

## Tax Reform?

As this is written, we do not know whether President Ford will sign or veto the "tax reform" bill recently passed by Congress. This measure, which is the product of an intensive year-long effort by Congress, reportedly runs to some 1500 pages and has been dubbed by some as "the Second Accountants' and Lawyers' Relief Act" (the first being the 1969 tax law).

We do not intend to assess the merits of specific provisions or of the bill as a whole. Such an assessment would be beyond the scope of these reports. However, we can assert with confidence that it will hasten the time when the U.S. tax structure will collapse of its own complexity. (That time will arrive when no two auditors, lawyers, judges, or other experts — let alone a taxpayer — will be able to agree on the amount of taxes owed by any taxpayer.) In this article we describe some essential aspects of taxation that we hope will better equip the reader to evaluate the arguments and rhetoric employed in discussions of tax reform in the future.

### *The Ability to Collect*

The ability to collect is the primary essential feature of any tax. This simple but often-ignored aspect of taxation is the reason why many economic activities are not the target of taxation. It also reveals why taxes on real property, which can be seized in case of nonpayment of taxes and which cannot be concealed, have been levied for centuries. The development of our industrial society has greatly enlarged the number of economic activities upon which taxes can be levied and collected. Employers and managers must keep records of their payrolls, sales, and other transactions, and these records make feasible the imposition of some types of taxes. Transactions involving intangible property, such as stocks, bonds, and bank deposits, usually also require the keeping of records by third parties.

The modern-day tax collector thus not only depends on the records of corporations, banks, probate courts, *et al.*, for his ability to collect many taxes, but also uses some such entities as his agent for the collection of taxes. For example, employers must withhold taxes on wages from employees and remit such funds to the tax collector. The Internal Revenue Commissioner's annual statement praising the "self-assessment" feature of the American tax system notwithstanding, many wage-earners probably file their tax returns only in hopes of refunds. If tax withholding were reduced or eliminated, the number of tax returns filed probably would decrease, and the task of collecting income taxes from many wage-earners would become impossible or more costly than the revenues it would gain.

Recent Congressional testimony revealed that the amount of taxable interest and dividends known to be paid in the U.S. is several billion dollars more than the amount of such payments reported on income tax returns. Such interest and dividends payments were reported to tax

authorities by the entities that made them, but they were not subject to withholding. This evidence suggests that the tax authorities concluded it was not worthwhile to try to match the millions of information returns of the paying entities with the millions of individual tax returns. Such matching would have to be done for holders of small savings accounts and small lots of stocks and bonds as well as for holders of large amounts of such assets.

### *Taxation Without Representation*

Taxes are never popular with the taxpayers. Thus, government officials prefer to impose taxes whose payments do not appear to affect large constituencies. Because they seem to be imposed on foreigners, customs duties are the classic example of taxes that do not anger a large constituency. One of the few useful achievements of the economics profession has been to get government officials to recognize that the impact of tariffs on the international division of labor raises costs to consumers by more than the amount of the tariffs involved. In fiscal year 1975, customs duties averaged only about 2.7 percent of the value of imports and provided only about 0.8 percent of all government receipts.

The imposition of excise taxes on "vices," such as liquor, cigarettes, and certain forms of gambling, arouses little political opposition. Presumably this is because few persons wish to appear to advocate the use of such things, although many may indulge in them.

Today, taxes on corporate income and, to some extent, the progressive tax schedule on incomes and estates appear to be the major taxes whose imposition reflects the relative political weakness of those upon whom those taxes appear to be levied. Perhaps one day a majority of economists will recognize the deleterious effects of these taxes as they are now imposed on saving and capital formation and therefore on economic growth and the public well-being.

### *Tax Evasion Versus Tax Avoidance*

Understandably, most people try to pay as little tax as they have to pay. In this connection, few aspects of taxation appear to be as misunderstood as the distinction between tax evasion and tax avoidance. Tax evasion is a criminal act. It is the failure to report transactions subject to taxation. Oppositely, tax avoidance involves entering into transactions that reduce or eliminate taxes. As such, tax avoidance reflects compliance with the law rather than defiance of it.

In terms of the number of people involved, tax evasion perhaps occurs largely among persons of moderate or less-than-average incomes. One reason for this conjecture is that tax evasion is easily accomplished by those who receive payments in currency for their own account. Such persons would include small shopkeepers (who operate the cash register themselves), handymen, and artisans. If the

amounts of currency are small and record keeping is avoided, the risks of detection and punishment also would be small. As noted above in connection with unreported dividends and interest, the tax collector must concentrate his collecting efforts on matters that bring in more revenues than their cost of collection. Tax evasion also is presumably practiced by those engaged in criminal activities, such as gambling, narcotics traffic, or loan sharking, to whom the additional crime of tax evasion is irrelevant.

