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Introduction to the Edwin S. Cohen Symposium: An Overview of Business Taxation

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INTRODUCTION TO THE EDWIN S. COHEN TAX SYMPOSIUM: AN OVERVIEW OF BUSINESS TAXATION

*Michael J. Graetz**

It is an honor and pleasure for me to be here today to launch this symposium on current tax reform topics in honor of Edwin S. Cohen on the occasion of his retirement from the University of Virginia as Professor of Law. This is the second occasion I have been asked to speak honoring Ed Cohen on his retirement and, knowing him well, I look forward to many more of his retirements in years ahead.

My assignment today is to provide a brief overview of issues in business taxation. I was tempted simply to repeat the program for this symposium, but I now understand that this is not what the planners of this conference had in mind. Let me instead then simply outline the handful of critical factors that I believe will (or should) direct the current legislative effort at reforming the taxation of business income.[1]

I. The Corporate Tax as a Source of Revenue

The most striking detail about business taxation in the United States is its declining role as a source of federal revenues. The past thirty years have witnessed a dramatic shrinking of business taxes as a share of both federal revenues and gross national product. In 1953, the corporate income tax accounted for 28.4% of federal revenues and 5.4% of gross national product.[2] In 1983, after the most recent liberalization of depreciation allowances, the corporate tax was estimated to account for only 6.2% of federal revenues and 1.1% of GNP.[3] The current U.S. corporate income tax has not

* Professor of Law, Yale University. I wish to thank Rita Cavanagh for research assistance.

[1] The ideas set forth in this article are treated in considerably greater detail in Graetz, *Reform of Australian Business*, . . . Australian Tax Forum . . . (1985). *See also* Graetz & McDowee, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 Yale L. & Policy Rev. 5 (1985).

[2] U.S. Treasury Department, Annual Report of the Secretary of the Treasury on the State of the Finances for 1953, at 616-17 (1954).

[3] Joint Comm. on Tax'n, 99th Cong. 1st Sess., Economic Issues Relating to the House-Passed Tax Reform Bill (H.R. 3838) (JCS-2-86) (January 29, 1986).

been projected to produce more than about 10% of federal revenues in any future year.[4] The individual income tax, by contrast, has accounted for a relatively steady percentage of federal revenue and GNP — 48.1% of revenues and 8.7% of GNP in 1983 compared to 45.2% of revenues and 8.6% of GNP in 1953.[5] Employment taxes, principally the Social Security tax, have grown enormously during this period.

This relative decline in the business share of taxation — in combination with huge and unprecedented federal deficits — imposes a constraint on corporate tax reform that makes the current reform endeavor quite different from those of the past. Now, and for the foreseeable future, tax reform simply cannot become the occasion for further reduction in the share of taxes paid by business. Corporate tax revisions that would cost revenues will necessarily have to be offset by corporate tax increases, most likely by reduction or elimination of special tax concessions to particular industries. Moreover, a portion of the revenue shortfall from individual rate reductions and retention of costly individual tax preferences may well be recouped through business tax increases. At its most benign to business, corporate tax reform must be revenue neutral, and both the President's tax reform proposal and the House bill would increase corporate tax revenues to finance personal tax reductions for individuals in a tax reform package having the overall goal of revenue neutrality.[6]

II. The Importance of the Corporate Tax to Ensure Taxation of Income from Capital

Even with the striking decline in its revenue productivity, the corporate tax remains extremely important as a tax on income from capital, including distributed corporate income. In 1982, for

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[4] *Id.*

[5] U.S. Treasury Department, *supra* note 2, at 616-71; U.S. Office of Management and Budget, Budget of the U.S. Government Fiscal Year 1985, at 4-3 (1985).

