This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Studies in Income and Wealth, Volume 2

Volume Author/Editor: Conference on Research in National Income and Wealth

Volume Publisher: NBER

Volume ISBN:

Volume URL: http://www.nber.org/books/unkn38-1

Conference Dates:

Publication Date: 1938

Chapter Title: Capital Gains in Income Theory and Taxation Policy

Chapter Author: Roy Blough, W. W. Hewett

Chapter URL: http://www.nber.org/chapters/c10565

Chapter pages in book: (191 - 263)

Part Four

CAPITAL GAINS IN INCOME THEORY AND TAXATION POLICY

ROY BLOUGH AND W. W. HEWETT
UNIVERSITY OF CINCINNATI

Discussion

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ROY BLOUGH AND W. W. HEWETT

CAPITAL GAINS IN INCOME THEORY AND TAXATION POLICY[1]

ROY BLOUGH AND W. W. HEWETT

I Introduction

The subject of this paper presents the broad question of how capital gains should be treated in the concept of income and in taxing income.[2] The unavoidable difficulties of the subject are multiplied by a serious lack of uniformity in the use of the terms capital

[1] Profiting by the excellent contributions of the several discussants at the American Economic meeting in December 1937, this paper differs from the preliminary draft presented there in several respects. Since the comments of the discussants printed in this volume were based on the paper in its present form, the extent of their contributions is not fully indicated. We regret this result but have concluded that some of the original criticisms were of such a nature that our paper should not be published without taking advantage of them. The following are the more important changes.
1) The short summaries of American and British experience in the taxation of capital gains have been deleted as not essential to the chief issues under consideration and as requiring additional investigation. We are indebted to R. M. Haig and George O. May for comments leading to this deletion.
2) The comments of H. M. Groves and H. C. Simons indicated that our theoretical analysis was not clear and this presentation has been recast. We have sought to retain the clash of ideas with these discussants where real differences of opinion were apparent.
3) A few alterations in style and mechanics of presentation have been made.
4) Our comments in reply to the contributions of the several members of the Income Conference, which follow this paper, appear below as Discussion VI.

[2] For briefer discussions of the problem of the treatment of capital gains and losses in estimates of national income, see *Studies, Volume One* (1937): M. A. Copeland, Part One, pp. 19, 20, 30-32, discussion by Simon Kuznets and Dr. Copeland's reply; Clark Warburton, Part Two, pp. 97-101; Simon Kuznets, Part Four, discussion by M. A. Copeland, Milton Friedman, and A. W. Marget, and Dr. Kuznets' reply.

gain and income. That income is a term with several somewhat conflicting definitions needs no elaboration. Capital gain likewise has no single accepted meaning. In the federal income tax law a capital gain is the gain or profit received when an asset, other than stock-in-trade held for sale, is sold or exchanged at a profit. Popular usage commonly extends the definition to include an increase in the value of a capital asset even though that increase has not been realized through sale or exchange. 'Paper profits' on stocks or real estate are capital gains in this sense. In the broadest sense all property value appreciations, whether or not in stock-in-trade, are included in this concept of capital gains. Most economists, however, have not used the term in this sense. They have defined capital in terms of social wealth as distinguished from property assets; a capital gain is then an increase in the stock of such wealth items as are included in capital. Unfortunately even from the social wealth approach capital and consequently capital gains are not uniform concepts. The differences in concepts of capital and income necessarily give rise to different conclusions as to the relation of capital gains to income. Avoidance of confusion over mere terminology requires special care in definition.

The present writers take it that their starting point is the broad popular usage of capital gains as appreciations in the value of property. Part of the task is to survey the gap between this usage and that of capital gain as an increase in the stock of wealth with respect to different income concepts. The main problem, however, is to make analyses that will furnish guidance for the adoption of policies, in one case research policy in measuring incomes, in the other government policy in taxing incomes. As was perhaps inevitable, the subject has proved too broad in scope to be covered in its entirety. Important omissions and limitations will be noted in the course of the paper.

