C. HARRY KAHN MEMORIAL LECTURE

reflections on tax reform

richard a. musgrave

C. HARRY KAHN

Harry Kahn was born in Frankfurt-am-Main, Germany, in September, 1921. With the seizure of power in Germany by the Nazis, he moved with his family to England, and subsequently to the United States. In this country, he studied at the Watkins Institute in Nashville, Tennessee, and later received his bachelor's degree at Vanderbilt University. He did his graduate work at the University of Wisconsin, where he received his master's and doctor's degrees.

Before coming to Rutgers in 1958, Harry Kahn was for six years a member of the staff of the National Bureau of Economic Research in New York City, and he retained this connection with the Bureau while at Rutgers. Previously he taught at the University of Wisconsin and the College of the City of New York. He also served in the late 1940s and early 1950s as a consultant to the City of Milwaukee and the State of Wisconsin, studying their tax and other fiscal problems.

Beginning with his graduate work at the University of Wisconsin with Professor Harold Groves, Harry Kahn devoted his major intellectual energies to the field of public finance. He published three major books in this area—*Personal Deductions in the Federal Income Tax* in 1960, *Business and Professional Income Under the Personal Income Tax* in 1964, and *Employee Compensation Under the Income Tax* in 1968—as well as numerous articles. His work and his testimony before Congressional committees and other public bodies won him a well-deserved reputation as an outstanding authority in the field of public finance.

Harry Kahn was a highly valued teacher and colleague during his years at Rutgers. His outstanding strength was the invaluable guidance and direction he gave to his graduate students and younger colleagues in their research efforts. He insisted on the highest standards of intellectual effort and integrity both for himself and his associates. During his last years, Harry Kahn fought valiantly against a painful and relentless disease. Until the last week of his life, however, he continued his teaching and other work with the bravest of perseverance. His death occurred on April 28, 1972.

C. HARRY KAHN MEMORIAL LECTURE

reflections on tax reform

richard a. musgrave

INTRODUCTION

On October 18, 1972, Harry Kahn's family, associates at the National Bureau of Economic Research, friends, and members of the Rutgers community met at the University Library to remember Harry in a way which we thought he would most appreciate. We recalled the principal events of his life, the contributions he had made to economics and the singular way in which he influenced his students and associates. And then we talked about a live topic in economics as Harry would have done.

Harry's principal interest was in public finance. His expertise in the area was available to the State Government, the U.S. Treasury and the Social Security Administration. At Rutgers he found himself with the more serious students at the undergraduate level, and the more devoted at the graduate level. He was never guilty of casually glancing through a dissertation and relying on one of his colleagues to tell him whether it was good or bad. Quite the contrary, he read and he reread, he worried, he invited the student to his home and talked until finally they had worked through the point in the same careful way Harry did his own work and research.

Those who knew Harry do not need material things to remember him. We remember the pleasure of having spent time with him, and we are better for having observed his habits of work and having admired his relentless pursuit of logic, his meticulous scholarship and his imaginative policy recommendations. Yet if we do need something to remind us of the scholar who will no longer be with us, we felt the most appropriate would be the record of the evening we spent discussing public finance.

Professor Richard A. Musgrave, H. H. Burbank Professor of Political Economy at Harvard University spoke on Reflections on Tax Reform which is reproduced here as the C. Harry Kahn Memorial Lecture.

We know Harry would have approved. We only regret that he could not have been there, raising his stimulating and pertinent questions and to pursue his point in the discussion. The immediate shock and grief occasioned by his death have passed, but for all who knew him, the void he left will not be filled.

Reflections On Tax Reform

Richard A. Musgrave
H. H. Burbank Professor of Political Economy Harvard University

Tax reformers—like their brethren in other walks of life—have their eyes fixed on a distant star, a stance which invites stumbling when the footing gets rough, as unfortunately it will in the pursuit of tax reform. Yet, without a star there is no direction, and better to stumble towards the right goal than to proceed swiftly on a random walk. This at least has been our premise; and the star which has guided us—by "us" I mean that motley crew of tax economists of which Harry Kahn was an esteemed member, who have tread this path for the last 30 years—was the comprehensive and federal individual income tax. From Simons to Carter the message was clear: income is the best base on which to tax; and the best definition of income is accretion, independent of the source from which it flows and of the uses to which it is put.

Let me take this occasion to ask how correct we have been in following this star and what need there is, if any, to chart a new course? More specifically, I shall ask these questions:

1) Have we been correct in placing central emphasis upon the equity of the tax system?

2) Have we been justified in our emphasis upon income as the best measure of tax-paying capacity?

3) Have we been justified in our insistence that taxable income be defined as increase in net worth plus consumption?

4) Have we handled the issue of progression properly?

5) Was it wise to focus so heavily on federal as distinct from state and local taxation?

6) Has it been proper to view the equity issue in terms of taxation only or should one take a broader view of fiscal equity, including expenditure benefits along with tax burdens?

