TAX REFORM: THE TIME IS NOW

By JOSEPH W. BARR

LAST January 17, before the Joint Economic Committee of the Congress, I indulged myself in a sentimental journey in which I reviewed our accomplishments of the past eight years. I also outlined what I termed "unfinished business." First on this list was tax reform. This is what I said:

"Our income tax system needs major reforms now, as a matter of importance and urgency. That system essentially depends on an accurate self-assessment by taxpayers. This, in turn, depends on widespread confidence that the tax laws and the tax administration are equitable, and that everyone is paying according to his ability to pay.

"We face now the possibility of a taxpayer revolt if we do not soon make major reforms in our income taxes. The revolt will come not from the poor but from the tens of millions of middle-class families and individuals with incomes of $7,000 to $20,000 whose tax payments now generally are based on the full ordinary rates and who pay over half of our individual income taxes.

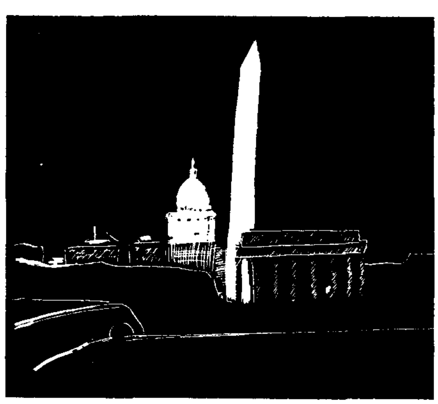
"The middle classes are likely to revolt against income taxes not because of the level or amount of the taxes they must pay, but because certain provisions of the tax laws unfairly lighten the burdens of others who can afford to pay. People are concerned and indeed angered about the high-income recipients who pay little or no federal income taxes. For example, the extreme cases are 155 tax returns in 1967 with adjusted gross incomes above $200,000 on which no federal income taxes were paid, including twenty-one with incomes above $1,000,000.

"Judging from taxpayers' letters to the Treasury, I would say that many people are upset and impatient over the need for correcting these and other situations which demand our attention. In this connection, I should point out that the 10 per cent surcharge has made many taxpayers more aware of the inequities in our present tax system and more demanding that reforms be adopted. I believe public confidence in our income tax system is threatened and that tax reform should be a top priority subject for the new Administration and the 91st Congress."

Frankly I was amazed at the response. The idea of a middle-class taxpayers' revolt caught the attention of the press, and the story was played up heavily around the country for a few days. Then the letters began to pour into the Treasury and Congress. Clearly this was an idea "whose time had come."

It is against this background that I am now violating a principle that has always appealed to me. An outgoing Treasury Department official should keep his mouth shut on controversial matters until his successor has had an opportunity to get organized. However, I started this uproar, and it seems only appropriate that I expand a bit on the brief remarks made before the JEC. This manuscript was submitted to the Treasury, not for approval, but to find out if anything in the presentation would get in the way of their plans. Officials have checked the manuscript for accuracy; they have offered several technical observations; they have no objection to publication. In developing the article, I examined three lines of argument: What do we mean by tax reform? Why the intense public interest at this time? What can we do about it?

Attitudes toward tax reform usually vary depending on whose ox is being gored. There is a saying in the Congress that one man's tax loophole is another man's sacred Constitutional prerogative. But for my purposes here, I shall use this quote from Secretary of the Treasury David Kennedy: "First, we have the question of equity: Are all Americans in similar circumstances paying approximately the same amount of tax?" This is the only issue which we shall examine —not because it is the *total* answer in the area of tax reform, but because this is probably the issue that generated the public outcry after my January 17 statement.



Probably nearly all Americans would agree with Secretary Kennedy's criterion of equity. What most taxpayers don't like is that many people with very large incomes pay very low rates of tax or no tax at all.