The discussion is divided into two parts. The first deals with property value changes as they relate to income in theory. Since measurement of income necessarily seeks to give quantitative expression to an income concept, this topic will have a bearing on income measurement. The second part deals with the treatment of property value changes in the taxation of incomes. The analyses of these two topics are quite distinct and the connection between them tenuous. The objectives are different—the measurement of social income versus the determination of personal tax liability. In our opinion the fundamental differences in the two problems makes the application of identical concepts of income to both purposes fallacious.

II Capital Gains and Income Theory

I DEFINITIONS

a) *Definitions of capital*

The lack of uniformity as to what elements should be included under the term capital is well known. Some writers would include all wealth existent at a point of time: land, producers' goods (other than land) and consumers' goods.[3] Others include only producers' goods.[4] A third group includes in addition to producers' goods those consumers' goods offered for hire.[5] Several writers do not define in terms of wealth at all, but call capital "a value sum expressed in terms of money".[6] It is clear that analyses of capital gains will yield different conclusions with different definitions of capital. If the first definition is accepted (all wealth in existence at a point of time) an increase in the market value of a capital asset is not properly classified as an addition to the total social capital unless it reflects a real increase in the stock of material economic goods; an increase in value is not necessarily evidence of a 'capital gain'. The last type of definition listed (a value sum) presents the opposite extreme: any increase in the market value of a capital asset must be classified as a capital gain regardless of its origin. An increase in the market value of a share of stock as a consequence of the development and ownership of a new patented process is then just as correctly labeled a capital gain as an appreciation arising as a consequence of additional equipment purchased out of earnings.

The other two definitions noted are merely restricted wealth

[3] See Irving Fisher, *Elementary Principles of Economics* (Macmillan, 1913), p. 38.

[4] See F. W. Taussig, *Principles of Economics*, 3rd ed. (Macmillan, 1921), I, 69-70.

[5] See T. N. Carver, *Principles of Political Economy* (Ginn, 1919), pp. 115-156.

[6] J. R. Turner, *Introduction to Economics* (Scribner's, 1919), p. 468. For a similar type of definition see F. A. Fetter, *Economic Principles* (Century, 1915), p. 267.

concepts, but each would lead to unique conclusions as to the items properly classified as capital gains.

Each of the many competing capital definitions was formulated by its proponent as a tool for general economic analysis. For an investigation of the more limited field of capital gains, the essential requirement of a capital definition is that it leave no misunderstanding as to the distinction between a value sum and concrete economic goods. Increases in the stock of wealth must never be confused with increases in the value of property that do not represent quantitative changes in the stock of wealth. This does not mean the denial of the opportunity to use a 'property value' or a 'capital value' concept without reference to the underlying situation with respect to economic goods; in fact, just such a procedure is followed in Section III where the problem of taxation policy is under review. *But it must be recognized that there are times when some economists desire to trace changes in the flow and stock of economic goods while other economists may be concerned only with alterations in the degree of ownership and control.* One may justly argue against the desirability of going behind an item of value for the purpose of tracing its relation to concrete goods, but as long as some authorities, rightly or wrongly, are interested in a study of changes in the flow or stock of economic goods, the student of income should define his terms in such a manner as to make quite clear whether the particular problem under review is one of value changes or of wealth changes. For this reason we shall restrict our use of the term capital to the total stock of wealth and reserve the word property to cover the concept of a 'value sum', whenever confusion of thought might otherwise result.[7]

b) *The definition of property*

In conformity with the above principles, the popular practice of using the word property as a synonym for capital or wealth must be avoided. Property is not wealth, but a title to wealth or a source of wealth—the legal right of ownership. "The three essential attributes of property are: first, the right to use and control; second, the right to enjoy the fruits and to receive income; and third, the right to alienate and dispose."[8] A house is wealth

[7] Cf. Simon Kuznets, Part One, especially Sec. I, 1.