As you will see, I shall answer questions 1 and 3 with a resounding "yes," hedge on 2 and 4, and say "no" to 5 and 6.

1. *The Case for Tax Equity*

There are those who argue that tax equity is a soft subject, better to be replaced by the harder issue of economic effects, such as excess burdens, work incentives, and the implications of tax policy for growth. We have been correct in rejecting this view. Efficiency and growth are important considerations of public policy, but equity is no less essential. Equity in taxation is perhaps the best barometer of social integrity in a society, well worth one's attention and the payment of some price in efficiency cost.

Even though equity is an elusive concept, there are aspects on which agreement can be reached. If taxation is viewed as the price of public services, the nature of such services calls for differential pricing. Whereas private goods may be consumed in different amounts by various consumers who pay the same price, public goods must be consumed in the same amount but be paid for at different prices, set in line with consumer evaluation of such services. If taxes are viewed as general contributions to government without specific benefit imputation, such contributions should be in line with the individual's tax-paying capacity, as defined in some meaningful fashion. Of the two approaches, the latter has been the underlying philosophy of our tax reform thinking and while I have some qualms about this, I shall follow it for the time being.

In developing the idea of equitable taxation we have distinguished between two aspects of the equity problem, horizontal and vertical. Horizontal equity calls for equal treatment of (imposition of equal taxes on) people in equal positions.[1] Whether equality is measured in terms of income, consumption or some other index, this dictum meets the obvious requirement of fairness in a democratic society and is generally accepted. Vertical equity poses the more difficult question of how taxes among people in unequal positions should differ. This is a more controversial matter even though at closer consideration horizontal and vertical equity are linked. Fairness as called for by horizontal equity means more than absence of willful discrimination. This becomes evident once we consider that assignment of tax bills by lottery (though operated free of discrimination) would not be acceptable. The requirement that people in equal position pay equal tax is thus inherently linked to its counterpart of vertical equity, i.e., that people in unequal positions should pay unequal amounts of tax.

The question is how these amounts should differ. Our stance in this matter has been to take refuge in the safe haven of the new welfare economics. Scientists, so we have been taught and have taught, have nothing to say about the problem of distribution. While most of us have favored progressive taxation, we have been prone to add that this is our personal value judgment only; or, that tax progression should reflect society's value judgment on income distribution. It is but recently that some new attempts at dealing with this problem have been made, a matter which I shall return to later. At this point, I need only note that an index of economic capacity is required in both the horizontal and vertical equity context. While there may be

[1] If people with equal income are alike in other respects, equal treatment defined as equal taxes is unambiguous. If they differ, equal taxes may not impose the same burden in terms of welfare lost. Taxpayer A may reduce his work effort more, in response to the tax than B. While both are left with the same net income (after the tax is imposed) A will suffer a heavier loss. Given the presence of the tax, A may receive the same before-tax income and pay the same tax. Yet, A may suffer a heavier burden as the introduction of the tax has induced him to reduce his work effort more than B. By overlooking this point, the traditional equity doctrine thus proceeds on the assumption that people with equal income have responded equally to the tax.

debate over the nature of the index, we have been correct in insisting that without it no decent tax system can be constructed.[2]

To hold that tax equity is of central importance does not mean that other aspects should be neglected. Equity considerations may or may not coincide with other objectives of policy; and where there is a conflict, trade-offs must be made. These trade-offs involve value judgments, but it is the job of the tax economist to find ways which involve the least cost in terms of either objective. The analysis of tax structure which we have pursued over the years may be viewed as an attempt to push out the possibility frontier against which these choices are applied. Thus, *if* it is desired as a matter of economic policy to stimulate investment and growth, such measures should take a form which involves the least damage to equity. Or, *if* it is desirable to redistribute income to the lower income groups, distributional measures should be taken so as to interfere least with efficiency considerations. Tax equity, I conclude, is not a soft subject but ranks on par with "economic effects" as a major feature of tax policy and, I dare say, even of tax economics.

2. *The Optimal Base*

All taxes in the end are paid by individuals and the world of tax equity makes sense only if our concern is with the distribution of the tax burden among people. It follows from this (1) that an equitable tax system should make use of personal taxes, i.e., taxes which (as distinct from *in rem* taxes) allow for the personal circumstances of the taxpayer. If progressive rates are to apply, it is essential, moreover, (2) that the base be defined in global terms. Thus, under an income tax all income should be taxed as a whole, rather than applying rates to particular schedules or sources of income. Under a consumption tax, all forms of consumption should be included in the tax base and so forth. I see no possible basis for disagreement with these two propositions, but the choice of the base itself is not at all obvious. What can be said for the three major contenders: income, consumption and wealth?

[2] On the need for and feasibility of such an index see B. I. Bittker, C. O. Galvin, R. A. Musgrave and J. A. Pechman. *A Comprehensive Income Tax Base? A Debate,* Federal Tax Press, 1968.

