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The Principles of Tax Reform

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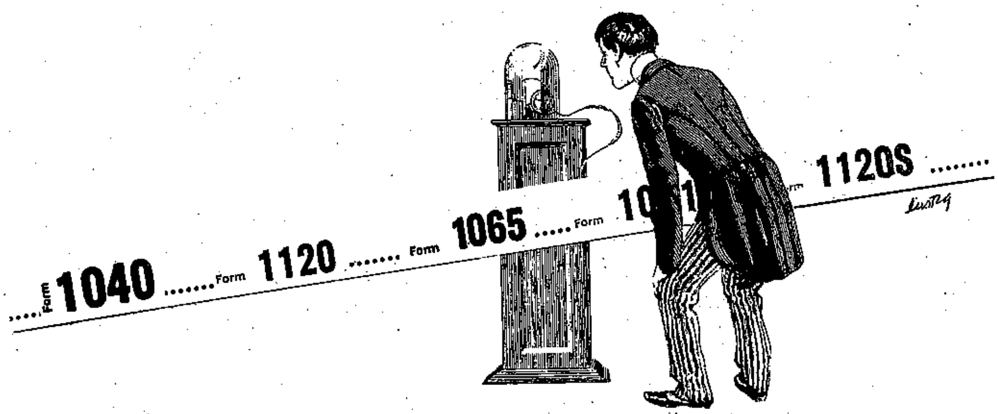

WARREN L. COATS, JR.

The Principles of Tax Reform

Judged by criteria of equity and neutrality, the U.S. tax system is badly in need of a major overhaul.

Concededly, a good deal of tax law is exceedingly technical and abstruse. But no on claims that voters can be magically transformed into tax experts in several easy lessons. The question rather is whether they would grasp the basic essential of tax policy if the issues were adequately presented to them. The real difficulty, I suspect, is they might understand too well.

—L. EISENSTEIN
The Ideologies of Taxation (1961)

Tax reform has become a motherhood issue. Unfortunately, however, changing the tax laws and improving them are not necessarily synonymous. Citizens pay the tax and, through their political representatives, decide from whom it is to be collected. It is the citizen, therefore, who must ultimately pass judgment on the tax system. This is an important responsibility and not at all an impossible one.

Judgment requires a standard against which to judge. There must be some concept of how things should be ideally in order to judge whether a change is an improvement or not. What follows is the presentation of two criteria of a "good" tax system, an explanation of why most economists favor them, and applications of these criteria to several tax reform controversies, namely, the tax treatment of tax-exempt bonds, capital gains, oil depletion allowances, and tax-exempt foundations.

This is a treatise not on government, but on the principles of tax reform. It is important not to confuse tax reform, which is concerned with how taxes are raised, with tax relief, which is concerned with the amount of taxes raised. It will be helpful if we

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assume that we are given a fixed dollar amount of taxes that the government must raise and that our task is to decide how it is to be raised. We are not discussing tax relief.

The first step is deciding what to tax—choosing the tax base. The tax to be raised might be spread evenly among all blue-eyed males or among all people with black hair, or "reasonably" black hair, etc. These alternatives do not seem reasonable because in the backs of our minds there are vague notions of fairness that they violate. If we are to proceed, these notions must be spelled out and settled upon.

Which principle?

Whenever the government collects taxes *someone's* income is reduced regardless of the intended sources of the tax. This is as true of corporate taxes, tariffs, sales taxes, etc., as it is of the personal income tax. This suggests the individual (or the household) as the reference point in refining our concepts of tax fairness. There are two major camps on this issue which have provided economic literature with a long, flowery and often heated debate. The newer of the two positions asserts that taxes should be levied against individuals in proportion to the benefits they derive from government. The "benefit principle" is a natural outgrowth of social contract philosophy, and was supported by men like Locke, Hume, Hobbes and Rousseau. The other camp asserts that taxes should be divided among individuals according to their respective abilities to pay. The ability-to-pay principle found support from men like Mill, Sismondi, Say, Marshall and Pigou. Support for both positions can be found in Adam Smith.

In my judgment there is a need for each of these principles. In general, free markets assume that people pay for what they get. This is a key factor in determining how the economy's scarce resources are to be employed. Likewise, in taxation, if people pay for the benefits they receive from government (that is, are taxed in accordance with the benefit principle), we can have greater confidence that the government will supply the "right" amount of services. This principle leads to the taxation of gasoline to finance highway construction, to the selling of stamps for postal service (if the word service can possibly be applied here), rather than complete "general fund" financing, and to the taxation of property to finance those municipal services that tend to benefit citizens in relation to the property they own (such as fire and police protection, roads, sidewalks, and waste disposal).