On January 17, I transmitted to Kennedy a report entitled *Tax Reform Studies and Proposals, U.S. Treasury Department*. On January 30, it was sent to the Congress by Kennedy and is now available as a joint publication of the House Committee on Ways and Means and the Senate Committee on Finance. The report was prepared by Assistant Secretary Stanley Surrey and his staff. The data I shall be using here is derived mostly from Part IV of that report.

THIS may come as a surprise to many, but the fact is that the vast majority of American taxpayers in similar circumstances do pay similar taxes. Look at the table accompanying this article. It is not as formidable as you would think. Forget about the legal language at the top (unless you are a taxpayer). If you read across the top horizontal line, you will see that the columns are divided into *effective* tax rates—arranged in 5 per cent brackets.

Now, *effective* tax rates are the basic measure of tax bite—the tax actually paid as a per cent of income. If you look at the left-hand vertical column of the table, you will see that it is broken into income classes—0 to $3,000, $3,000 to $5,000, etc., up to incomes in excess of $1,000,000 per year. These figures refer to total income—salaries, dividends, interest, profits, plus profits on the sale of stock or capital assets, tax-exempt interest, and excess depletion.

A look at this chart is very informative —and on the whole very heartening. You can see that most Americans (68 per cent) in the lowest income levels pay from 0 to 5 per cent of their income in taxes. Then a rather amazing phenomenon occurs. From a level of about $3,000 up to $20,000, most Americans pay from 15 to 20 per cent of their income in taxes. For example, the table shows that 63 per cent of the $3,000-to-$5,000 income group are in this tax-rate base; 72 per cent of the $5,000-to-$7,000 group; 70 per cent of the $7,000-to-$10,000 group; 85 per cent of the $10,000-to-$15,000 group; and 71 per cent of the $15,000-to-$20,000 group.

Now, before anyone shouts "Eureka,

this is where we need tax reform!" let me explain this phenomenon. It is an outgrowth of two sociological facts of life that happen to be reflected in the tax codes. First, the people in the lower end of the income brackets tend to be single and are denied the use of the split-income alternative available to married couples. This, however, is not too important in income ranges up to $20,000. What is more important is that married couples in these income brackets, particularly in the $10,000-to-$20,000 group, have increasingly tended to become homeowners, which means that they can take the interest on their mortgages and their property taxes as deductions from their taxable income.

At this point let me hastily retreat from the accusations of single ladies that the tax laws discriminate unfairly against them in a world where the proposal of marriage rests with the male initiative. That is correct if you are referring to the provision that married taxpayers can split their income and end up in lower brackets. However, this provision works best if a girl marries a man whose income is much larger than hers. In addition, the standard deduction works peculiarly for people with incomes under $10,000. For example, I checked out the tax return of my most recently married daughter and son-in-law. They are both employed; they both earn about $7,000 a year; and because of the workings of the standard deduction, they are paying more taxes married than they would have paid if they were single—in spite of the fact that they can split their income!

I will also avoid any argument over whether homeowners, as opposed to renters, should have a tax advantage. In most parts of the United States, the decision to rent or to own can be made without too much difficulty. Therefore, the tax advantages in favor of home ownership usually result in a matter of choice—not economic necessity.

It can be seen from this short review that most taxpayers in income levels up to about $20,000 do pay similar taxes. They tend to cluster around the 15-to-20 per cent rate, with variations above and below, depending largely on personal factors such as medical expenses and marital status.

However, look at the remaining levels up to $1,000,000 and more. You will see that from $20,000 to $50,000 the tendency to cluster around a rate drops sharply. For example, 45 per cent of this group pay rates of 20 to 25 per cent. The rest of the group is spread above and below this rate. From $50,000 to $100,000, the "cluster" tendency drops to 31 per cent in the 30-to-35 per cent rate brackets. From $100,000 to $500,000, there is almost no "cluster" point. Taxpayers are ranged widely—with 2 per cent paying rates from 0 to 5 per cent up to a few in the 60-to-70 per cent brackets.