Income vs. Consumption

The case for income as the superior base is its comprehensiveness. Defined as increase in net worth plus consumption—a definition which we examine in the next section—it measures the total of economic resources which come to a person's command, independent of their sources and of the use to which they are put.

The consumption base obviously is narrower as it involves the exclusion of saving, but this need not make it inferior. Among all taxes, the turnover tax has clearly the largest base, but it is a very inferior tax. By citing comprehensiveness as an argument in favor of the income tax base, the essential point is not that this permits more revenue to be raised with a given tax rate, but that *all* income sources and *all* options of income use should be included in measuring tax-paying capacity. As against this comprehensive view, a long line of economists from John Stuart Mill to Irving Fisher have held that the income tax is inequitable because it double-taxes savings. This, as I pointed out in my first venture into print, involves a confusion between equity and efficiency considerations.[3] While the income tax reduces the rate at which future consumption can be substituted for present (whereas the consumption tax is neutral in this respect) this has no bearing on the merits of income or consumption as an index of tax-paying capacity. A head tax, by being entirely neutral, is best in the narrow efficiency sense of non-interference with Pareto optimality, but this does not make it an equitable tax.

If A and B both begin with the same endowment, A may save and derive future capital income while B does not. The same options are open to both, and A's future capital income constitutes *new* income which becomes a proper subject of new taxation. Similarly, from the income concept point of view it would be inappropriate to tax C, who consumes out of dissaving (but receives no income) even though he would be taxed under the consumption tax approach. Whether one considers the income tax as involving double-taxation of saving or the consumption tax as involving an under-taxation of income thus depends precisely on what is considered the proper base to begin with. The double-taxation argument confuses the problem of excess

---

[3] See R. A. Musgrave, "Further Note on the Double Taxation of Saving," *American Economic Review*, September, 1939.

burden with that of equity, and does *not* tell us which base should be chosen.

A better argument for the consumption tax is Locke's proposition that a person should pay tax "in line with what he takes out of the common pot, rather than with what he contributes." Consumption, according to this view, is considered a selfish act which should be dealt with more harshly than saving which is taken to benefit others. I find it difficult to evaluate tax bases by motivation or desert. With a positive rate of interest, saving is rewarding and the income recipient allocates the time stream of his consumption as seems best to his interests (or to that of his heirs). Moreover, it can hardly be overlooked that accumulation of property yields benefits (in terms of status and power) which are a source of satisfaction to the owner. Viewed from the point of view of ability to pay alone I find it difficult, therefore, to rationalize the choice of consumption over income. The argument might be made that saving (and capital formation) yield external benefits which are not allowed for by the individual saver and should thus be subsidized. This may place the social discount rate below the private, but it will hardly justify total exemption of saving. In any case, this line of reasoning is not a matter of tax equity and thus raises the previously noted trade-off issue.

At a more practical (speak political) level, the choice between an income and consumption base has not been debated in terms of which constitutes the more "meaningful" measure of taxable capacity. Placed in historical perspective, the debate has been dominated by the simple fact that income taxation has been the vehicle of personal and progressive taxation, whereas consumption taxes have tended to be *in rem* and regressive taxation. In principle, at least this need not be the case. A personal expenditure tax could be constructed and applied with progressive rates. Such a proposal was initially advanced by Irving Fisher, put forth later by the Treasury during World War II and then revived by Nicholas Kaldor.[4] Unfortunately, such a tax is not easily applied, especially in the upper income ranges where the difference between saving and consumption matters most. To make it stick, balance-sheet accounting would be required with all the difficulties that this involves. With a personal and progressive consumption tax not as yet in the

[4] N. Kaldor, *An Expenditure Tax*, Alan and Unwin, London, 1955.

cards, the taxation of consumption continues to be viewed in terms of flat rate and *in rem* taxes imposed on sales. The crux of the debate remains focussed on the issue of progression rather than the choice of base.

Short of comparing the income tax with a full-fledged personal expenditure tax, consumption taxes can be adjusted to avoid regressivity at the lower end of the scale. Certain commodities which are consumed primarily by low income groups may be exempt from the consumption tax; or, preferably, an exemption or credit may be given for a basic amount of expenditures. Provided that it can be implemented properly, which I question, the credit could serve to render a broad-based consumption tax progressive up to an income range of, say, $15,000. This being the case, it might be argued that such degree of progression as is considered appropriate over the higher income ranges might be left for the income tax. In principle, there is no reason why the prevailing vertical pattern of burden distribution need be greatly affected if the federal tax structure were to make broader use of both taxes. Rather, the main shift would be from savers to consumers in the middle income ranges.

A Wealth Tax?

In addition to income and consumption a third base may be found in wealth or—as seen in the context of a personal tax—in net worth. Given an income tax to begin with, applicable to all accretions be they earnings or bequests and gifts, what justification is there on capacity-to-pay grounds for a tax on net worth?