Unfortunately, many necessary government services confer benefits which cannot be attributed to specific individuals or which, by their very nature, should not be paid for by the beneficiaries. National defense is an example of the first type. One person's consumption of it does not reduce its benefits to others. Welfare is an example of the second type. Any program whose very purpose is to transfer income, say from the wealthy to the poor, obviously cannot tax the poor according to the benefit they receive. At this point we must have recourse to the ability-to-pay principle.

Ideally all government activities that can be financed through direct charges or benefit-related taxes should be financed thus. That would still leave us with the problem of financing those government activities, such as national defense, for which no exclusive individual benefit can be established or for which a benefit-related tax would be inappropriate. For such activities, which will be the concern of the rest of this article, I support the ability-to-pay doctrine.

Ability to pay

This only begins our quest for principles of tax reform, for it does not resolve the problem of how ability to pay is to be determined. However, it does suggest that the search for a fair tax base should be limited to an individual's wealth, income or consumption. These three come down to essentially the same thing except in their treatment of savings. A consumption-based tax is most favorable to savings and a wealth-based tax is least favorable. Although reasonable arguments can be made for each of these tax bases, the most widely supported tax base is income. I am deliberately avoiding a serious discussion of wealth vs. income vs. consumption as the better tax base in order to get on with the discussion of tax reform.

I tentatively accept the majority's preference for income as the base for four reasons. First, the income tax is the backbone of our tax system. It is therefore more likely that we will succeed in amending it than in replacing it altogether with some other tax base. Second, any other tax base (such as wealth or consumption) can always be translated into its impact on income, something I suspect people would have a tendency to do anyway. Third, the techniques of applying the principles of taxation I will soon introduce are essentially the same whether income, wealth or consumption is used as the tax base. As we shall see, these principles suggest the desirability of using as comprehensive a concept as possible of whatever the base is. Fourth, the gains in fairness and efficiency of properly reforming the income tax far outweigh any possible gain that *might* result from a choice of wealth or consumption as the tax base.

Equal treatment of equals

If income, then, is to be the tax base, what is a fair way of taxing incomes in order to raise the required amount of revenue? One of the most widely held standards of tax fairness (or, in economic jargon, tax equity) is the principle of equal treatment of equals. If income is the basic measure of ability to pay, the principle requires that two individuals with the same income should pay the same tax.

A commonsense application of ability to pay suggests only one modification: since we generally tax households (or family units) rather than individuals, an adjustment should be made for the size of the household being supported by the income in question. The first criterion of an ideal tax system can then be restated to say that all households of the same size with the same income should pay the same tax. Bear in mind that this refers to taxes in excess of the benefit-related taxes households may pay.

Capturing the spirit of the above principle requires a proper definition of income. The business concept of net income is instructive. Net income for a firm is total economic gain, regardless of type or source, less all costs incurred in generating it. It is this concept of income as the tax base which, I think, best satisfies most people's sense of fairness in taxation and which is most consistent with the above principle of tax equity. Such a concept of income would constitute a substantial broadening of our current income tax base.

Neutrality

There is a second important criterion of an ideal tax system which is sometimes more difficult for the layman to grasp. This is the principle of neutrality. A tax is neutral if it does not alter the relative prices of goods and services—that is, the price of one good relative to the price of another. In a free-enterprise economy prices are the indicators of value. Prices tell firms how badly consumers want one good relative to another. Taking the cost of producing various goods into account, firms are encouraged by profit to produce that collection of goods that in aggregate are most highly valued. A neutral tax does not interfere with the price system's task of directing firms into the provision of the "optimal" quantities of the "right" goods and services. There are a couple of important exceptions, but this is the general rule.