[6] *See* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) at 461 [hereinafter cited as Treasury II]; H.R. Rep. No. 426, 99th Cong., 1st Sess. 76 (1985) (Committee on Ways and Means report on H.R. 3838) [hereinafter cited as Ways and Means Committee Report]. The Senate may not be so inclined and may, instead, attempt to shift the individual tax sources, either through increases in selective excise taxes or through individual consumption taxes disguised as taxes on business. Senator Roth's proposed "business transfer tax" is the prime example of the latter.

example, corporate tax revenue of $46.5 billion significantly exceeded the $33.3 billion estimated to be the individual income tax liability on all capital income.[7] While there remains considerable controversy over the incidence of the corporate tax, the Treasury's own measure of economic income used for the personal income tax distribution tables implicitly accepts the view that, at least in the short run, the corporate income tax is borne by stockholders.[8] The long-run incidence of the corporate tax also generates controversy, but the best assumption seems to be that owners of capital bear the tax.[9] To the extent that these conclusions are correct, the corporate tax is the *primary source* of federal revenue from the taxation of capital income.[10]

The critical role of the corporate tax in taxing capital income is either its curse or its blessing, depending on the attitude of the beholder. For those who would eliminate any taxation of capital income in favor of a consumption or wage tax, this role of the corporate tax produces demands for elimination of the corporate tax; the failure to eliminate the corporate tax by statutory repeal only spurs efforts to eliminate it through tax planning. For those with this view, any strengthening of the corporate tax is a step in the wrong direction. On the other hand, for those committed to taxation of income from both capital and labor, this significant role of the corporate tax makes it an important candidate for improvement and strengthening.

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[7] *See* E. Steuerle, Taxes, Loans and Inflation — How the Nation's Wealth Becomes Misallocated 13 (Brookings 1985).

[8] Ballentine, *Where is the Income Tax Rationale for the Shift to Higher Corporate Taxes?*, Tax Notes, February 3, 1986, at 445-46.

[9] *See* J. Pechman, Who Paid the Taxes 1966-1985 Ch. 2, esp. at 29 (Brookings 1985).

[10] The textual point, that the corporate income tax plays an important role in supplying tax from capital income, notwithstanding its recent decline as a source of federal revenue, is undeniable. It is worth noting, however, that this importance results in large part from the exclusion from the income tax base of the imputed income from owner-occupied homes. Steuerle obtains a total effective tax rate on income from capital of 16.2% by adding together the corporate tax revenue of $46.5 billion and the $33.3 billion estimated individual taxes on capital income and dividing by the total capital income. Steurle, *supra* note 7, at 13. Ballentine points out, however, that the total effective rate of tax on business capital income is 23%, as offset by a negative rate of tax on owner-occupied housing and consumer durables, which constitute one-third of the capital stock. Given that imputed income from owner-occupied housing and other consumer durables will undoubtedly never be subject to income tax in this country, business taxes will inevitably remain a critical aspect of the taxation of capital income. The demise of the federal estate tax also contributes to this state of affairs. *See* Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 Yale L.J. 256 (1983).

III. Variation in Effective Business Tax Rates

Perhaps the most disturbing overall trend in corporate taxation in the United States has been the wide variation in effective rates of tax, both among industries and among companies within the same industry. The Treasury and many private economists have demonstrated the wide disparities in the effective rate of corporate tax for different industries.[11]

Tax preferences, combined with certain structural features of the tax system such as the preferential treatment of debt financing and the consolidated return mechanism, produce wide variations in effective corporate tax rates among industries and among companies within the same industry. For example, in the United States one estimate suggested that the effective rate of corporate tax ranged from a low of negative 20.2% for the water transportation industry to a high of 37.1% for the industry composed of water supply, sanitary services, and certain utilities. Wholesale trade corporations were estimated to be subject to an 8.3% effective corporate tax rate while retail trade corporations were subject to a rate of 23.5%.[12] Similar variations in effective rates may exist among companies in the same industry that have followed different investment, financing, or accounting practices.