Among the socially responsible and well-to-do, the risks of detection and the social stigma associated with tax evasion are great. Moreover, they can use to advantage the opportunities for *tax avoidance*, since tax-avoidance strategies usually require not only investment funds but also highly-paid advice and counsel.

### *Millionaires Who Pay No Taxes*

There is an apparently widespread belief that those with very large "incomes" pay little or no tax. This simply has not been the situation as a general rule. However, statistics published by the Internal Revenue Service reveal that each year *some* persons with large "adjusted gross incomes" (AGI) pay little or no Federal income tax. There are various ways in which this has occurred. Among these have been:

(1) The taxpayer incurred large business expenses, such as mortgage interest, and gross receipts, such as rentals, were included in AGI. Taxable income was the taxpayer's profit, if any, not his gross receipts, or AGI. Yet, the statistics would show a large AGI without a large tax.

(2) The taxpayer earned most of his income abroad and paid taxes to other jurisdictions. Although income earned abroad is reported as AGI, only the U.S. taxes, if any, are reported in the IRS statistics.

(3) The taxpayer had a far larger income the year before and paid large state and local income taxes on it. Such state and local taxes substantially reduced his Federal taxable income in the current year.

(4) The taxpayer made large contributions to charity, as permitted by law.

The all-too-familiar demagoguery concerning taxpayers with large AGI's and small Federal income tax liabilities ignores these relatively simple explanations for those situations. Few of the other permitted deductions and credits, such as medical expenses, child care, taxes and interest on owner-occupied homes, interest on consumer credit, or non-business gasoline taxes, are ever large enough to be significant factors in reducing taxes on returns showing very large AGI's. Such "loopholes" principally benefit middle income taxpayers. Nevertheless, that there have been taxpayers with large AGI's who have paid little or no Federal income tax does suggest that the measurement of "income" is not a simple matter.

### *What is Income?*

As mentioned above, "adjusted gross income" as reported for Federal tax purposes often bears little or no relation to everyday notions of income. The "taxable income" reported farther down on the return usually bears even less of a relationship. In addition to the items previously mentioned, interest received from State and local governments and one-half of "long-term capital gains" are never included in AGI. No "capital gains" are included in AGI until realized in a transaction.

If "income" were viewed as the amount of goods and services the taxpayer could obtain with his funds, it is apparent that current income-tax laws are applied only

against "income" if a taxpayer spends all he currently receives. Changes in the purchasing power of assets currently are not used in computing taxes, only the nominal dollar amounts are so used. Therefore, during periods of rising prices, income taxes incurred on interest earnings and capital gains are, wholly or partially, taxes on assets, or on capital. They would not be income taxes in an economic sense. The case of corporations, where taxes are levied on nominal profits from inventory that has appreciated in price but must be replaced at higher prices, is perhaps the clearest example of how income taxes sometimes are taxes on capital.

### *An Alternative*

Current income-tax laws appear to be based rather haphazardly on some notion of one's "ability to pay." Taxes alternatively could be based on cash flows. To identify a receipt of cash (a royalty payment on an oil well, for example) is far simpler than to decide whether or not it is "income" according to some complex designation. All cash receipts would be presumed to have been used for consumption unless the taxpayer demonstrated otherwise. This form of taxation would remove the bias of current income tax laws against capital formation. Such a tax presumably could be supported by all those who favor "closing the gap between rich and poor," because it could be made to fall directly on the tangible manifestations of inequality (mansions, yachts, etc.), which the present system seems not to have affected. Such a tax also would appeal to those concerned with the conservation of resources, for it would be related to an individual's use of the Nation's resources. Moreover, most of the nonproductive maneuvering now undertaken to establish capital gains, tax write-offs, and other "tax shelters" would cease.

Such an alternative no doubt would be opposed by those with vested interests in the present system, including accountants, lawyers, and the bureaucrats involved in its administration. Presumably it also would be opposed by die-hard Keynesians who hold, apparently as an article of faith, that inadequate consumer demand (consumption) is the economic bogeyman of our era.

### *Conclusion*

Significant tax reform will require a thorough review of the various economic activities that currently are taxed and that might be taxed. Such a review should include consideration not only of the feasibility of equitable assessment and collection but also of the effects of taxes on the current and future functioning of the economy as a whole.