Viewing wealth as capitalized income from non-labor sources, a tax on wealth is equivalent to a supplementary tax on capital income. In the tradition of a global income tax, such a supplementary tax is not needed. If A chooses to consume his income or wealth while B chooses to accumulate or retain it, B should not pay an extra tax, other than the normal income tax on the additional income derived from his investment. Only where holding of wealth yields a nonpecuniary return that is not reached by the personal income tax, or where the initial acquisition of wealth by bequest or gift was not subject to tax, would a supplementary tax be in order. But even then, this may be done more conveniently as a surcharge on capital income under the individual income tax.

Vertical Equity as a Case for Multiple Bases

Looking at the choice of tax bases as a measure of individual taxpaying capacity, I find little reason to budge from the income concept. Society's notions about vertical equity may, however, call for a multiple base. Considering the distributions of income, consumption and wealth, the desired state of equality or inequality need not be the same on all three counts. At the first sight, this seems unreasonable. If income is the broadest measure of a person's economic capacity, and assuming bequests and gifts to be counted as income, why should not also the state of distribution be settled in terms of income? Provided that an individualistic welfare function is employed, there is no reason to interfere with how a person wishes to use such income (be it between various forms of current consumption or between consumption and saving) as has been assigned to him.[5]

Yet, it might be argued that this is not all there is to the problem. The externalities or social implications of various states of distribution may differ with the base. Society may assess the implications of a given distribution of income differently depending on how it is used. Society may feel differently about inequalities in consumption than it does about inequalities in saving and the resulting inequalities in property distribution. In the first case issues such as unwillingness to tolerate substandard food levels or dislike of conspicuous consumption are involved. In the second, the problem may be one of imbalance in the distribution of political and social power due to concentration of property ownership.

Moreover, the distribution of consumption (by size brackets of consumption) is more equal than that of income (by size brackets of income) and the latter, in turn, is more equal than the distribution of wealth (by size brackets of wealth). The shares recorded by the highest and lowest quintiles, for instance, are estimated at 35 and 8 percent for consumption, 41 and 6 percent for income, and 76 and zero percent for wealth. If society wishes to apply different standards of equality or inequality to all three variables, more than one tax base will be needed. Since the three distributions are interrelated, only two of them can be adjusted as desired while the third will follow. For this purpose two tax bases will be needed, be it income and consumption, consumption and wealth or wealth and income.

[5] See also Lester C. Thurow, "Net Worth Taxes," in *National Tax Journal*, September, 1972, p. 418.

Balancing Loopholes as a Case for Multiple Bases

A further case for the use of multiple bases may be one of administrative expediency. In developing countries in particular, it is difficult to reach capital income under the income tax but possible to tax real property where located. More generally, as Harry Kahn has argued in a recent paper, one tax in the system might serve to offset shortcomings of another.[6] Thus, the "double-taxation" of dividend income under the corporation tax may be considered a partial offset to imperfect taxation of unrealized gains; or the property tax might turn out to compensate for homeowner preferences under the income tax. Consumption taxes might cover income components on the uses side which have escaped taxation on the sources side and so forth.

Constructing a good tax system out of compensating components is, however, a difficult task. A combination of taxes may compound rather than correct inequalities. The corporation tax imposes an additional tax on capital income, but the incremental burden is highest per dollar of dividend income for the small shareholder for whom the capital gains preference is least important. Nor is a consumption tax well suited to compensate for omissions under the income tax. Imputed income from housing, which is among the most important omissions, is also a type of consumption which would not likely be reached under even the broadest of consumption taxes. Indeed, it would seem that the major activities which are hard to reach from the income side (e.g. farming, residential housing, and services) would also be hard to reach from the consumption side. A more successful matching is provided by the property tax on residential housing (unless viewed as a benefit tax) but even here its deductibility from the income tax base tends to limit the correction to the lower end of the income scale.

A general expenditure tax, finally, might be viewed as a way of getting at high spending individuals who, due to low income, are not reached effectively under the income tax. This consideration was a major factor in Kaldor's proposal for a progressive expenditure tax. The income-poor British gentry, living high on selling castles, could not be reached effectively under the income tax but would be susceptible to an expenditure tax. Taking

[6] See C. Harry Kahn, "The Place of Consumption and Net Worth Taxation in the Federal Tax Structure" in *Broad Based Taxes,* R. A. Musgrave, ed., Committee for Economic Development, Johns Hopkins Press, 1973.

an income tax approach, there is no obvious reason for so doing. Dissaving, from the income tax point of view, does not constitute a taxable act. The problem, rather is that income taxation (by failing to include the castle in the tax base when received by bequest) was deficient so that the subsequent consumption tax may be viewed as a corrective for income tax omission. Similar considerations may be applied where consumption is taxed in lieu of inclusion of unrealized gains under the income tax, or in lieu of full taxation of realized gains. Such constructions are possible, but compensations are difficult to apply with any degree of precision. In all, I do not see great promise in securing horizontal equity for the system as a whole by combining inequitable components.