These disparities among industries are largely the result of accelerated depreciation and the investment tax credit combined with favorable tax treatment of debt financing. Accelerated depreciation and the investment tax credit have reduced the corporate tax burden on capital-intensive industries relative to labor-intensive industries.[13] Tax burdens also may vary depending upon the mix of property used by the industry; for example, industries that invest primarily in equipment are often taxed at a lower effective rate than industries that invest primarily in buildings or inventory.

Varying tax rates at the company level, as opposed to the indus-

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[11] U.S. Treasury Department, 1 Tax Reform for Fairness, Simplicity and Economic Growth: The Treasury Department Report to the President 106, 108 (2 vol. 1984) [hereinafter cited as Treasury I].

[12] Auerbach, The Corporation Income Tax, *in* The Promise of Tax Reform ch. 3, at 12 (J. Pechman ed. 1985).

[13] *See* 2 Treasury I, *supra* note 11, at 156 ("ACRS disproportionately benefits capital-intensive industries and methods of production. Income from sectors of the economy without significant investments in depreciable property typically faces higher effective tax rates.").

try level, result in part from variations in each company's history of gains and losses. This history depends, in turn, on whether the company has been able in the past to take advantage of accelerated depreciation and the investment tax credit. Several unintegrated companies may have the same combined taxable income as a single conglomerate company but pay a higher corporate income tax; that is because the conglomerate may elect to file a consolidated return, which permits the tax losses of one subsidiary to offset the tax gains of another. This disparate treatment may encourage economically inefficient mergers and acquisitions as well as other economically inefficient transactions, such as leasing, among unaffiliated companies.

Variations in financing patterns among companies — especially in their use of debt versus equity financing — also produce variations in their relative tax burdens. The U.S. corporate income tax traditionally has favored debt over equity financing by providing that interest paid on indebtedness is deductible to the company while dividends paid on equity are not. This preference has been exacerbated by the asymmetrical taxation of assets and loans that has resulted from the failure of our income tax to respond systematically to inflation. Meanwhile, the Congress, the Treasury Department, and the courts repeatedly have shown themselves incapable of imposing clear rules to distinguish between debt and equity.

The uneven tax burden among industries, and among companies within a single industry, has produced enormous misallocations of resources in our country that cannot be explained as any sort of coherent national industrial policy. Instead, investment capital seems to run around like a bad "keystone cop" movie, shifting from industry to industry, from company to company, for little purpose but to achieve the greatest tax benefits. As the Treasury has observed, these "tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lost productivity, lost production and reduced consumer satisfaction." The tax system has skewed corporate financing decisions away from equity and in favor of riskier debt, induced the retention of earnings, encouraged marginally productive activities, discouraged investment in the corporate sector, as well as savings generally, and encouraged participation in tax shelter partnerships.[14]

A goal of business tax reform must be to reduce these tax-induced distortions and the related losses in equity and economic efficiency. Efforts to correct these distortions should focus on depreciation, inflation adjustments, and integration of the corporate tax. The adoption of a depreciation system that more closely approximates economic depreciation, including appropriate adjustments for inflation, would reduce tax benefits from investment in capital instead of labor or in one category of asset instead of another. These changes would reduce both the influence of the corporate tax on economic decisionmaking and the disparities among industries in the taxation of corporate income. Proposals to integrate the corporate and individual income taxes by eliminating the "double taxation" of dividends would reduce the disparate treatment of debt and equity.

Although business tax reform including economic depreciation, inflation adjustments, and integration of business and individual taxes was advanced by the Treasury in its November 1984 Report to the President, no such comprehensive business tax revision now seems likely to emerge from the current tax reform process.[15] Nor are we likely to have a cash-flow tax that would allow deductions for equity investment either by including borrowing in receipts or by disallowing interest deductions. Significant distortions in both tax burdens and resource allocation will continue to plague our tax

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[14] 1 Treasury I, *supra* note 11, at 118-19.