Study of the Federal income tax system appears highly urgent. The definition of "income" as a legal rather than an economic concept involves both real and imaginary inequities. That most of the difficulties with the current Federal income tax system appear to arise from the attempt to define "income" suggests that such an attempt might not be useful. The time has come when alternatives, such as taxation of outlays for consumption, warrant serious consideration.

### **STATISTICAL INDICATORS**

The percentage of primary leading indicators of business-cycle changes appraised as expanding cyclically remained unchanged at 83 percent. Revised and new data for the index of net business formation reveal that this series increased during June and July. The 2-month moving

average of this series therefore increased during June (to the highest level since April 1973) and revealed that this series clearly was expanding cyclically through July. New orders for consumer goods and materials in constant dollars decreased during June and July. However, the 3-month moving average of this series was unchanged during June after increasing during the preceding 15 months, and this series remains appraised as expanding cyclically. Contracts and orders for plant and equipment increased during July to the largest amount since September 1974. The moving average of this series has trended upward since October 1975, which clearly suggests that this series is expanding cyclically. The index of housing permits increased during August, and continued to expand cyclically then. Revised and new data for the net change in inventories on hand and on order revealed that this series increased during May and June and also continued to expand cyclically then. The percent change in sensitive prices decreased slightly during July; however, the 4-month moving average of this series remains appraised as expanding cyclically. The percent change in total liquid assets decreased slightly during July. Nevertheless, the cyclical status of this series remains indeterminate, inasmuch as no cyclical trend is yet evident.

Among the primary roughly coincident indicators, the index of industrial production increased during August to a near-record level. This series has increased during every month since March 1975 and clearly is expanding cyclically. Personal income in manufacturing in constant dollars decreased during August. The moving average of this series has decreased for 3 months, raising some doubt that the cyclical expansion of this series is continuing. Nevertheless, it and all other primary roughly coincident series are appraised as expanding cyclically.

Among the primary lagging series, the continued cyclical expansion of the inverted average duration of unemployment now seems somewhat doubtful. The 3-month moving average of this series increased during the 4 months ended in April, but decreased during the subsequent 3 months ended in July. Nevertheless, this series is appraised as expanding cyclically. Commercial and industrial loans decreased during July, and the cyclical status of this series remains indeterminate. This series remains the only primary lagger not appraised as expanding cyclically.

*That 10 of the 12 primary leading indicators appear to be expanding cyclically has favorable implications for the continuation of general business activity during the next few months at least.*

### SUPPLY INDUSTRIAL PRODUCTION

Production of steel, automobiles, and electric power (1) in the 1- and 4-week periods ended on the indicated dates in the current year and (2) in the corresponding periods of earlier years was as follows:

Steel	1929	1932	1973	1974	1975	1976
Ingots (million tons)						
1 week: September 18	1.17	0.23	2.89	2.76	2.24	2.37
4 weeks: September 18	4.80	0.91	11.20	10.81	8.53	9.80
Automobiles						
Vehicles (thousands)						
1 week: September 18	87	17	189	166	161	156p
4 weeks: September 18	368	72	612	600	591	614p
Electric Power						
Kilowatt-hours (billions)						
1 week: September 18	1.8	1.5	36.5	36.1	35.6	39.0
4 weeks: September 18	7.0	5.8	155.0	147.8	151.2	161.3

Percent change from 4 weeks a year earlier: +6.7

p Preliminary.

### DEMAND RETAIL SALES

Estimates of retail sales during the most recent week and 4 weeks compare with such sales during the corresponding periods a year earlier as follows:

Period	Percent change
Week ended September 17	+ 9
Four weeks ended September 17	+12

### BUSINESS

#### STEEL PRODUCTION, USES, AND PRICES

During the first 8 months of 1976, domestic steel manufacturers produced an estimated 89.6 million tons of "raw" steel (ingots, castings, and other first stage forms of steel). This amount was 11 percent more than that produced during the corresponding period of 1975 but 10 percent less than the record amount produced during the first 8 months of 1973.

As the accompanying table shows, domestic steel production decreased from a peak of 38.5 million tons during the second quarter of 1973 to a trough of 26.3 million tons during the third quarter of 1975. Most of that decrease in steel production occurred during the second and third quarters of 1975. Such production increased slightly during the fourth quarter of 1975, and increased substantially during the first and second quarters of 1976. During the subsequent 2 months, however, the rate of steel production changed little.