[8] Eustace Seligman, 'The Relation of Law to the Modern Developments in Property Ownership.' *Proceedings of the Academy of Political Science*, Vol. II (1924-25), p. 442.

(or capital); the right to live in the house, control it, receive any income it may earn, and dispose of it at will is the property right, or simply property. Property is not a physical object, but a bundle of rights. A franchise, or an annuity, may represent no particular items of wealth, but, because they have a present value due to the control of rights to future income, such assets are classified as intangible property.

c) *Capital gain vs. property gain*

If capital is defined as a stock of wealth, capital can 'gain' only by an increase in that stock of wealth. A business that adds to its machinery, buildings, or inventory out of its earnings has increased the national capital. Capital 'gains' when the stock of capital goods has been increased. But in current usage a capital gain means an increase in the *value of an asset*, that is, of property. The federal income tax law states: "For the purpose of this title, 'capital assets' means property held by the taxpayer . . ."[9] Now an increase in the value of property is not necessarily evidence that a corresponding increase has been made in the national capital as a stock of wealth. Indeed, since with a franchise or a patent, greater profit is obtained by the control of output, production will probably suffer a reduction rather than an increase. Property gains may or may not represent increases in real capital.

This divergence between *property gains* and *capital or wealth gains* is a relatively recent development. Adam Smith seems to have used property to mean the same thing as wealth. "Property with Smith . . . was the protection by law of the laborer in holding for his exclusive use . . . the physical products of his labor . . . His commodities are always individually owned. His wealth of Nations is the sum of individual wealth. He thus has the double meaning of wealth as materials and their ownership."[10]

The development of intangible property and the corporation have played important roles in this trend toward the separation of property and wealth into distinct categories.

[9] *Revenue Act of 1936*, Sec. 117, par. C. In quoting only partially, no implication is intended that all kinds of property are capital assets.

[10] J. R. Commons, *Institutional Economics* (Macmillan, 1934), pp. 166-7. This work bases much of its analysis upon the distinction between property and wealth.

2 THE INCOME CONCEPT

a) *Relativity of income definitions*

As Simon Kuznets has so clearly stated in his article on 'National Income,'[11] income may be defined in many ways and the choice of definition depends upon the purpose, or use, to which it is to be applied. The point may be illustrated by contrasting three objectives: the measurement of (1) the volume of production; (2) standards of living; (3) taxpayers' ability to pay.

1) If one is interested in the measurement of a nation's production of wealth, and changes in that production of wealth, a definition of income in terms of consumers' goods proves inadequate. Production of consumption goods may fall while total production is rising, and rise while total production is falling. New producers' goods are part of the total product and so must be included. To disregard them would mean that a shift in the application of productive powers would be misinterpreted as a shift in the total volume of production. Depreciation of producers' goods must be deducted to avoid duplication, since producers' goods are destroyed in the production of new wealth. If the objective is to trace and compare the production of economic goods through time, a definition of income must be formulated in terms of the total net production of all commodities and personal services.

2) If one is interested in measuring changes in living standards, a definition of income in terms of consumers' goods (commodities and services) will be essential. Capital accumulations (that is, savings[12]) are excluded from income, since they are not directly consumable. The depreciation of capital goods is not deducted from consumers' goods produced; the failure to replace capital goods in the process of production allows an increase in the flow of consumption goods in the short run, making it possible to maintain living standards, or perhaps even to advance them, in the face of declining total production. A definition of income as a flow of services (advocated by Irving Fisher) would satisfy the needs of an investigator concerned with current standards of living.

3) A third objective may be a desire to estimate an individual's

[11] *Encyclopaedia of the Social Sciences*, XI, 206.

[12] For the sake of simplicity in analysis, it is assumed here that savings will all be converted into new capital accumulations.