[15] The Treasury proposed inflation adjustments through retention of indexation of individual tax brackets and indexation of basis of capital assets, inventories, depreciation deductions, and indebtedness, moving towards a system of economic depreciation and a 50% dividends-paid deduction. *See* 1 Treasury I, *supra* note 11, at 17 (indexing of tax brackets); 2 Treasury I, *supra* note 11, at 178-88, 189-92, 152-72, 193-200 (inflation-indexed basis adjustments), 152-72 (real cost recovery system for depreciation), 145-55 (dividends-paid deduction).

Treasury II scaled back the dividends-paid deduction to 10%, recommended an inflation-adjusted depreciation system (capital cost recovery system) permitting more acceleration of deductions than proposed in Treasury I, eliminated indexing of indebtedness and capital assets (optional indexing for the latter starting in 1991), and retained loss flow-through treatment for limited partnerships. *See* Treasury II, *supra* note 6, at 132-59 (capital cost recovery system for depreciation), 120-29 (10% dividends-paid deduction), 164-69 (optional indexing of capital assets starting in 1991), 322-24 (interest deductions).

The House bill proposes an incentive depreciation system (IDS), retains the 10% dividends-paid deduction, and retains indexing of individual tax brackets and IDS capital assets (starting in 1988). *See* Ways and Means Committee Report, *supra* note 6, at 137-60 (depreciation and capital asset indexing), 234-42 (dividends-paid deduction).

system.

The primary source of hope for the would-be business tax reformer now seems to lie in that theoretically most inappropriate of solutions — the corporate minimum tax. For a variety of reasons that I shall not detail here, an alternative corporate minimum tax may now be ecomonically and politically the most appropriate mechanism to ameliorate the worst consequences of our imperfect tax system.[16] At the least, a properly designed corporate minimum tax, by placing a floor on the effective income tax rate applicable to corporate economic income, could serve to reduce significantly the wide disparities in effective corporate tax rates and, at the same time, could restrict opportunities for large U.S. corporations to pay little or no corporate tax on their economic income.

IV. The Necessary Relationship of Business and Individual Taxation

Business taxation cannot be considered in isolation from a country's overall tax system. There are important theoretical and practical reasons for coordination of our systems of business and individual taxation.

A. *Theory*

Some people believe that corporations and other business entities should be treated as separate taxpaying entities with an ability to pay taxes that is independent of the collective taxpaying ability of their owners. I, however, regard the system of business taxation as inherently linked to the system of personal taxation.

This view implies that once an income tax is imposed on individuals, a corporate income tax is necessary only to ensure that undistributed corporate income does not escape tax. Theoretically, it is inappropriate to tax corporations on earnings that are distributed to shareholders as dividends, because dividends, if subject to tax both at the corporate level and at the shareholder level, are taxed more heavily than other kinds of individual income. By the same

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[16] I have set forth both my arguments for an alternative corporate minimum tax and what I regard as its most significant structural attributes in testimony to the Senate Finance Committee. *See* Statement of Michael J. Graetz before the Senate Finance Committee, October 9, 1985; *see also* Graetz, *The 1982 Minimum Tax Amendments as a First-Step in the Transition to a "Flat-Rate" Tax*, 56 S. Cal. L. Rev. 527 (1983).

token, undistributed corporate earnings are improperly taxed whenever the corporation's effective tax rate differs from the collective rate of its shareholders. This suggests that the theoretically proper reform would be to repeal any separate corporate tax and to attribute undistributed corporate income directly to shareholders for taxation at their marginal rates. The corporate tax would be reduced to a withholding tax that would be credited to shareholders against corporate income distributed or attributed to them.[17]

Political and practical obstacles, however, have made "full integration" of the individual and corporate income taxes and the resulting repeal of the corporate income tax unacceptable in the United States. Commentators have urged, as a second-best solution, the repeal of the corporation tax on earnings distributed to shareholders as dividends.[18] These proposals have encountered considerable resistance from corporate managers, who prefer that any reduction of the corporate tax be focused on retained earnings rather than on distributed earnings. As a result, proposals for dividend relief repeatedly have been rejected, and the President significantly scaled back the Treasury's 1984 dividend relief plan.[19]