#### STEEL PRODUCTION (millions of tons)

Year	Q1	Q2	Q3	Q4
1972	31.6	34.4	32.1	34.9
1973	37.1	38.5	36.7	38.2
1974	37.1	37.4	35.8	35.2
1975	34.4	29.3	26.3	26.8
1976	31.0	35.2	35.1e	

e Estimate of production for quarter at the rate of output during July and August.

The outlook for steel production during the remaining months of 1976 is unclear. Steel industry analysts expect automobile manufacturers to continue to purchase large amounts of sheet steel on the assumption that automobile sales and production will continue at comparatively high volumes. They also expect demand from capital-goods manufacturers to increase in the near future. According to Edgar B. Speer, Chairman of U.S. Steel Corporation, "there's a pent-up demand for capital goods expansion" that could "break loose" at any time.

On the other hand, the amount of steel used in 1977 large-model General Motors Corporation cars is an average 500 to 800 pounds less per car than in earlier models. This will tend to restrain orders for sheet steel even if auto production remains large. Furthermore, new orders for steel during the early summer months were less than those during the spring months. Reportedly, this reduced rate of new orders was a temporary development attributable to the unusually large amount of orders placed earlier to avoid the expected price increases that occurred in June.

The reduced level of new orders for steel products recently has had an adverse effect on employment in the industry. Temporary layoffs totaling at least 2,000 workers have been reported at U.S. Steel, Bethlehem Steel, Kaiser Steel, Lykes Youngtown, and Jones and Laughlin. These layoffs were attributed to the "poor demand" for steel.

Steel manufacturers shipped 46.9 million tons of steel during 1976 through June, the most recent month for

which such data are available. At the end of 1975, industry analysts forecast that such shipments during 1976 would total about 96 million tons. During the spring, when orders for steel were increasing, these analysts raised their forecasts to 98 million tons for the year. However, because the amount of such orders recently have been disappointing, analysts have revised their forecasts to about 95 million tons. In order to reach that level of shipments, steel manufacturers would have to ship about 24 million tons during both the third and the fourth quarters. If the expected increase in orders from capital-goods producers does not materialize, or if production of new cars is reduced substantially during the coming months, fourth quarter shipments easily might be less than this forecast. Nevertheless, total steel shipments during 1976 most probably will be much greater than the 80 million tons shipped during 1975.

As reported by the Bureau of Labor Statistics, the index of iron and steel prices increased 2.2 percent during June and about 0.9 percent during July to a record 384.7 (1947-49=100) then. That index increased about 7.5 percent during the first 7 months of 1976. During all of 1975 this index increased less than 4 percent. The rate of increase in iron and steel prices during 1974, however, was a marked 38.1 percent. The large increase in the index during June reflected price increases for sheet steel made effective by major steel manufacturers then. In early August most domestic steel manufacturers announced further price increases for such products to be effective on October 1. Later in the month, however, these increases were cancelled. According to a statement by a spokesman for U.S. Steel Corporation, "In spite of high demand and full cost justification for these products, competitive factors forced this decision."

The composite price of No. 1 heavy melting steel scrap, as reported by *Iron Age*, averaged \$79.56 per long ton during August. The No. 1 composite price reached a peak of \$127.60 per long ton during July 1974. From that level,

steel scrap prices decreased to \$58.00 per long ton during July 1975 and \$58.50 per long ton during November 1975. It then increased to a high of \$91.75 per long ton during April 1976. The average price during August was the lowest since that during February of this year.

On June 14, 1976 the United States imposed import quotas on some specialty steel products (stainless and tool steel). Domestic steel manufacturers had complained that they had unused capacity while imports of such products were increasing. The Specialty Steel Industry Group reported that 1.46 million tons of specialty steel were consumed in the U.S. during 1975. Of that amount, imports accounted for 176,000 tons, or about 12 percent. The new quota restricts such imports to a maximum of 147,000 tons during the year ended June 13, 1977. The quota will increase gradually to 155,900 tons during the third subsequent year, unless the import restrictions are ended sooner.

*Until new orders for steel products from capital-goods producers increase substantially, steel production probably will remain at or below the present level and add little further impetus to the business expansion.*

### PRICES COMMODITIES PRICES

Index	1975		1976	
	Sept. 15	Sept. 6	Sept. 13	Sept. 23
Spot-market, 22 commodities*	537	534	539	
Commodity-futures	624	730	723	
Steel-scrap	\$75.33	\$73.17	\$73.50	
Gold	Sept. 25	Sept. 16	Sept. 23	
	\$134.50	\$114.00	\$117.75	

\*For the preceding Tuesday.

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