(or a corporation's) gain in control over commodities and services as a basis for taxation on the ability to pay principle. Here the definition of income must face squarely the possibility that one individual may gain in control at the expense of other individuals without adding to the net product of industry. Net property value changes resulting from trade marks or monopolistically controlled natural resources—in fact, all changes having their origin in monopoly or imperfect competition—are examples of items that fall into this classification. A definition of income in terms of *economic power*, such as that of R. M. Haig, serves admirably these requirements. Professor Haig defines income as "the money value of the net accretion to one's economic power between two points of time."[13] Problems arising in the precise definition of economic power will be treated later, in the discussion of taxation.

Because of these, and other objectives, a great array of income definitions has resulted.[14] Of these numerous formulations, three types have come to dominate economic literature: (1) income as an accretion of economic commodities and services; (2) income as an accretion of services—a consumption concept; (3) the accounting type of definition utilizing the device of the balance sheet. The third type has many variations and would appear to include Professor Haig's concept of 'economic power' and Henry C. Simons' 'personal income'.[15]

We cannot here explore all the possibilities of each of these and other types of income definitions as they relate to capital gains. Since the definition of income in terms of the production of economic goods has been generally accepted by the students of social or national income, considerable emphasis on the relation of capital gains to that concept will appear in the following pages. The excellent income studies of the National Bureau of Economic Research and the United States Department of Commerce have

[13] R. M. Haig, *The Federal Income Tax* (Columbia University Press, 1921), p. 7. This definition is similar to that proposed by G. v. Schanz in 'Der Einkommensbegriff', *Finanz-Archiv* (1896) cited in P. H. Wueller, 'Concepts of Taxable Income: I, The German Contribution', *Political Science Quarterly*, Vol. LIII, No. 1 (March, 1938), pp. 102 ff.

[14] For an excellent list of definitions of income see Irving Fisher, *The Nature of Capital and Income* (Macmillan, 1927), Ap. to Ch. VII.

[15] *Personal Income Taxation* (University of Chicago Press, 1938).

in each case sought to go behind the raw data of the balance sheet and endeavor to trace changes in 'real income'; one of our primary interests will be to examine the problem of capital gains in relation to this type of income study. Before proceeding to this analysis a few comments concerning the consumption and accounting concepts of income are in order.

b) *The 'consumption' concept of income in relation to property value changes*

Irving Fisher, the chief proponent of the consumption concept, defines income as "a flow of services through a period of time",[16] asserting: "The only true method in our view is to regard uniformly as income the service of a dwelling to its owner (shelter or money rentals), the service of a piano (music), and the service of food (nourishment); and in the same uniform manner to exclude alike from the category of income the dwelling, the piano, and even the food."[17] Commodities have no place in the definition; income is received only when a service is rendered.

Under this definition savings are not income. Savings out of earnings will increase the future flow of services but the amount saved is not income. On the other hand, depreciation or the depletion of capital does yield services. In his writings, Professor Fisher repeatedly warns against "the fallacy of deducting from income any depletion of capital".[18] From this reasoning it is clear that property value increases are not income, regardless of their nature or source; likewise property value decreases are not deductible from gross earnings to obtain net income. If we accept Professor Fisher's definition, the whole capital gains controversy apparently disappears as a problem in theory, measurement, and taxation. The difficulty with this apparently simple solution is the obvious fact that the controversy has merely shifted from 'income' to 'earnings'. This conclusion is tacitly admitted by Professor Fisher, for he writes: "I used the term *earnings* to include capital gain and the term *income* in the sense of the value of services rendered by capital."[19]

[16] *The Nature of Capital and Income*, p. 52.
[17] *Ibid.*, p. 106.
[18] *Ibid.*, p. 134.
[19] *The Theory of Interest* (Macmillan, 1930), p. 455.