The cluster reappears with incomes from $500,000 to $1,000,000 and in incomes of $1,000,000 or more. These groups cluster in the 20-to-25 per cent and 25-to-30 per cent brackets. But here again the dispersion is wide, with 2.5 per cent of the $1,000,000 and more class paying taxes at the 0-to-5 per cent rate and 9.5 per cent of the group paying 60-to-70 per cent rates.

Thus we can safely observe that the pattern of comparability of effective tax rates in income classes starts to erode at $20,000, disappears above $100,000, and reappears in the highest income groups, but at quite low rates. What has happened? The answer lies in the way income is treated for tax purposes. One-half of the profits from the sale of capital assets—stocks, bonds, buildings, etc. —held for more than six months is not counted as income; and the remainder of such capital gains are not taxed at more than 25 per cent. Next in importance (in terms of income not treated as ordinary income for tax purposes) is the interest from state and local bonds. This interest is completely tax-exempt, not counted as income at all. Then comes the "unlimited charitable deductions," followed by farm losses and, finally, by depletion allowances in excess of cost of drilling.

THESE five factors, plus the practice of borrowing large sums of money and throwing the interest deductions against taxable income, leaving tax-exempt income to "ride free," account for most of the wide-ranging disparities among high-income taxpayers. I shall not deal with tax escapes on appreciation of assets transferred at death; there are a number

Percentage Distribution of Returns by Effective Tax Rate Classes

(by Amended Gross Income Classes, 1969 Levels)

Amended Gross Income ($000)	Effective Tax Rate Classes													
	0-5	5-10	10-15	15-20	20-25	25-30	30-35	35-40	40-45	45-50	50-55	55-60	60-65	65-70
0- 3	**68.0**	0.3	1.4	6.0										
3- 5	14.5	2.3	10.9	**63.0**	5.6									
5- 7	3.9	2.0	22.2	**71.6**	0.1									
7- 10	0.9	1.0	22.2	**70.5**	5.3									
10- 15	0.7	0.8	6.3	**85.2**	6.6	0.4								
15- 20	0.6	1.5	4.8	**71.2**	19.8	2.2								
20- 50	0.9	1.6	7.0	**27.9**	**45.2**	13.5	3.0	0.6	0.2					
50- 100	1.2	0.8	3.3	7.5	12.7	**21.6**	**31.2**	16.4	3.9	1.2	0.2			
100- 500	1.9	1.3	1.9	6.1	**17.9**	**15.9**	**11.5**	**14.1**	**14.4**	8.7	4.1	1.9	0.3	
500-1,000	2.1	0.7	0.8	0.7	**31.9**	**32.8**	6.3	4.3	3.0	2.4	3.1	4.6	6.7	0.4
1,000 & over	2.5	0.4	0.3	0.4	**36.6**	**37.8**	4.3	1.7	1.8	2.1	1.2	1.3	6.1	3.4

Office of the Secretary of the Treasury, Office of Tax Analysis of extraordinary examples there, too.

There is one other avenue of tax avoidance that is becoming increasingly important but is not included here simply because the Treasury has not yet isolated the statistics. It works like this. You build an office or apartment building for $1,000,000 (using about $100,000 of your money and borrowing the rest). You establish a super-fast rate of depreciation, and then pay the mortgage, interest, and maintenance from rents, plus *some* of the depreciation. Although the building is paying its way, it still shows a large tax loss which can be thrown against salary, dividends, etc.

I am assuming that this listing of tax provisions used by high-income taxpayers is understandable, but it might be unclear what the "unlimited charitable deduction is." The answer to this question requires a story.

There has always been a limit on the amount of income that an individual can give to charity. At the moment, the limit stands at 30 per cent. Back about forty years ago, a young lady from a very wealthy family entered a convent and took the vows of poverty. Her family created a trust for her that gave her all the income, which she turned over to the convent. But she could not touch the principal.