By contrast, if instead of an income tax, an expenditure tax or a consumption tax were imposed on individuals, there would be no theoretical reason to allocate undistributed corporate income to shareholders, because a consumption tax should apply only when that income is devoted to consumption. Thus, to the extent that the taxation of business is regarded as complementary to the taxation of individuals, the adoption of a consumption tax at the individual level should imply the elimination of taxes on business income: businesses are engaged in production, not comsumption. Corporate earnings retained for additional investment should be exempt from tax, as should amounts invested and saved by individuals.

Most proponents of expenditure taxation, however, would prefer to retain a separate corporate tax, usually in the form of a cash-flow tax. I am skeptical about a cash-flow tax, and no such tax is

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[17] *See* U.S. Treasury Department, Blueprints for Basic Tax Reform 69 (1977); C. McLure, Must Corporate Income Be Taxed Twice? 146-84 (1979); Warren, *The Relation and Integration of the Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719, 739-41 (1981).

[18] *See, e.g.*, C. McLure, *supra* note 17, at 42-44.

[19] *Compare* 2 Treasury I, *supra* note 11, at 136-44, *with* Treasury II, *supra* note 6, at 120-29.

now under active consideration in the United States. Such a corporate tax essentially would make the government an automatic joint venturer in all corporate endeavors, but without the participation in management generally accorded to important joint venturers. Of course, if the government were to become such a joint participant, it might demand a commensurate role in corporate decisionmaking. A cash-flow corporate tax is often advanced merely to prohibit windfall gains on old investments made at a time when investors assumed a continuing corporate tax; it seems likely that there are better ways to eliminate such windfalls (the important issue of losses would continue to be of great importance under a cash-flow corporate tax).

B. Practical Considerations

Practical as well as theoretical considerations require a close relationship between business taxation and individual taxation. This is largely because our legal system allows businesses great flexibility in their selection of legal form and in their entry into myriad legal relationships. These choices are often influenced by differences in the systems of business and individual taxation with respect to applicable tax rates and tax base. This country has sometimes experienced great disparities in individual and corporate rates of tax. When the top corporate rate is significantly below the top individual rate, or, as is the case today, when low corporate rates are available to individuals with large amounts of other income, individuals have found the corporate tax to be an opportunity, rather than an additional tax burden. Rate disparities have often induced individuals, especially professionals, to incorporate so that both their personal service and investment income may be taxed at the corporate level rather than at the individual level. A number of complex devices have been enacted to combat this form of tax avoidance.[20]

Likewise, individuals have often attempted to enjoy the special advantages available to corporations (or other business entities) for the calculation of taxable income. For example, employees have bargained for tax-free fringe benefits and have claimed deductions

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[20] These include, for example, the special tax on "personal holding companies" and the "accumulated earnings tax." *See* I.R.C. §§ 541-547, 531-537.

for "business expenses" that involve substantial elements of personal consumption. The favorable tax treatment of pension payments to corporate employees, as opposed to self-employed persons or members of partnerships, was a major incentive for taxpayers to structure their activities in corporate form. This explains why many of our nation's law firms are structured as partnerships of professional corporations whose shareholders are individual lawyers, or variations on this theme.

The point is that differences in the individual and business tax systems, in terms of both rates and the structure of the tax base, must not permit tax avoidance either through manipulation of income or deductions or through shifting of income or deductions between businesses and their owners. It is far easier to point this problem out, however, than to enact laws that will successfully redress it.

V. The Necessary Relationship of the Corporate Tax to the Taxation of Other Entities

Collection of business taxes is made considerably more difficult by the wide disparities in tax burden that depend on whether a business is structured as a corporation or as some other legal entity. In some countries, this problem has arisen most dramatically in the use of trusts, rather than corporations, as a means of conducting business.[21] In the United States, this problem has been most evident in the use of limited partnerships, which are not subject to the corporate level tax, and the tax losses of which immediately flow through to the partners.[22] As a matter of practical effect, the larger limited partnerships have most of the legal characteristics of corporations, including centralized management, limited liability, and ready transferability of ownership; indeed, interests in some of these limited partnerships are routinely traded on major stock exchanges.