c) *The accounting definition of income as related to value changes*

The following appears to be fairly typical of accounting definitions of income. "Income is increase in wealth measured in terms of money, accruing or receiving during a given period. It arises from the use of capital or the rendering of personal service or both, as distinguished from the return of capital. It includes earnings, gains, or profits from any source."[20] On its face this appears to be close to a commodity and service definition. However, observation of accounting practice indicates that income in accounting is a property, not a wealth concept. Certainly, so far as the present writers have been able to ascertain, the usual accounting definition of income does not endeavor to distinguish sharply between gains that represent increases in economic goods and gains that grow out of mere transfers of rights to goods. The propriety of counting a gain or profit as income does not depend on its being traceable to a net increase in economic goods for society as a whole.

The accounting definition of income quoted above would seem to comprehend income as the accretion of economic power. Economic power is a balance sheet concept corresponding to the net worth of the business. If all changes in the values of assets and liabilities were recorded, income (or loss) under this concept would equal the difference in the net worth of the business (value of assets minus liabilities) at the beginning and end of the year, after adjustments were made for dividends paid and new capital invested.[21] Regardless of the accounting definition of income quoted above, however, the accountant apparently does not arrive at net income or profit from the balance sheet, but rather from the profit and loss statement. While the figures on the profit and loss statement and the balance sheet must check, not all increases in net worth are considered profits. Profits are distinguished from mere increases in the value of capital. Dividends are supposed to be paid only out of profits.

A capital gain arising from the sale of an asset is a profit and

[20] Preliminary Report of a committee on Terminology, American Institute of Accountants. Quoted from G. A. D. Preinreich, *The Nature of Dividends* (New York, 1935), p. 21.

[21] See R. M. Haig, 'Capital Gains and How They Should be Taxed', *Proceedings of the Academy of Political Science*, Vol. II, No. 1 (1924-25), p. 135.

may ordinarily be paid as dividends if the effect is not to diminish the working capital unduly or to impair the earning power of the business. Unrealized appreciations in the value of assets are ordinarily not recorded on the books. When they are recorded they are considered increases in capital and placed in a reserve account as not available for dividend payment. However, a decrease in the value of capital due to fire or obsolescence, or in some cases to a decline in market value, is recorded and recognized as a deduction from the net profits available for dividends. The accountant undoubtedly follows this somewhat inconsistent course as a rule of caution and conservatism.[22]

Although the above statement seems to be the general practice, opinion among accountants as to just what should be included in income is not unanimous. This is to be expected since accounting "is not a set of fixed rules or unbending principles" but "an instrument of public policy and of private management".[23] Accounting definitions will thus vary with what is accepted as good business practice or sound public policy. Since few if any business practices are universally accepted as good and since business practice and public policy may conflict, no precise definition of income is likely to be universally accepted in accounting.

The accounting concept of income is of particular importance to the statistician in measuring income and to the taxing official in taxing income, since the accounts are vital sources of data. A modified accounting definition including unrealized as well as realized property value changes as income is the basis of 'total book income' accepted in one of the outstanding measurement studies.[24] 'Total book income' differs from accounting income not only because of the inclusion in the former of unrealized value changes, but also because in its computation: (1) all values are reduced to dollars of constant purchasing power; (2) some attempt is made to look behind the items of income in an effort to obtain a more accurate estimate of national income in relation to the national net product.

[22] Cf. Solomon Fabricant, *Volume One*, Part Three, especially pp. 120 ff.

[23] John Bauer, 'Accounting', *Encyclopaedia of the Social Studies*, I, 412.