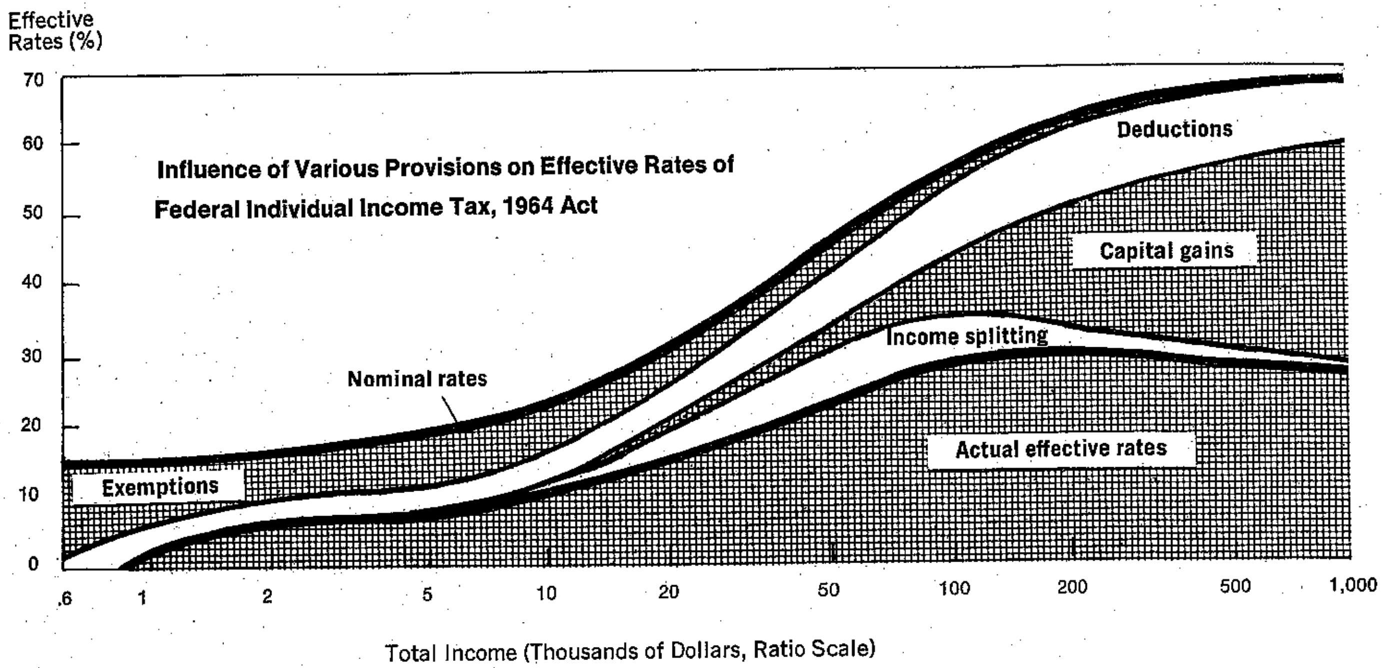
In practice, a neutral tax is one that affects the prices of all goods and services equally, thereby leaving their relative prices unchanged. It may help to point out that an excise tax (a tax on one good or a small number of goods) is anything but a neutral tax. It causes the good to appear artificially expensive relative to other goods to the consumer and artificially unprofitable to the producer, with the result that less of the good will be produced and in its place more of other less valued goods will be produced. In this way an excise tax causes a misallocation of resources; it causes the economy to function inefficiently.

The tax base

In a very impressive attempt to apply these principles to tax reform in Canada, the Royal Commission on Taxation (generally known as the Carter Commission) recommended that the income tax base be made as comprehensive as is administratively possible, all sources of income being treated alike. As expressed in the Carter Commission's 1967 *Report*:

> The proposed tax base must of necessity take into account all of a person's net gains over the year. All gains, after meeting the expenses necessary to generate them, must be reflected in the base. . . . The distinction between wages, interest, dividends, business incomes, gains on shares, bequests, sweepstake winnings, and so on, all would disappear. . . . If economic power is increased it does not matter in principle whether it was earned or unearned, from domestic or foreign sources, in money or in kind, anticipated or unanticipated, intended or inadvertent, recurrent or non-recurrent, realized or unrealized.

Broadening the tax base in this way has the great virtue of raising the same tax revenue with lower tax rates. Such a comprehensive base also measures up well to both our criteria: equity and neutrality. In



SOURCE: Special file of about 100,000 Federal Tax Returns for 1962. Chart reprinted from Joseph A. Pechman, "Individual Income Tax Provisions of the Revenue Act of 1964," *Journal of Finance*, Vol. 20 (May 1965). Based on 1962 incomes, with rates applicable beginning Jan. 1, 1965.

terms of neutrality it leaves all consumption choices —relative prices—unaffected, save that of leisure. That is, there is no change in economic behavior that will reduce the tax—hence that is caused by the tax—except the decision about how much to work (there is also some discrimination against saving). This might be a serious tax distortion in resource allocation if it were not for the fact that the personal income tax sets up two opposing forces affecting work effort. The tax reduces the reward for each hour of work and hence acts to reduce the number of hours worked. At the same time, it lowers income and hence acts to increase the number of hours worked in an effort to replace the lost income. Although good evidence is hard to come by, what there is tends to suggest that in the case of current U.S. rates, these two forces more or less offset one another, that the income tax has little or no effect on work effort.

Tax-exempt bonds

In terms of equity, two families of the same size, same general state of health, and same income would pay the same tax. But the existing U.S. income tax clearly falls short in both equity and neutrality. This can be quickly and clearly illustrated by tax-exempt bonds.

States and municipalities are allowed to issue bonds, paying tax-free interest income to their owners. This practice was initiated to reduce the cost of debt financing for these levels of government. This is achieved because the more desirable, tax-free earnings of these bonds cause their prices to be bid up relative to other bonds (meaning that money can be borrowed at lower interest rates) until their desirability to the marginal investor is equal to that of other bonds. A few numbers will quickly illustrate the point.