Assuming an expenditure tax to be feasible, the compensation process may work better for vertical equity, but even here difficulties arise. Thus, combining a regressive (or less progressive) consumption tax with a more progressive income tax may leave the overall degree of progression unchanged, but households with relatively high propensities to consume will be taxed less progressively than households with relatively low propensities. The compensatory result applies only with regard to households with average consumption and saving ratios in each bracket. While there can be no question that what matters is the distribution of the entire tax burden and not of its parts, it remains difficult to design an equitable distribution of the total burden (in both its horizontal and vertical aspects) without also considering the equity of each component.

Conclusion

I conclude that we have been generally correct in championing the income base as the best capacity measure, but that our position has been somewhat too rigid. If the differing distributional implications of consumption, income and wealth are allowed for, a multiple system may turn out to be the better solution.

3. *Accretion as the Definition of Income*

However this may be, the income tax is surely going to remain the core of the federal tax structure. Given this fact, it remains important to ask whether our insistence on the accretion concept has been the correct position to take. Here we have been clearly on the right track. If an income tax, then accretion.

Need for an Income Concept

The definition of income for tax purposes was given lengthy attention by German students of public finance during the close of the last century, a tradition which was transmitted to the U.S. through the writings of Robert Haig and Henry Simons, followed up by William Vickrey, thus saving us from the much more pragmatic approach which has been the British tradition. Income according to these authors equals the increase in net worth plus consumption. It also equals the sum of wages, profits, interests, rents, capital gains (realized or not) and imputed income of various kinds. While the general concept is clear, its application encounters difficulties and second best solutions have to be found. But this, as we have been correct in insisting, does not invalidate the concept. Nothing is perfect, except in the philosopher's mind and the guidance provided by a clear cut and meaningful income definition is essential. The same, of course, holds regarding the need for a consumption concept under an expenditure tax or a net worth concept under a wealth tax. Without such a concept each special situation has to be dealt with on an *ad hoc* basis. No consistent structure can emerge and the door is wide open to proliferation of preferences in treating particular cases.

Capital Gains

While many issues may be raised in this context, much the most important one is that of capital gains. Preferential treatment of gains is not only a major source of horizontal inequity, resulting in highly uneven tax burdens among income recipients within the same bracket, but also the major reason why there exists such a sharp differential between the actual pattern of progression (or lack thereof) over the upper brackets and that which full application of statutory rates would produce.

As it turns out, the capital gains treatment is the crux of the tax preference problem (in so far as higher incomes are concerned) and dwarfs in importance most other provisions. The crux of income tax reform, therefore, is recognition of the fact (1) that capital gains are income not distinguishable as tax paying capacity from other forms of income and (2) that such is the case whether the gains are realized or retained in accrued form. In principle, capital gains should be taxed as other income, just as capital losses should be treated as other losses.

The nature of realized gains as income would seem self-evident. While it is true that gains may be more volatile than wage or dividend receipts and, therefore, subject to potential discrimination under progressive rates, this difficulty may be met readily through adequate averaging provision. Given such provision, volatility or "surprise" does not offer a reason for differential treatment.

Nor is there a conceptual basis on which to argue that unrealized gains do not constitute income. If an investor decides not to realize, must it not be concluded that he considers this preferable to realization? Such being the case, he cannot claim to be worse off than had he chosen to realize. Nor is separate treatment of unrealized gains justified by a consumption tax approach. While unrealized gains would not be taxed under a consumption tax, neither would realized gains or any other income which is saved. Consistent application of the consumption tax principle must exclude all saving and not only that which occurs in the form of unrealized gains.

As a further case for exclusion, it is held that taxation of unrealized gains would be unfair because the taxpayer has no cash with which to pay his tax. In the case of divisible and negotiable assets, the taxpayer may readily meet this problem by liquidating part of his assets to pay the tax. In the case of indivisible assets (such as family enterprises or farms) this may be more difficult and other ways have to be found to deal with the problem. At the same time, such assets involve a relatively small part of the total picture and should not be permitted to block dealing with the problem. Moreover, similar problems have to be met under the estate tax.

There are, of course, practical difficulties which must be met in bringing capital gains into the tax base. Full taxation of realized gains without taxation of unrealized gains would generate severe lock-in effects, so that the taxation of unrealized gains becomes the crux of the problem. In dealing with such gains, annual valuation of all accruals would hardly be feasible. While some types of assets (such as traded shares) may be valued and taxed periodically, say every five years, others will have to be valued and taxed at the time of death or transfer. Such a plan which now has been introduced in Canada is administratively feasible and if strictly applied should go far to solve the problem.