The tax burden of a business should not differ significantly merely because of the legal form in which the business is con-

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[21] *See, e.g.,* Reform of Australian Tax System, Draft White Paper 52-56 (June 1985).

[22] The Treasury has noted that the number of taxpayers claiming losses from partnerships increased almost five-fold, to 2.1 million, between 1963 and 1982. *See* 1 Treasury I, *supra* note 11, at 138. For a discussion of the tax treatment of limited partnerships and the problems that have resulted from such treatment, see 2 Treasury I, *supra* note 11, at 146-68.

ducted. Whenever choice of legal form has an effect on a business' tax burden, taxpayers will attempt to structure their businesses to utilize tax losses and to avoid taxation of income. We have not yet adopted a satisfactory solution to this problem, although some proposals would impose the corporate tax on any entity, including a partnership, with more than thirty-five owners.[23]

Small businesses and farmers exercise great political power in Congress and have often won tax concessions that not only prevent special hardships for them, but also create new avoidance opportunities for large corporations. The anti-abuse components of the resulting provisions — designed, for example, to provide benefits to family farmers but to deny them to large farming syndicates — have added to the length and complexity of the Internal Revenue Code. Line-drawing in such cases is extremely difficult both theoretically and politically, and attempting to distinguish a "small" corporation from a "large" one is inherently controversial, but a more general tax distinction between large and small businesses merits further study. Our experience with so-called Subchapter S corporations,[24] which are exempted from corporate tax, suggests that only those corporations with the simplest form of capital ownership should be treated as "small" corporations, and it may be necessary to treat even a small business like a large one if the small one has multiple classes of stock.

VI. Conclusion: The Need for Self-Determination in Taxing Businesses

In conclusion, let me emphasize two points. First, taxation is a very important legal area for the populace to exercise self-determination. A tax issue sparked our Revolutionary War.

The internationalization of the world economy seems to me a rising threat to each country's self-determination, particularly in the area of business taxation. Arguments grounded in alleged impact on international trade are routinely advance by members of the business community in an effort to lower their own tax burdens. The result, in this country at least, is routine assertions that we must adopt a depreciation system no less favorable to business

[23] *See* 2 Treasury I, *supra* note 11, at 146-50.
[24] *See* I.R.C. §§ 1361-1363, 1366-1368, 1371-1375, 1377-1379.

than the most favorable in the industrialized world, that our financial institutions must enjoy the same tax benefits as those in countries where they are most favored, and even that if we dare to tax investment income or capital gains, capital will flow abroad — and on and on. Many self-serving claims are made regarding still-controversial empirical economic issues with respect to the impact of business tax reform on the cost of capital and the short-run and long-run impact on the competitive position of U.S. companies. This line of argument has a great tendency to shift the burden of taxation from income of capital to income of labor, which is concededly less mobile. This international "least common denominator" principle of business taxation must be avoided if the citizenry is to be allowed to exercise its own attitudes about tax fairness and tax justice in its own country.

Finally, let me express my view that one must be cautious about structuring a business tax system responsive solely to arguments grounded in economic efficiency considerations. The choice to tax income implies an acceptance of some economic inefficiency. While this does not necessarily require the widespread ineffecient distortions that have occurred within the U.S. system of business taxation, it does suggest a conflict of economic efficiency with other important values. The subject of business taxation is necessarily linked to the system chosen to impose the costs of government fairly on individual taxpayers. There is great danger in losing sight of the important role of fairness in taxing corporations and other business entities.

Comments of Panel Commentators to Prof. Graetz' Address

Commentators:

Dr. Charls E. Walker
Charls E. Walker & Associates, Inc.
Washington, D.C.

