,000 to 500,000	5.36	7.15	8.93	10.71
500,000 to 750,000	5.77	7.70	9.63	11.54
750,000 to 1,000,000	6.25	8.34	10.40	12.50
1,000,000 to 2,000,000	6.53	8.70	10.87	13.05
2,000,000 to 5,000,000	6.81	9.10	11.38	13.62
over 5,000,000	7.14	9.53	11.90	14.28

[1] Source: Finance Department of the Chamber of Commerce of the United States.

Of course the higher the income, the higher the surtax and the greater saving from the investment in tax-free bonds. A table is presented which indicates the yield which one would need to obtain from a taxable investment to make it equal the tax-exempt security for various incomes. What this means may be illustrated. According to *Standard Statistics* indexes for 1938, obtained by averaging the 12 monthly figures, the yield on 15 municipal bonds was 2.91%; on 15 public utility bonds was

4.80%; on 15 industrial bonds was 5.07%; on 20 industrial preferred stocks was 5.17% and on 15 railroad bonds was 8.37%. If we assume that the investor was guided only by yield we may take the 3% municipal bond as being nearest to the 2.91% yield. Then a taxpayer with an income of $56,000 could not afford to buy public utility bonds for they yield only 4.80% before the tax and the municipal bond is equivalent to a taxable yield of 4.92%. In the same way a taxpayer with an income of $62,000 could not afford to invest in industrial bonds or in industrial preferred stocks, and finally a taxpayer with an income of over $200,000 could not afford to invest in railroad bonds. One effect of the provision about the taxation of capital gains and losses discussed in other papers in this symposium[8] is to force investments into bonds instead of stocks. We shall see that the high surtax rates accentuate this tendency. The government has always contended that capital gains are income and should be taxed as such. However, they have not always been willing to allow the deduction from income of capital losses. The present Act permits partial deduction of losses on investments held more than 18 months. At present, the investment in equity capital is ordinarily made by the purchase of capital stock. The investor hopes to make a profit by selling the stock. He knows that he is taking a risk. If he is a big investor he will distribute the investment among a number of companies. He knows that some will not be profitable but he hopes that the average return after allowing for the losses will be higher than he could get in a safer investment. His calculations will be upset if he has to pay taxes on the gains but cannot deduct the losses. More propositions would be turned down or, to put it differently, in order to be accepted the proposition would have to show more chances of profit than formerly to make up for the change in the taxation system.

The surtaxes add another element to the checking of equity investment. As the income increases and presumably the ability to invest, the investor is presented with this dilemma. If the investment turns out well and he gets a good return either in the form of dividends or a capital gain he must turn over to the government more and more of the successive increments up to 79% of his income exceeding $5,000,000. The amount left after the government takes its share may not seem to be adequate to compensate for the risk and the investor would be likely to turn to bonds, probably to tax-exempt bonds. Thus does the taxation system make it harder to get equity capital for business.

One type of evidence of the effect of the surtaxes on the direction of investments is the composition of estates. The limitations are obvious. The estate of an active business head might well have no securities at all or, if the business were incorporated, only the securities of his own business. A retired business man might leave an estate entirely composed of securities. Another limitation is the time lag. A small estate might be shifted as tax laws were changed but large estates, the ones most affected by surtaxes, would take a long time to adjust. Again, as the size of estates increases, the number of estates decreases and we cannot be sure that we have enough for a fair sample. In the table in the $8,000,000 to $9,000,000 class the figure of 0.00%

[8] *Infra* pp. 194-216.

of tax-exempt securities in 1930 was from two estates while the figure of 74.09% for 1936 was for only one estate. No one could contend that either figure gives us accurate knowledge of the percentage of tax-exempt securities in estates between $8,000,000 and $9,000,000.

With these cautions we present the table. It gives the year 1930 when the 5% normal tax and 20% surtax making a total tax of 25% had been in effect for 5 years. It also presents the year 1936, the latest for which the data are available. The total maximum rate became 79% in 1935, too late to have much effect, so the total maximum rate of 63% which started in 1932 is the rate which would be more effective. The tax-exempt securities are those issues of the federal government which are wholly tax exempt and those of state and localities which are in the same class. In all of the classes except gross estates of $10,000,000 or more the percentages of tax-exempt securities are higher in 1936 than in 1930. It is a fair presumption that the increase in the surtaxes was an important factor in bringing about the change.

PERCENTAGE OF GROSS ESTATES HELD IN TAX-EXEMPT SECURITIES ARRANGED IN CLASSES BY SIZE OF NET ESTATES[1]

Net Estates (in thousands)	Percentages in Tax-exempt Securities 1930	1936
under 50	2.18	3.66
50- 100	2.41	4.22
100- 200	3.19	6.56
200- 400	4.96	7.23
400- 600	7.03	8.80
600- 800	5.58	12.91
800- 1000	8.97	13.31
1000- 1500	10.40	11.04
1500- 2000	9.74	15.27
2000- 2500	11.26	18.72
2500- 3000	11.31	21.23
3000- 3500	7.30	17.20
3500- 4000	6.44	14.76
4000- 5000	6.81	16.15
5000- 6000	18.76	24.21
6000- 7000	11.69	32.00
7000- 8000	4.20	17.63
8000- 9000	0.00	74.09
9000-10000	1.15	....
10000-and over	17.98	8.90

[1] Source: U. S. BUREAU OF INTERNAL REVENUE, STATISTICS OF INCOME.

The conclusion is that the surtaxes should be lowered to remove the hindrance to capital investment since capital investment will increase national income and raise standards of living. However, it must be remembered lowering the surtaxes will not alone bring the desired recovery; other things are necessary.