There remains some further questions including (1) gains from tax deferral and (2) the treatment of inflationary gains.[7] Deferral gains arise because the tax liability which has to be paid in the future is less burdensome than one which must be paid when the income occurs. By permitting postponement until death or gift, the government in effect grants the taxpayer an interest-free loan and the effective tax rate may be reduced substantially as a result. This is the case especially for young investors who can look forward to a long holding period. To deal with this problem an interest charge is in order. Certainly, the logic of deferral gains calls for the tax on capital gains to rise rather than to fall with the length of the holding period.

The inflation problem is more difficult to deal with. The accretion concept as a measure of taxable capacity must surely refer to the accrual of real income. This is a matter of importance for tax policy in general, but it is of special significance in the capital gains context. In a world in which people hold no assets but receive work income only, the bearing of inflation on tax equity would arise only in the context of progressive rates, but would be absent with proportional rates. As a taxpayer's income rises in money terms, so does his tax but both remain constant in real terms. Yet, where assets are held, inflation generates nominal income without creating real income (e.g. the resulting increase in the money value of equity shares) just as it creates real losses without accompanying losses in money value (e.g. the real loss suffered by creditors and gain incurred by debtors) or real gains without money income (i.e. the real gains experienced by debtors).

It seems clear, therefore, that equitable taxation calls for capital gains to be adjusted to allow for inflation; and the longer the asset has been held, the greater should the adjustment be. The same reasoning, however, also calls for the allowance of losses which result from the decline in the real value of balances or claims and for the taxation of gains which accrue to debtors. Given the fact that such universal adjustments would be difficult

---

[7] Another problem which I shall pass over here relates to the treatment of changes in capital value which reflect a change in the rate of interest. Should a rise in bond prices due to a decline in the rate of interest be considered a taxable gain? The future income stream yielded by the bond is not affected, yet I would suggest that it be considered a gain since the *potential* consumption value which could be obtained from dissaving is increased. This follows if current income as defined in terms of accretion is interpreted as *potential current* consumption rather than as a potential source of claim to a future income stream.

to implement, it is hard to say whether it would be equitable to deflate capital gains without accounting for the rest of the problem. In the end the only adequate solution will be to forestall inflation to begin with.

Some observers grant the equity case but hold that preferential treatment of capital gains is needed to assure an adequate level of saving and investment. Here we need only note that even if special tax concessions to growth are needed, the prevailing capital gains treatment is not the most suitable technique. Investment incentives when needed can be given more directly and with less damage to tax equity. A revised system including full taxation of gains, combined with more moderate bracket rates and incentives such as the investment credit would be preferable to the prevailing system on both equity and efficiency grounds. In all, I conclude that we have been on the right track in this case.

The Role of the Corporation Tax

Another issue which cannot be avoided if the case for an equitable income tax is to be taken seriously pertains to the role of the corporation tax. All taxes, as noted before, must in the end be borne by individuals so that the principle of tax equity can relate to individuals only. Assuming the corporation tax to fall on the shareholder, it is thus a supplementary income tax on corporate source income. While a case might be made for a supplementary tax on capital income in general, selection of this particular source of capital income is hard to defend. The proper solution is to impute retained earnings to the shareholder, thus taking all corporate source income at the individual level while scratching the corporate tax. The case for integration and removal of an absolute corporation tax, moreover, becomes the stronger if the corporation tax is shifted to the consumer, in which case it becomes a rather arbitrary type of excise tax.

The case for integration seems to me an essential component of consistent income tax philosophy. While widely considered such some years ago, it has now fallen from favor. Partly this is because the tax is convenient to collect and integration would involve a substantial revenue loss. On distributional grounds, the tax is supported by some because as a tax on profits it is taken to add to the progressivity of the tax structure, while others (frequently including business observers) find it harmless and paid by consumers anyhow. Thus, support for integration is difficult to muster. Yet, tax politics aside, our earlier case for integration was clearly the right position. Under either incidence assumption, integration combined with rate adjustments to recoup the revenue loss will provide the superior solution. The demise of the integration case, therefore, has not strengthened the credibility of the tax reform package.

A tax reform package involving (1) full taxation of capital gains with a revenue gain of say 15 billion dollars, (2) integration of corporate source income into the individual income tax with a revenue loss of say 20 billion dollars, (3) reduction in the top bracket rate on capital income to 50 percent, costing less than one billion dollars, and (4) reform of the treatment of tax exempt interest, depletion and depreciation, yielding around 6 billion dollars would, I believe, result in a much sounder and more equitable structure of income taxation. The minimum tax approach, introduced in 1969 and under current reconsideration, is at best a poor substitute for such thoroughgoing reform.

4. *How Progressive Should the System Be?*

I now return briefly to the problem of progressivity or vertical equity. In appraising the current setting, it has been our position that the present combination of high marginal rates with a deficient base is unsatisfactory and that a less progressive rate structure applied to a more comprehensive base would be preferable. This position, of course, was with the angels and everyone should agree with it. But beyond it, matters become more difficult.