Mr. Emil Sunley
Director of Tax Analysis
Deloitte, Haskins & Sells
Washington, D.C.

Professor Alvin E. Warren, Jr.
Harvard University Law School
Cambridge, Massachusetts

Excerpts from commentators' remarks:

WALKER: I've got a slight bone to pick with the management. Mike Graetz gets up here and gives an absolutely outrageous overview of the issues involved in business taxation. We should have at least an hour to counteract that sort of subversion. I will address my remarks to what Mike had to say on questions about the incredibly shrinking corporate tax, on the rate of corporate taxation, and on these questions of disparate rates being unfair.

I say it is absolutely outrageous to speak of high rates on one corporation and low rates on another and suggest that is unfair, without also looking at the ultimate impact on the ultimate taxpayer, and that we do not know. We do know, for example, that any tax increase, as under Treasury II on electric utilities, will be passed through to the ultimate consumer. We know that any tax increase on steel companies cannot be passed through without increased protectionism. Are increased taxes fair on those industries in order to increase their tax rates? It's a very unsatisfactory analysis just to look at the tax rates and not look behind them, and the difficulty is that we have great trouble in looking behind them.

There is something very fundamental here that makes a difference in outlook and difference in approach, and makes it impossible to say that there is a theoretical consensus as to what ought to be done to the corporate tax. I question that on the surface but also look into it a little more deeply. What is involved here is this:

if you are going to tax income, what are you going to include in the income to be taxed? Are you going to take the views of Henry Simon at the University of Chicago and say that any increase in net worth is income and ought to be taxed regardless of the saving that is involved in that process, or are you going to take the views of the classical economist in Irving Fisher, the neoclassicists, and say no, you should not tax saving because you are in effect taxing capital and capital is not income?

We don't have a scroll from Heaven. Moses didn't bring down the 11th commandment and say, "Thou shalt tax total increases in net worth as income." This is a pragmatic decision and if, as I will note in just a moment, excluding taxation on capital, and in effect expensing capital equipment, gives you a more neutral system for decisionmaking in business, which most economists agree with, and if, secondly, taking the classical approach means that you are going to get more saving, investment, and capital formation, and therefore more economic growth, then I am going to go with the classicists, toward the definition that excludes taxes on savings, investment, and capital income. And that's what the debate, I think, pretty well boils down to.

There is a very respectable group in the economic community that believes that we should move toward — in fact were moving toward from '78 to '81 and a little longer — basically a consumption tax. The movement in those days was towards a consumed income tax by gradually eliminating or reducing the taxes on capital income, for example, the capital gains tax cuts, the IRAs, the 401(k)s, and things of that type. Implicit in that some of the economists would say that we ought to abolish or at least to make the corporate income tax shrink either explicitly or implicitly, and certainly implicitly involved in any pure consumption tax is the expensing of capital expenditures, that is, immediate write-off as you do with labor expenditures, advertising expenditures, or whatever it may be.

The real question involved here is whether we should move towards expensing in the context of the current income tax system. Some economists say you should not or cannot, and I fail to see that entirely. What we were trying to do with 10-5-3 (ACRS) in 1979 when it was developed was to replicate the expensing of capital outlays on machinery and equipment. Some people would define that as a corporate effective tax rate of zero, others would disagree that the tax rate is actually zero. Regardless, we were trying to replicate in some type and some form of present-value basis and also some form of cash-flow basis an expensing approach. This would give you neutrality in your decisionmaking because, in effect, corporate saving currently is taxed much more than once. A 46% rate applies when the money is first earned regardless of how much you save, then that saving is put into machinery and equipment. The income on that is taxed again, that's the second level of taxation. The remaining income is taxed a third time to the extent dividends are paid out to stockholders, incurring three levels of taxation on some portion of corporate savings, although not every dollar for dollar. That is bound to give you a lack of neutrality in corporate decisions. There will be a decision to move less toward capital formation and expansion and more toward other types of expenditures. The value of 10-5-3 in my view was that it was front-end loaded, in contrast to Graetz' criticism that CCR is better because it is not front-end loaded.