A taxpayer in the 50 percent bracket would find himself indifferent to a choice between two equally riskless government bonds if one were a taxable U.S. bond yielding 6 percent and the other a nontaxable state bond yielding 3 percent, because his after-tax income from each would be the same. Such an individual gains no special benefit from tax-exempt bonds. He is the marginal investor referred to above. However, someone in the 70 percent tax bracket would find the tax-exempt bond decidedly advantageous. The 6 percent U.S. bond yields him an $18.00 after-tax income (per $1,000 invested) whereas the 3 percent tax-exempt state bond yields him a $30.00 after-tax income. This means that two people, both with the same 70 percent tax bracket income but different holdings of tax-exempt bonds, would pay different amounts of income tax. This violates our criteria both of equity and of neutrality.

The carefully avoided issue of tax rate progression must be faced at this point. It is often and convincingly argued that marginal tax rates of 60 or 70 percent are unrealistically high and so-called tax loopholes such as tax-exempt bonds are needed to provide necessary relief. In fact, tax-exempt bonds in conjunction with other tax loopholes such as preferential capital gains treatment, income splitting, charitable contributions and some other personal deductions lower the actual average rates paid to below 30 percent. This result is depicted in the chart from Joseph Pechman's *Federal Tax Policy*, and was arrived at as follows:

> If the total income reported by taxpayers were subject to the nominal tax rates without any exemptions, deductions, or other special provisions, effective tax rates would begin at 14 percent and rise to almost 70 percent in the very highest brackets. But nobody pays these rates on his entire income. After allowing for all special provisions, the *maximum average effective rate* for any class is less than 30 percent and the tax becomes slightly regressive above $200,000 of income.

The problem with these loopholes is not that they lower the effective tax rate—many economists would agree that these rates should be lowered—but that they are inequitable and non-neutral. In fact, removing the loopholes becomes a way of lowering tax rates without lowering tax revenue. Not every wealthy taxpayer has the same access to the same loopholes, so that people with the same income might pay substantially different taxes. The preferential treatment of one source of income over another also distorts the efficiency with which we use our resources by generating a lot of effort to earn income in lightly taxed forms (capital gains treatment—discussed below—affords a good example of this). The resulting inefficiencies mean that the economy enjoys fewer goods and services from given resources. If marginal tax rates are too high, as in my opinion they certainly are, they should be legislated down directly rather than through the creation of inequitable and distorting tax loopholes (or "foxholes," as Arthur Willis calls them in the American Bar Association's *Studies in Substantive Tax Reform*).

There is still more to the case against tax-exempt bonds. As a means of aiding local financing, tax-exempt bonds are inefficient. The federal government loses more revenue from this device (over half a billion dollars—which must be made up by higher taxes elsewhere) than the states save by it. A more direct subsidy would save everyone money. It would, however, be grossly unfair to begin suddenly taxing the income from such bonds. This is an important point with some slightly delicate aspects well worth pursuing with some care.

The effect of taxing previously tax-exempt bonds would be to cause a fall in their price. To the extent that their tax advantage had been capitalized (i.e., the extent to which their price had risen above other bonds), it would now be uncapitalized, as the advantage would no longer exist. To illustrate: our 50 percent tax bracket marginal investor found the after-tax return on a 3 percent state bond to be the same as on a 6 percent U.S. bond. If we suddenly tax the former along with the latter, its price will fall (as investors, always seeking the highest rate of return for any given risk, move out of the now lower-yielding state bonds into other assets—e.g., U.S. bonds) until its after-tax income of $15.00 per $1,000 bond ($30 less 50 percent income tax) represents the same yield as the $30 after-tax income of a U.S. bond ($60 less 50 percent income tax).

In this hypothetical example, the price of the state bond would be cut in half. It would fall from $1,000 for a $15 per year after-tax income (a 1.5 percent rate of return) to $500 for a $15 per year after-tax income (a 3 percent rate of return), which is the same after-tax yield as that earned on U.S. bonds. This imposes an unfair capital loss on our marginal investor, who was deriving no personal benefit from the nontaxable status of this state bond in the first place.

One solution to the problem is to forbid the issuance of any new tax-exempt bonds while continuing to honor the tax-exempt status of previously issued state and municipal bonds (until all have matured). An alternative solution, one recently proposed by Congress, is to "bribe" local governments to do the same thing—that is, to offer them a cash subsidy for borrowing with taxable rather than nontaxable bonds just sufficient to offset their borrowing advantage with tax-exempt bonds. This approach would stop the issuance of new tax-exempt bonds and phase out the old ones, as in the first case above, while also preserving the revenue advantages of such bonds to state and local government borrowing. Either solution would be an immense improvement over present treatment.