Asked about the "correct" degree of progression which vertical equity might call for we have argued that as economists we have nothing to say about this issue other than to point out the economic effects which might result. Yet as tax technicians we have been concerned with designing a tax structure which lends itself to substantial progression and as policy advisors we have generally opposed regressive taxes.

Perhaps we have been either too modest or not quite modest enough. I have always suspected that the "new" welfare economics went too far in outlawing at death penalty the Pigouvian model of inter-personal utility comparison. There does seem to me a presumption that marginal income utility (I intentionally use the old fashioned term rather than that of risk aversion) *is* declining and that the dispersion of utility levels (derived from any given income) is distributed more or less normally among potential recipients. This in turn suggests that the Benthamite principle of maximum total satisfaction does call for equal distribution of a given total income.[8] The case for progressive taxation, therefore, is not as totally a matter of subjective value judgment as the post-Pigouvian discussion has suggested.

At the same time, economists must note the fact that the level of total income available for distribution is in itself a function of redistribution. This, of course, is the reason why utilitarians such as Edgeworth have always qualified their case for equalization by allowance for disincentive effects. It is on the latter aspect that the interest of recent work has focused. Since income can be redistributed but not leisure, people may respond to progressive taxation by working less. The optimal degree of redistribution under various social welfare functions then depends on work responses. Thus, it may be postulated in line with Rawls that equalization (i.e. a redistributive tax-transfer system) should be carried to the point where income at the low end of the scale could not be increased further thereby.[9] By learning more about work (and for that matter, capital formation) responses, progress might be made towards determining what patterns of progression are in line with what social welfare functions.[10] I am pleased to see this direction of research and the general revival of interest in the economics of income distribution.

5. *Focus on Federal Taxation*

Our work over the last three or four decades has focused primarily at the federal level, with relatively little attention paid to state and local finances.

The reason for preoccupation with central finances, apart from the superior glamour of Washington, derived from the fiscal policy focus which the "Keynesian Revolution" of the late 1930s bestowed on public finance as a field of research. Since the

[8] See A. P. Lerner, *The Economics of Control*, Macmillan, New York, (1944), p. 30.

[9] See John Rawls, *A Theory of Justice*, Harvard University Press, 1971.

[10] See Ray C. Fair, "The Optimal Distribution of Income," *Quarterly Journal of Economics*, November 1971; and E. S. Phelps, "Taxation of Wage Income for Economic Justice," *Quarterly Journal of Economics*, August 1973.

stabilization function was clearly central, state and local governments could be disregarded and even treated as part of the private sector. In the stabilization context, this view of the matter was essentially correct and has remained so. But from the point of view of tax (or, for that matter, expenditure) structure, the one-sided focus was a narrowing factor.

With the reorientation of fiscal economics toward allocation and distribution issues, as well as the recent concern with the economics of decentralization, the inherent importance of state and local finances has been rediscovered. This applied to the tax as well as to the expenditure side of the picture. Looking upon the U.S. tax structure as a whole, the federal income tax still dominates, but neither the local property tax nor consumption taxes at the state level can be disregarded as major components of the overall system. Viewing both horizontal and vertical equity in terms of the *total* tax structure, as they should be, a quite different pattern emerges than the income tax oriented federal focus suggests; and looking at the state, and local structures as separate units, the interesting problem of inter-jurisdictional tax relations has to be faced. Thus, the problem of tax structure as a whole becomes more than its parts and both problems of efficiency and equity have to be rethought in the broader context of multi-jurisdiction and multi-level finance.

6. *Fiscal System Equity*

I now turn to my final topic, namely the validity of viewing tax equity independent of the expenditure and benefit sides of the fiscal picture. This, clearly, is what we have done in our tax work, but it is the weakest part of the Simons tradition. Taxes, after all, go either to provide public services or to finance transfer payments. They are not—at least not generally so—payments which yield no benefits once made. While taxes are not imposed on a specific benefit basis, each person is engaged with both the benefit and the cost side of the fiscal system. His ultimate concern must be with comparing the two and assessing the net residue—be it a gain or a loss—which he derives therefrom.

Thus, it is difficult to evaluate the equity—or for that matter, the efficiency—of gasoline taxes without noting that government also provides free roads; or to consider the regressive nature of payroll taxes without also noting that benefit payments are made to the aged. The fact that tax legislation is related only obliquely to expenditure determination is no excuse for dealing with the economics of taxation as if expenditures did not exist. Indeed, our practice of doing so may have contributed to the balkanization of legislative action with regard to tax and expenditure matters and (by way of Hegelian justice) to the emergence of an equally separate view of the expenditure problem in the context of project appraisal. Yet, it is precisely the interrelation between tax and expenditure legislation which provides the lever by which consumers (or voters) must be induced to reveal their preferences for public services; and without such revelation no efficient public sector can be constructed. In appraising the quality of a tax—or of a tax structure—an important question, therefore, is how well it serves this purpose, a consideration which involves not only the quality of the tax, but also the setting in which the legislature operates, including its relation to the appropriations process.