[24] W. I. King, *The National Income and Its Purchasing Power* (National Bureau of Economic Research, 1930), pp. 36 ff.

d) *Social income as a net product*

In that excellent little volume *Income in the United States*, national income was defined as "the commodities and services produced by the people of the country or obtained from abroad for their use . . . reckoned on a net basis, that is negative income, maintenance and depreciation charges are deducted, but not extentions and betterments".[25] This approach to the concept of social income has been basic to the great majority of income measurement studies and is in harmony with the income concept found in the writings of classical economists and their contemporary disciples. It represents an attempt to define the net product of the economic system.[26]

In order that human wants may be satisfied, an elaborate machine-like organization has been evolved to secure the production of commodities and services. The output of commodities and services includes: (1) new commodities produced—boots, clothes, bread, coal, dwelling houses, machinery; (2) personal services rendered—the sermon of the preacher, the physician's advice, the singer's song; (3) services of durable goods that have been carried over from the preceding income period—the services of dwelling houses, furniture, factory buildings, machinery. This third group, it will be noted, includes both *producers' durable goods* and *consumers' durable goods*—a point of great importance in the measurement of capital gains.

Taken together, the three groups constitute the total outpouring of commodities and services annually accruing to society. At the beginning of an income period society starts with a stock of factories, machines, land, dwelling houses, automobiles, and durable consumption goods. During the income period, new commodities are produced, new personal services rendered, and the old durable goods continue to yield their services. This total output may be called gross social income and is available for disposition as the receivers elect. In the process of production producers' goods will wear out and be discarded as obsolete, and national

[25] (National Bureau of Economic Research, 1921), p. 42. Modifications made for statistical reasons such as the omission of produce consumed by a farm family on the farm are not pertinent here and have been deleted in the above quotation.
[26] See Alfred Marshall, *Principles of Economics*, 8th ed. (London, 1920), pp. 71 ff.

resources will be depleted. If allowance is made for these items, the net social income remains. *Net social income is the total flow of commodities and services, through a given period, available for distribution after maintaining the capital fund intact.*

This definition of social income counts the items that make up the total social income, at the time production takes place. Every addition to what Josiah Stamp calls the 'national heap'[27] of commodities and services is part of the gross income and, after the costs of production have been deducted, the residual sum is the national or social income. From this reasoning it follows that the source of all capital is income; income must first accrue before saving for capital extension can take place. Capital can therefore 'gain' only by an increase in the stock of wealth by saving out of income. The only capital gain that can be recognized is a realizable increase in that stock of wealth.

e) *Income as a quantitative concept*

After reaching an agreement as to the meaning of the terms 'economic goods' and 'social income', there remains for the economist the very perplexing problem of expressing a given social income quantitatively. We can agree that a horse, a phonograph, and a Gibson Girl picture hat are all economic goods and, when produced, are part of the social income. We can also agree that if a change in consumers' desires and habits results in the substitution of the automobile, the radio, and the simple felt hat for the above-mentioned economic goods, the new commodities are also properly classified as part of the social income when produced. But, how can we express the first three goods as a total sum, and if we do succeed in solving this problem, would a comparison of that total with a total computed in a similar manner for the second three goods make possible a conclusion as to the relative *size* of the social income in the two periods?

If automobiles, radios, and felt hats could be reduced to a common denominator, the measurement of the social income for a given period and comparison between two periods would present relatively few difficulties.[28] The search for such an 'absolute'

[27] J. C. Stamp, *Wealth and Taxable Capacity* (London, 1922), pp. 42-43.

[28] We are not concerned here with practical statistical difficulties inherent in data. Such questions as, on the one hand, the advisability of including housewives' ser-

unit of measurement has been for economists the historical equivalent of the religious quest for the Holy Grail. In the absence of a physical unit of measurement such as the unit of energy, we are forced to resort to money prices as a 'second approximation'. The definition of social income is in effect amended to read—'a flow of commodities and services expressed in terms of money prices'. The significance of this shift to a quantitative income concept has not been sufficiently explored by students of income theory and income measurement. The difficulties are usually noted, but a few words of caution are not enough. Prices are value in exchange relations expressed in terms of a monetary unit. When the items of income are converted to money sums and these sums added, the procedure involves: (1) the adding of relative quantities, (2) expressing these relative quantities in a *non-stable* monetary unit. "As quantities of money expended, particular prices and particular incomes are capable of addition, and the total arrived at has a definite monetary significance. But as expressions of an order of preference, a relative scale, they are incapable of addition. Their aggregate has no meaning. They are only significant in relation to each other. Estimates of social income may have a quite definite meaning for monetary theory. But beyond this they have only *conventional* significance . . . A comprehensive aggregate of prices means nothing but a stream of money payments . . . But, of course, this does not exclude a *conventional* significance . . . [We] may assign to the movements of these aggregates a certain arbitrary meaning which is not without its uses".[29]