Clearly this nun was in violation of the income tax laws, and the Government tried to collect the tax due. Just as clearly, this was an impossible situation because the nun could not get at her principal in the trust to pay the tax the Government insisted she owed. So Congress passed a law which provided that anyone who gave away 90 per cent of his income for a period of five years was thereafter excused from paying income taxes, so long as he continued this pattern of giving.

This innocent law, which has unquestionably provided millions for charity and education, has had some peculiar results. If one is *very, very* rich, this law becomes quite interesting. Take the case of the taxpayer whose income one year totaled $10,800,000—mostly from dividends. He made contributions totaling $10,500,000, and as he had qualified previously for the unlimited charitable deduction, he paid no tax at all.

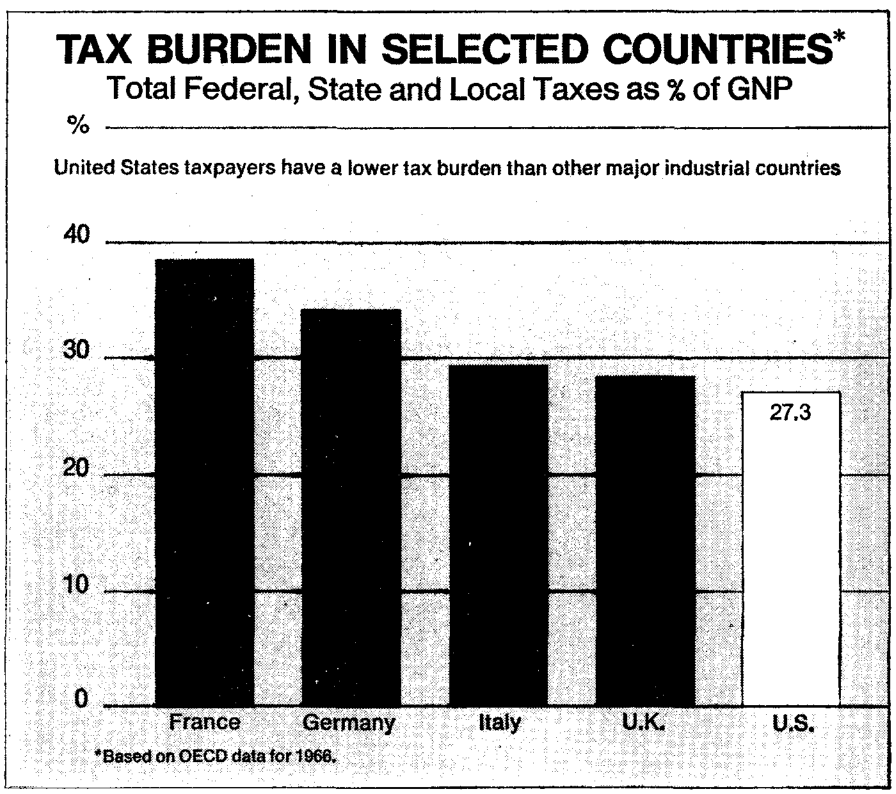
But one might say, "Yes, that's true, but he did give away nearly all his income." However, what probably happened was that this taxpayer gave away securities that he had inherited or acquired years ago at a much lower price. The law provides that contributions are valued at *market*, not at cost, value. If this taxpayer had dividends in excess of $10,000,000, his stocks were probably worth more than $200 million. Many corporations pay out in dividends less than half of what they have earned. So probably this taxpayer's portfolio of stocks increased in value more than the dividends he received and the money he gave away. It would not be at all impossible for this taxpayer to have started the year with $200 million in stocks; to have received $10,000,000 in cash dividends; to have given away $10,000,000 in stocks at market value; to have ended up the year with stocks worth $205 million; *and to have had $10,000,000 to spend with no taxes to pay*!