Turning to the distribution aspects of budget policy, it appears that redistribution operates more strongly through the expenditure or benefit side than it does through the tax or burden side. As a result, the distribution of the *net* benefits (or burdens) is more favorable to low incomes than consideration of the tax side only would suggest. While I have been less guilty on this point than some of us, it is surely necessary that both sides of the picture be considered.[11]

This should be done even though there are serious difficulties with the estimation of expenditure benefits. While the distributional impact of transfers can be analyzed without much difficulty, or with only the same difficulties as are involved in the determination of tax incidence, the distribution of benefits from public services is harder to determine. In the case of some items, such as education and highway expenditures, benefits can be imputed to individual recipients and estimates of benefit distribution can be made. Costs incurred (if not value received) "on behalf of" various groups may be imputed to them. Again there is a problem of shifting and incidence (or more appropriately of benefit snatching) but once more the difficulties are not too different from those encountered on the tax side.

[11] See Richard A. and Peggy B. Musgrave, *Public Finance: Theory and Practice*, McGraw Hill, 1973, Chapter 15.

The main difference arises with expenditures of a more general type, the benefits of which are not directly allocable to particular households. Here the road to careful analysis is blocked and rough and ready assumptions must take its place. But fortunately, some 80 percent of state-local expenditures do permit a direct benefit allocation. At the federal level 50 percent of the total (or 90 percent if defense is excluded) may also be assigned. The task of considering the distributional implications of the expenditure side is thus by no means hopeless and, for the bulk of expenditures not that much more difficult than tax burden assignment.

What then are the implications of the benefit distribution for tax equity and tax system analysis? Leaving aside the problems of benefit taxation as it applies to particular expenditure functions (such as highway finance), linkage to expenditure benefits does not remove the need for taking a global view of the tax system. The individual after all, is taxed by the system as a whole and not just by separate components; and the linkage to expenditures rests on the contribution which the *system* imposes on any particular individual (be it marginal or average tax dollar) rather than on his liability under any particular tax. It does mean, however, that the qualities of the system and its burden distribution should be assessed in relation to the expenditure structure.

As far as vertical equity is concerned, the argument is clear enough. If it is the intention of policy to secure a certain amount of redistribution through the fiscal system, what matters is the *net* result of both tax and expenditure policy that is obtained. If one considers what happened to the distributional implications of the fiscal system over the last ten years, both sides of the picture should be included. At the federal level this is of particular importance because the growth of payroll taxes has added a heavily regressive feature to the tax structure. Yet, it has been accompanied by an expansion of transfer payments which worked in the opposite direction.

Some further difficulties need be noted. While it is troublesome to draw inter-bracket comparisons of tax burdens or expenditure benefits by comparing the position of the average taxpayer in various brackets, this procedure proves even more troublesome when it comes to the distribution of *net* benefits. Particular households in any one bracket may be greatly above the average with regard to burdens and below the average with regard to benefits or vice versa. This is especially evident with regard to the payroll tax and to OASI benefits. Thus, retired people benefit from higher pensions while low-income wage earners suffer from the payroll tax. It will thus be necessary, in dealing with net benefits or burdens to use a more disaggregative approach. Horizontal equity in terms of net benefits or burdens is perhaps the least attainable of all our goals. Moreover, the benefit pattern, especially in the social security sector differs greatly depending on whether the estimate is based on a cross section view or on a distribution of lifetime income. Viewed in the lifetime context, redistribution is substantially less.

7. *Conclusion*

In all, what assessment is there to be made of the premises which have guided our tax reform thinking? Normative concern with the "proper" tax base as against a pragmatic and *ad hoc* approach was essential and all to the good. Without it chaos beckons. Focus on income as the most meaningful base was also proper although more flexibility with regard to other bases has come to be in order. Accretion as the key to income definition surely was the right answer. More can be done to get handles on the problem of vertical equity than has been accomplished so far. Neglect of state and local taxes was a narrowing factor. Finally, and here I part sharply with the Simons tradition, the isolation of tax thinking from expenditure issues was too confining a view. While there are tax-technical problems which do not pertain to the expenditure side, the choice of the "good tax system" can in the end not be made in total independence of the expenditure side of the budget. Fiscal analysis requires consideration of both the expenditure and the tax side of the picture. What matters is the net impact of the fiscal system, both with regard to its results and the forces which determine it. While the difficulties of this net approach are substantial, they are not insuperable, and it is important that the comprehensive approach be pursued.

* * * * * * * * * * *

In concluding, let me say that I have had the benefit of discussing many of these problems with Harry, sitting on the back lawn of his Vermont farm and looking over the green hills towards Mount Ascutney. He would have agreed with much of what I have said here, but being the independent and unsentimental thinker he was, not with all. I for one shall miss these discussions for a long time to come.