Capital gains

Another important area where the current tax law falls far short of the norms of tax equity and neutrality is in the treatment of capital gains. There is no meaningful sense in which a $10,000 capital gain affects one's ability to pay taxes any differently than $10,000 acquired in any other way, yet for tax purposes it is treated quite differently. Income derived from a capital gain (such as from the profit—sale price less purchase price—on the sale of a corporate stock) is taxed at one-half the rate of "regular" income or at the rate of 25 percent, whichever is smaller. If the gain is passed on unrealized at death (for example, if a stock is bequeathed unsold), it escapes income taxation altogether.

It is inequitable for a man with a $10,000 wage income to pay at least twice the tax that his neighbor pays with the same—but capital-gain derived—income. This treatment is clearly non-neutral as well. At present, income in capital-gain form is preferable to the same before-tax income in other forms; therefore, much energy goes into classifying income as a capital gain. Corporations tend to retain more of their earnings than otherwise so that the stockholders will receive the profits as an appreciation in the price of the stock—as a capital gain—rather than as a more heavily taxed dividend. This confers a bigger tax saving on high-income people than on low-income people. Collapsible corporations were once a popular way of converting regular income into a capital gain. This technique was popular in Hollywood for lowering taxes on movie profits.

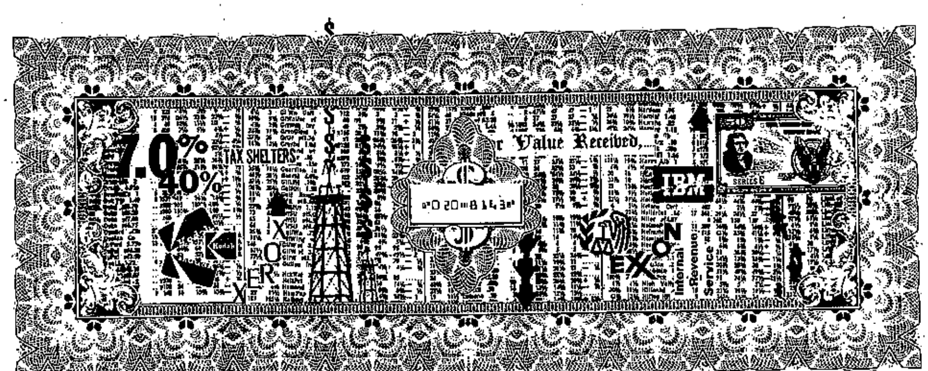
The 25 percent maximum capital gains rate once meant that all taxpayers above the 50 percent tax bracket got a bigger break than the rest. The Tax Reform Act of 1969 removed the 25 percent ceiling on capital gains in excess of $50,000, taxing such capital gains at one-half regular income rates (taxing only half of capital gains income). This was certainly a laudable step in the right direction, but a very modest one indeed. Capital gains should be treated and taxed in full, like any other source of income. The hardship that progressive rates might impose on those realizing capital gains at uneven intervals is better handled by income-averaging provisions.

In any broader tax reform drive, this proposal should be considered in conjunction with the abolition of the corporate income tax. This tax is at the root of all kinds of inefficient and tax-evasive corporate behavior. It is inequitable as well, leading to double taxation of corporate income, once at a 48 percent rate before distribution and again at the rate applying to the individual stockholder on the remaining 52 percent if distributed. This represents a progressive rate structure of 48-85 percent on this source of income rather than the usual 14-70 percent on other sources of income. The corporate tax could be eliminated with only a negligible loss of revenue and with a substantial gain in equity and neutrality by attributing corporate income to the appropriate individual stockholders and taxing it.

Oil depletion

The treatment of the depletion of mineral reserves (particularly oil) has surely aroused as much emotional reaction on both sides as any tax provision that might be named. Yet the results of applying our standards of equity and neutrality are quite clear. However, the issue has been so long and hotly debated that a careful though cryptic examination is surely needed.

Both corporation and personal income taxes are



levied against net income, that is, all costs of producing the income are subtracted from revenue or gross income before arriving at the tax base. This is straightforward except in the treatment of capital such as durable machinery and equipment. Investment in a machine is not a current cost of producing current income, because the machine is only partially used up in the current tax year. It is appropriate to add to current costs only that part of the machine that is actually used up in production: an amount equal to the fall in the value of the investment. This is what we attempt to approximate with depreciation. Thus if the machine is expected to last for ten years we might write off (expense) a tenth of its cost each year.

In the case of oil wells the problem is particularly tricky. The investment, or capital, is the well itself. The *cost* of producing that investment consists of all of the exploration costs leading to its discovery (such as the dry holes) plus development costs at the well needed to turn it into a producing asset. The *value* of this investment (the price for which the producing well could be sold or the capitalized value of the net revenue it is expected to produce), which is what *should* be depreciated, may be greater than, equal to, or less than the cost of producing it. It follows that cost depletion (depreciating the cost of producing the well) does not generally give rise to a correct measure of the actual depreciation of the investment's value. It was in part for this reason that the rough-and-ready alternative of percentage depletion was offered. Percentage depletion allows firms (or individual owners) to deduct 22 percent of the well's gross revenue as a depletion allowance regardless of the amount invested.