In summary, the principal reasons for large variations in the rates of tax paid by high-income taxpayers, and the reasons for the very low rates they pay (sometimes none at all) are: 1) the tax treatment of capital gains, plus the fact that high-income taxpayers often have large capital gains; 2) the tax exemption of state and local securities; 3) the unlimited charitable deductions; 4) farm losses; 5) depletion allowances; 6) tax losses on real estate; 7) the practice of allocating all deductions against taxable income—leaving untaxed income for a "free ride."

WHY is there such intense public interest in tax reform at this time? The fact that my January 17 statement caused a stir and that there is a continuing public interest in tax reform has puzzled me. After all, there is nothing new here. Congressman Wilbur Mills and former Senator Paul Douglas have been saying the same things for at least a decade. Treasury Secretaries Douglas Dillon and Henry H. Fowler have used the same arguments for the past eight years. There is nothing new in the fact that people with very large incomes have paid little or no tax. Secretary Dillon reported to the Congress years ago that one taxpayer whose income totaled $23,000,000 in one year had paid no tax.

Probably there are two answers to this problem, and probably the answers split on income groups. The people in the $7,000-to-$20,000 group are probably angry because they are being loaded with an ever-heavier burden of state and local taxes. Since our analysis has indicated that the federal tax laws seem to work fairly in these income classes, what these people are complaining about is not so much that their neighbors get a better break on federal taxes, but that the additional taxes imposed at the state and local levels, when added to their federal taxes, constitute a heavy load. They are probably also saying that they are irritated that taxpayers in much more fortunate circumstances are not bothered by this load and, indeed, may be paying less federal taxes than they are, on a per cent basis—and, in many cases, in dollars.

However, my personal observation leads me to believe that there is still another group with a serious complaint. If you will look at the table again, you will see that more than half (52 per cent) of the taxpayers in the income brackets between $50,000 and $100,000 are paying effective tax rates ranging from 30 per cent up to 50 per cent. But, surprisingly, 64 per cent of the taxpayers in the



income brackets from $500,000 on up are paying effective tax rates of only 20 to 30 per cent.

I have met a lot of people in the $50,000-to-$100,000 brackets in the past few years because they are lawyers, bankers, corporate executives, etc., who usually represent their organizations with the Government. I am continually amazed at the fact that so many of these people complain that they are living from hand to mouth. One of these individuals recently sent me a story on "How to Go Broke in New York on $80,000 per year."

It seems that many of these people, while they have very high incomes, do not have the capital to take advantage of the tax provisions I listed earlier. When they get hit with a federal tax bill of $35,000 a year, plus state and local taxes, it is not hard to understand why they are complaining—especially when they see all around them people with much larger incomes paying far less in taxes than they.

These $50,000-to-$100,000 income group taxpayers know all about the tax advantages. They do the legal and financial work that enables their higher income clients or customers to use these provisions. What they lack is the capital to use these tax advantages themselves. For one reason or another, they end up as a highly irritated group—as I know by personal experience.

"How big a plowshare did you have in mind?"

WHAT can be done? One thing is obvious to me: there are few "villains" to be found in this whole area. Look back at the list of tax advantages. One can't make villains out of investment bankers and brokers, governors, mayors, charities, and educational institutions, and it's a bit hard to make the city farmer into a "villain." It is also apparent that oil depletion, the favorite whipping boy in the past, ranks an ignominious fifth in the order of tax importance of tax advantages.

One may be flabbergasted and perhaps irritated that the taxpayer with the unlimited charitable deductions could get such handsome treatment, but it is still difficult to label this taxpayer a villain. After all, he is transferring huge sums to charity and education. Whenever an attempt is made to close off this particular tax provision (and it was tried once), the people who object the most are some of the nation's most distinguished educators. It is not easy to tell these men, many of whom I know personally, that this provision should be abolished on the grounds of tax equity.