One final point has to do with the international competitive aspects of this. I simply cannot agree that these ought to be overlooked. It seems to me that if you are saying we are very concerned about taxing labor versus taxing capital, and it would be better for the American people to tax capital instead of labor, that is just a modern type of Luddism, as we had back in the earlier years when they tried to abolish the steam engine. Graetz would be on a crusade of destroying computers and robotics and all these other techniques, which are really where the jobs are going to come from in the long run. As far as international competition is concerned, it is a very tough world out there. In the international competitive market, the current $150 billion trade deficit that we have is a result of many factors, but most economists agree that an overvalued dollar is one of the biggest. If you look beyond the overvalued dollar, if you look 10 or 20 years into the future, and ask what will be our situation in trade vis-a-vis the rest of the world, you've got to agree that our comparative advantage is not going to come from our labor costs. We are a high-cost society on labor and we are competing with lower-cost societies, some of them much lower when you get into southeast Asia and the advancing industrial societies of that type. This means, it seems to me, that if we are going to be competitive we are going to have to maintain a maximum volume of investment in modern, state-of-the-art machinery, facilities, and equipment. I'm not talking about buildings; you can produce efficiently in an older building, if maintained. I'm also not talking about inventory, so I'm not talking about the general cost of capital business. I'm talking about the cost of investing in machinery and equipment.

10-5-3 even with the adjustment of TEFRA gave us a competitive capital cost-recovery system. In terms of 5-year capital cost recovery we rank third among 16 industrial nations. What the Ways and Means Staff plan would do to that proposal would reduce us to 16th, dead last, just behind Taiwan. It would increase the capital cost of investment in machinery and equipment by 20%. It would raise the effective corporate tax rate on investment in machinery and equipment by 39 percentage points, which would greatly reduce the present value. I maintain this is very important public policy, and the debate we now have really comes back to this fundamental issue, should we be arguing about depreciation, economic depreciation or otherwise, or should we try to move ahead towards outright expensing of all capital outlay?

SUNLEY: I have a comment that relates to Charlie Walker's comment on expensing and possible economics in a classical approach. It may well be true that a consumption-tax base is preferable to an income-tax base, but I think we need to remember that in that world of a consumption tax base where you are going to expense investments in machinery and equipment, you also do not have deduction of interest, and that's the point that Al Warren has stressed in his work: that we have gone beyond the consumption tax world, where not only do we permit expensing, but we also permit deductibility of interest.

WARREN: I would like to add just a word on Michael Graetz versus Charls Walker, who I notice has come out courageously and resoundingly in favor of the classicists, as opposed to University of Chicago radicals. Charlie promotes expensing in the corporate context because it will permit neutrality with respect to corporate investment decisions. I think that is entirely right. But I also think it is correct to say that a well formed income tax also would not interfere with decisions by corporate managers among investments that they would otherwise make. On the other hand, the current ACRS system does interfere with investment decisions because it does not treat all assets the same. Nevertheless, there is a substantial difference between a tax which is based on economic depreciation and one that is based on expensing, and it is the difference that both Michael and Emil mentioned, that a tax based on expensing effectively reduces the rate of tax on capital income to zero. So the fundamental question becomes whether or not the kind of arguments that Charlie made about international competition should lead us essentially to eliminate our corporate income tax base through the mechanism of expensing. That strikes me as a very serious debate that is not particularly illuminated by saying that the classics and neutrality are on one side or the other.

I also want to associate myself with Emil's remarks that if you move towards expensing, to be consistent you also have to set up a regime in which there is no deductibility of interest. Otherwise, we are back in the area of Fred's paper and all the problems created by tax arbitrage.

(Additional remarks made by the commentators with respect to the deductibility of interest in an expensing system are included in the remarks following Mr. Hickman's paper, infra.)