For the purchaser of a producing well, percentage depletion usually entails little or no advantage over cost depletion; and as firms may choose which type to use, one method is chosen about as often as the other. Cost depletion in this case *is* based on the true economic value of the investment (the purchase price of the well) and affords no special advantage over normal depreciation of capital in other industries.

The real tax breaks accrue to the discoverer of a productive well, whether he chooses to sell out or operate it himself. If he sells he benefits in two ways. First, the excess of the sale price over the investment cost, called the cost basis, is by definition a capital gain and hence is taxed at the preferential 25 percent rate. Second, the cost basis greatly understates the true investment cost by allowing expensing (immediate deduction of costs against other income) of all exploration costs leading to the discovery and much of the cost of developing the successful well itself. These costs should be treated as part of the cost of the investment (and hence be included in the cost basis used in calculating capital gains) and be depreciated over its lifetime. A hypothetical example may clarify this.

If four unsuccessful wells (dry holes) must be sunk in order to find a successful one, and each well costs $200,000 to drill and $100,000 to bring to a productive state if oil is actually discovered, then the investment in a productive well will be $1,100,000. But $1,000,000 of this can be immediately deducted from other taxable income (that is, expensed, the other $100,000 of development costs becoming the cost basis of the well rather than the full $1,100,000) for a tax savings of $700,000 if we take as our imagined investor a person in the top—70 percent—tax bracket. If the well is then sold for $600,000, the capital gain will be $500,000 (the sale price of $600,000 less the nonexpensible development cost basis of $100,000), which carries a 25 percent capital gains tax liability of $125,000. Our investor will be out $525,000 ($1,000,000 drilling costs, less $700,000 tax refund, plus $100,000 development costs, plus $125,000 capital gains tax on sale of well) but will take in $600,000 from the sale. This is a profit of $75,000. The economy, however, will have expended $1,100,000 worth of its resources in an investment it valued at only $600,000, which is clearly wasteful. These advantages do not even involve percentage depletion.

If our discoverer decides to hold onto the well and operate it himself, he receives preferential treatment by being allowed to use the 22 percent depletion allowance and to expense the exploration costs as well. This is equivalent to depreciating the investment at least twice. Professor Arnold Harberger of the University of Chicago has estimated the implied subsidy of this tax treatment of the petroleum industry (when the depletion allowance was still 27.5 percent) to be about 35 percent on average for the second example (holding onto the well) and about 50 percent for the first example (selling the well). This compares with a 5 percent subsidy in 1926, when these provisions were first enacted. The difference is due to the much lower personal and corporate income tax rates at that time.

As the petroleum industry is quick to point out, the industry, for all this, does not enjoy exorbitant profits. They are, in fact, quite normal; and it would be quite surprising if they were otherwise. The profit potential of our tax laws has long since attracted enough additional exploration to beat oil's after-tax rate of return down to the average. This, in fact, is the great tragedy of the percentage depletion allowance: it has caused a large and wasteful overinvestment in oil exploration, that is, more than the economy would find profitable in the absence of the special tax treatment. Another way of stating Harberger's findings is "that in order to obtain an equivalent income stream, between 1.36 and 1.95 times as many resources will typically be used in oil exploration by producing companies as in ordinary business investment."

It is sometimes argued that it is in the interest of national defense to subsidize the oil industry. By providing tax inducements for exploration we will make available more domestic oil reserves, so essential for waging modern warfare. This requires two replies: If this argument has merit it would be preferable to make this subsidy openly, as a government disbursement, rather than hide it as an inequitable tax loophole. In that way the sum could be annually reviewed by the Congress and the taxpayers. As Joseph Pechman reported in 1966, "Studies made over the years by the Treasury Department indicate that the annual depletion deductions for oil and gas average out to more than ten times the deduction computed on the basis of the original investment (after allowance for depreciation). . . . The tax benefits of those special provisions are now in excess of $1.5 billion per year."

The defense argument, however, is surely *not* sound. The subsidy will stimulate extra exploration (this is part of the overinvestment waste referred to above), and this will make known more oil reserves than would have been the case. However, in conjunction with totally unwarranted and unreasoned restrictions on the use of foreign oil, the subsidy also stimulates more rapid exhaustion of these reserves, so that unless the national emergency hurries, we will find ourselves with diminished domestic oil reserves. That time may well be upon us.