It is equally difficult to argue with the investment community on capital gains. These are men of intelligence and reason, and they argue with great force that the tax treatment of capital gains should be *liberalized*, not tightened, in order to generate the investment capital that this nation and the world clearly need. Try to argue with a governor or a mayor, who is desperate for funds, that the tax exemption of state or local governments should be changed. They need money so badly that they quickly become convinced you are some kind of a nut. There is quite a bit of merit in Professor Henry Wallich's homily that "an old tax is a good tax." This is especially true when the Congress moves into the sensitive and highly controversial areas that I have mentioned.

The question at issue, however, is whether we can maintain compliance and self-assessment among many millions of taxpayers who are convinced that for one reason or another many very-high-income individuals are not paying their fair share.

In my opinion, some answer along the lines of a proposal suggested by the former Treasury staff is about right. This proposal would provide that everyone pay a minimum tax no matter how they get their income. This tax would be at rates roughly one-half of the current rates, which range from 14 to 70 per cent. In addition, the proposal states that no one should pay more than one half of their total income in federal taxes.

The result of this proposal would be to move the group of taxpayers with incomes above $500,000 per year from their present effective rates of 20 per cent to 30 per cent up to a 30-to-40 per cent rate. And, finally, it would reduce to a 50 per cent rate the roughly 12 per cent of high-income individuals who are currently paying at higher rates. This proposal, however, does not cure the unlimited charitable contribution situation, and it does not get at the tax advantages in real estate or depletion. If the Congress does decide to act in these areas, it will require an additional set of proposals.

In spite of the fact that the Treasury staff proposal does not close off all tax advantages, it is at least a start. It is a "half-way" approach that may well appeal to the Congress as a starting point for action. It also has one additional appeal. It reduces the total tax any individual would have to pay to 50 per cent. I think that there is a rather general feeling that rates of 70 per cent and the old 90 per cent rates tend to be confiscatory. As a result, the Congress is always looking for ways to take out some of the sting.

Quite possibly, the 50 per cent maximum rate proposal will be the most significant aspect of tax reform. Ultimately, if the top rates could be reduced to 40 per cent or 45 per cent, with compensatory plugging of loopholes, then I think that there may be a good chance to meet Secretary Kennedy's goal—"all Americans in similar circumstances paying approximately the same amount of tax."

SHOULD THE GOVERNMENT SHARE ITS TAX TAKE?

By WALTER W. HELLER

WASHINGTON *must* find a way to put a generous share of the huge federal fiscal dividend (the automatic increase in tax revenue associated with income growth) at the disposal of the states and cities. If it fails to do so, federalism will suffer, services will suffer, and the state-local taxpayer will suffer.

Economic growth creates a glaring fiscal gap; it bestows its revenue bounties on the federal government, whose progressive income tax is particularly responsive to growth, and imposes the major part of its burdens on state and local governments. Closing that gap must take priority over any federal tax cuts other than the removal of the 10 per cent surcharge. And even this exception may not be valid. For, as New York Governor Nelson A. Rockefeller has proposed, the revenue generated by the surcharge can easily be segregated from other federal revenue and earmarked for sharing with the states. So perhaps even the taxpayer's "divine right" to get rid of the surcharge may have to give way to the human rights of the poor, the ignorant, the ill, and the black.

FOR when the state-local taxpayer is beset with—and, indeed, rebelling against—a rising tide of regressive and repressive property, sales, and excise taxes, what sense would it make to weaken or dismantle the progressive and growth-responsive federal income tax? Whether our concern is for justice and efficiency in taxation, or for better balance in our federalism, or, most important, for a more rational system of financing our aching social needs, there is no escape from the logic of putting the power of the federal income tax at the disposal of beleaguered state and local governments.

Calling for redress of the fiscal grievances of our federalism is, of course, far from saying that state-local government has reached the end of its fiscal rope. The taxpayer's will to pay taxes may be exhausted, but his capacity is not:

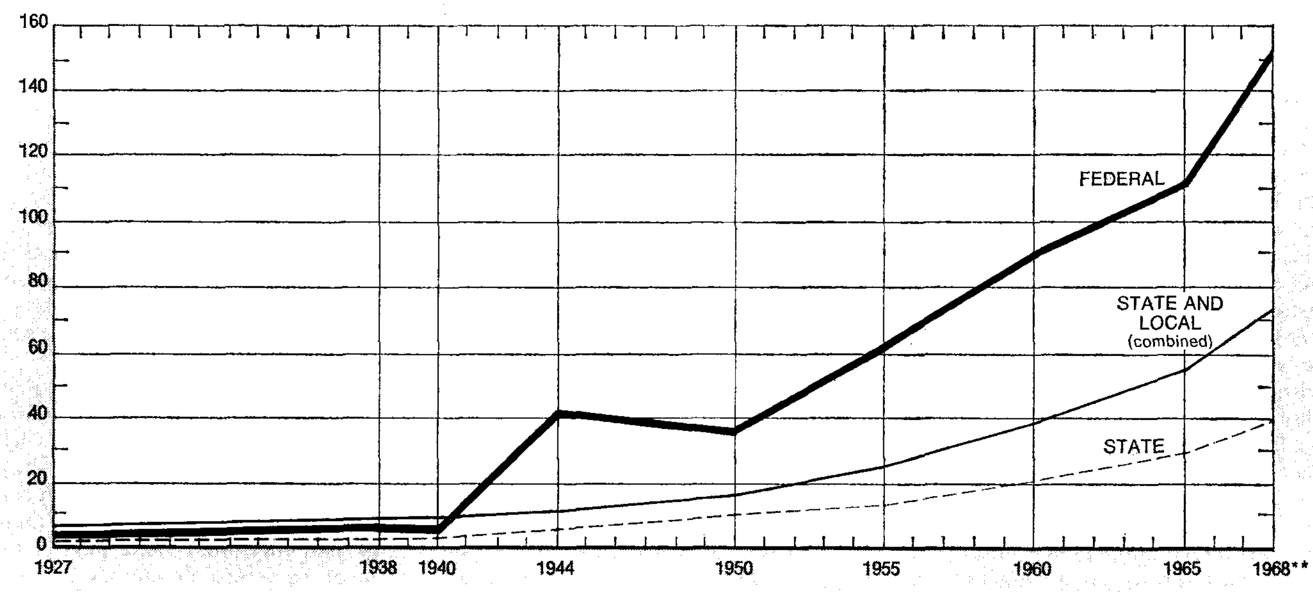
► Our overall tax burden—roughly 28 per cent of the GNP—falls far short of the 35-to-40 per cent levels in Germany, France, the Netherlands, and Scandinavia. Small solace, perhaps, but a strong suggestion that the U.S. taxpayer has not been squeezed dry.

► Untapped and underutilized tax sources still abound in state and local finance. For example, fifteen states still have no income tax, and six still have no sales tax. If all fifty states had levied income taxes as high as those of the top ten, state income tax collections in 1966 would have been $11 billion instead of $5 billion. The same type of computation for state and local sales taxes shows a $5-billion add-on. As for that sick giant of our tax system, the property tax, the aforementioned top-ten standard adds $9.3 billion to the existing collection of $24.5 billion.

It is only fair to point out, however, that states and localities have not been exactly reticent about tapping these revenue sources. In spite of taxpayer resistance and the frequent political penalties that go with it, the fifty states have been doing a land-office business in new and used taxes. In the past ten years, the six major state taxes (sales, personal and corporate income, gasoline, cigarette, and liquor) were the subject

FEDERAL, STATE, AND LOCAL TAX RECEIPTS*

(SELECTED FISCAL YEARS 1927-1968)
IN BILLIONS OF DOLLARS



*Includes social insurance taxes
**Data for 1968 estimated

Source: Dept. of Commerce, Bureau of the Census