Although the inequity and non-neutrality of these tax concessions—(*a*) expensing of the investment costs; (*b*) preferential capital gains treatment; and (*c*) depreciating more than original investment value—have been established, it does not follow that Congress should abolish them. Oil companies make the going rate of return on their investments. Suddenly to remove the promised tax subsidy upon which the investment was based would unfairly impose losses on the industry. The problem is the same as with tax-exempt bonds, and so is the solution: deny the subsidy to all future wells while maintaining it for all existing wells for as long as they last.

Tax-exempt foundations

The tax treatment of tax-exempt foundations is another area of considerable controversy. Tax exemption is nothing more than an administratively, and more important, a politically, convenient way to confer a government subsidy. A taxpayer in the 50 percent bracket who gives $1,000 to his church realizes that he has actually given up only $500, because deducting $1,000 from his taxable income saves him $500 in taxes. Uncle Sam kicks in the other $500 in lost tax revenue, which must be raised elsewhere. The question then arises: Should foundations, with their multimillion-dollar spending power, enjoy the government subsidies bestowed by their tax exemption? The answer should depend on whether it is foundations per se that we desire social policy to encourage, or the desirable things some foundations do or support. Some critics have argued that much foundation money is spent foolishly or dangerously. The objection here is hopefully not that some foundations spend their money in ways we disapprove of, but that they do so with tax-exempt funds that result in higher taxes for the rest of us. If there are activities that we desire to encourage with government subsidies (charity, research, the arts, etc.), then we can do so more directly than by subsidizing foundations that may or may not spend their money as we wish.

It would be preferable, in my opinion, to enact an equitable tax treatment of foundations without restrictions on how they spend their money. After all, it is not the existence of great wealth or the ways it might be spent that we should object to; it is the fact that it is often gained and maintained with the aid of preferential tax treatment not available to all.

The principles of taxation that have been sketched here will be better understood if we outline some general approaches to foundation tax treatment consistent with them. To do so it is necessary to include some discussion of gift and estate taxation.

It is my position that a man's total income, regardless of sources, should be taxed at the same rate as an equal income of another man in the same general situation. Once this has been achieved, what a person then does with his after-tax income is surely his own affair. It should make no difference if he buys a $4,000 car, $4,000 worth of gratitude from his church, a $4,000 education for his son, or gives $4,000 in cash to his son or to the Socialist Party.

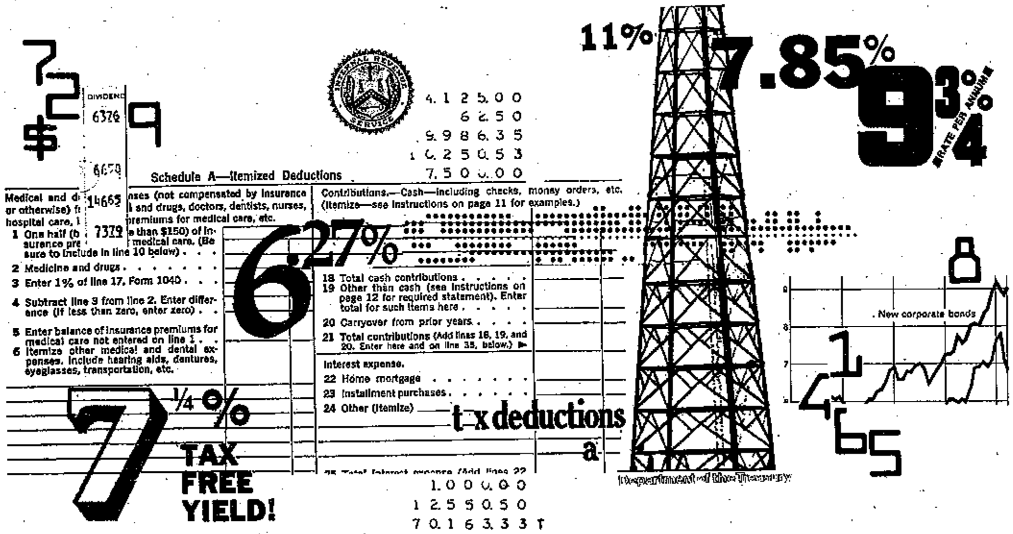
This should be true whether his income is disposed of directly or by the administrator of his estate. There is no place here, in other words, for gift or estate taxation. The more equitable and neutral tax treatment is to include the above $4,000 consistently in the income of whoever receives it (the car salesman, the church, the son's school or the son) and to tax it there. If we choose to subsidize churches or schools, their incomes could be made tax exempt. Exemplifying this very important principle further, it surely seems "fairer" to levy a heavier tax on a man's million-dollar estate when bequeathed to his already rich brother than when divided equally among 100,000 poor families. This is so, not because the one or the other seems a "better" thing to do but because the wealthy brother has greater ability to pay than the 100,000 poor families combined. There should be no tax on estates (they were already taxed when earned) but on inheritances or gifts, which should be taxed as a part of the income of the receiver.

A foundation is often little more than an estate in trust and as such should not be taxed itself; rather, the benefits it bestows should be counted as a part of the income of its recipients and taxed there. In this sense the foundation is much like the corporation, whose income should also be attributed to its owners and taxed there. The foundation, unfortunately, presents more formidable administrative difficulties than the corporation. The major one arises when a foundation or trust exists for the personal benefit of particular individuals, say one's children. A million-dollar estate divided between two children will increase the taxable income of each (ignoring the legitimately deducted expenses incurred in acquiring the money, such as in administering the will) by half a million dollars. If instead the estate goes into a foundation which earns an income which is divided between the two children, their taxable income should nonetheless go up by half a million each plus whatever income the estate subsequently earns. At present they would escape taxes on the million held in trust. This, of course, is the major inducement to the creation of foundations. My example is stretched a bit because foundations cannot so blatantly exist for personal aggrandizement, but in practice it often comes down to much the same thing. The appropriate course would be to attribute to each child for tax purposes the wealth (as well as its income) from which he receives the income. In the above example that would be easily done by attributing half a million dollars to the rest of each child's taxable income, but in practice it would be more difficult.

I propose the following scheme for consideration. Since it is often difficult to ascertain, and accordingly to tax, the beneficiaries of foundation activities, and since these foundation distributions are often deferred for many years, all foundation income (which would include the initial endowment) should be taxed once at the highest existing personal tax rate (currently 70 percent). Any foundation disbursement to a taxable individual would be "grossed up" and added to that individual's taxable income. The tax already paid by the foundation would then be credited to the individual in question.

An example may help. A foundation is set up with a $100,000 estate. The foundation must then pay a tax of $70,000 (the top personal rate is used to ensure that the foundation is not used by the wealthy for tax avoidance, and, who knows, such a rule may elicit foundation support for lowering the top personal rate). If, for simplicity, it then disburses the entire remaining $30,000 to Mr. Smith, Mr. Smith must "gross up" that $30,000 to $100,000 while simultaneously receiving a tax credit of $70,000. If Mr. Smith previously had a taxable income of $10,000, his taxable income would now be $110,000. At a 60 percent average tax rate his tax liability would be $66,000. He has a tax credit of $70,000 for taxes already paid on his behalf by the foundation, so he receives a refund from the government of $4,000, for a total gift of $34,000.

This seemingly complex procedure simply gives the foundation the job of withholding potential taxes without paying any taxes itself yet taxes all foundation grants to the individual recipient at the tax rate



that applies to that individual.

In the event that the foundation gave its $30,000 to an organization which was itself tax exempt (say a church or charity), that organization would receive a full $70,000 tax refund on its $70,000 tax credit, as its tax liability would be zero. Notice that the tax exemption in this scheme is granted to specific groups or activities on the basis of the purposes for which they spend their money rather than to the foundation which distributes the funds to such working organizations. The foundation is not taxed for spending its money any more than the individual, whose estate the foundation represents, would have been.

A third category of disbursement is possible. In addition to taxable individuals and tax-exempt activities there are those not-for-profit operations which neither are tax exempt nor pay taxes. Political parties are in this group—large donations are not deductible. The foundation once again should be treated like an individual. If its $30,000 went to a political party, there would be no accompanying tax credit. In this one instance the foundation would be taxed. It is my belief that such an approach would remove the artificial tax dodge incentive for foundation formation while equitably preserving the just functions of a foundation.

A major overhaul is needed

The Tax Reform Act of 1969 was a large patchwork of proposals, occasionally in the right direction and occasionally a bit crude or misdirected. What is really needed, however, is a major and thorough overhaul of the entire tax system along the lines of the impressive Carter Commission proposals for Canada. The Commission recommended, as I have, the adoption of a comprehensive income tax base wherever administratively feasible coupled with the abolition of the corporate income tax and estate and inheritance taxes (by integrating both into the personal income tax base). Pechman estimates that adopting the Carter Commission proposals in the United States would have enabled the government to raise from a personal income tax alone the same tax revenue as was raised from personal and corporate income taxes plus federal estate and inheritance taxes. It could be done, moreover, while reducing the 14-70 percent tax rates to 12-53 percent, with the maximum rate applying to all income over $100,000.

If that does not excite your imagination, consider that the American Bar Association's Special Committee on Substantive Tax Reform, using a substantially broadened but by no means comprehensive income tax base and eliminating the separate corporate income tax, found that the same tax revenue from both corporate and private incomes could be raised by a *flat rate* of 14 percent on personal income alone.

Of course, it is possible to judge each tax and suggested tax reform on the basis of how it affects us personally. Do our tax liabilities go up or down? Such a standard of judgment simply leads to the powerful and influential's achieving their favored loopholes at the tax expense of the rest of us. Until more general standards are adopted and applied, the U.S. income tax will remain in a hopeless mess.