Obviously, statistical adjustments for price level (value of money) variations will not meet adequately the problems raised by continually shifting inter-price relationships. Very few spots in the field of economic research require the alert awareness on the part of the student that is necessary whenever deductions as to shifts in physical quantities are being drawn from social income aggregates.[30]

vices and food raised in one's own garden, and on the other, the limitations of accounting technique and depreciation reserves, all present difficulties that are extremely important but not directly relevant to the present study.

[29] Lionel Robbins, *The Nature and Significance of Economic Science* (London, 1935), p. 57.

[30] See M. A. Copeland and E. M. Martin, Part Two.

The conventional nature of the social income aggregate has a very direct bearing upon the problem of capital gains. We have noted that gains usually known as capital gains are in fact appreciations in the value of property assets. If the social income is defined as a net product of economic goods, value appreciations that are at root merely shifts in existing property rights must be differentiated from value appreciations that represent net additions to the flow of economic goods. This procedure is necessary if the social income aggregate is to have significance as an index of the productive achievement of an economic system. But complete confidence cannot be placed in the accuracy of the final result. Alterations in the habits of consumers, the development of new production techniques, the shifting of inter-price relationships as an indirect consequence of price level variations, all set traps for the investigator, especially in periods of rapid dynamic change. Only for short periods, during which the conventional assumptions that consumers' preferences and production technology remain unchanged are reasonable, can a relatively high degree of confidence be placed in the accuracy of definite conclusions. And even within such limitations, honest differences of opinion will arise repeatedly as to the relation between specific value variations and the net flow of economic goods.

f) *The problem of natural resources*

The definition of net social income in terms of the net social product must be admitted to be purely conventional. This principle can be well illustrated by an examination of the relation of natural resources to the social capital and income. Assume that a farmer discovers coal under the surface of his land and that after a careful survey the coal is found to be of excellent quality and approximately one million tons in quantity. Should this discovery of one million tons of coal be considered an addition to the social capital, and, for the income period in which the discovery was made, a part of the social income?[31] This issue can be

[31] This problem is of very great significance to the student of capital gains, for the same issue arises in other related and analogous forms, such as new technological developments. This part of the argument can better be discussed after the complication of *measurement* has been introduced.

solved only by making a conventional assumption consistent with the concept of social income. What is the function that the concept of social income as a net product is expected to satisfy? Common sense would appear to dictate that the objective is a method of appraising the degree of achievement of the economic system in supplying man with economic goods. Economists are interested in a concept of social income as a means of testing the success with which economic activity results in available economic goods. The logic of this reasoning demands that the discovery of new, economically available, natural resources be considered an act of production and the new resource part of the gross product. Since the stock of wealth has also been increased, the social capital may be said to have increased.

However, if the function that the social income concept is expected to satisfy can be better approximated by a conventional assumption that rules out new discoveries, it would be foolish to take issue with the authority assuming such a position as long as the intent and usage of the authority concerned is made quite clear. To decide otherwise might place arbitrary difficulties in the path of legitimate research.

g) *Individual income in relation to social income*

An individual, like the social group, may be said to have received income when he gains control of commodities and services through a period of time. In part, these commodities and services will come to him directly as, for example, the services of his wife, the use of his automobile, and the vegetables from his garden. The major proportion, however, must come from other producers through the medium of the exchange process. An individual is continually exchanging previously acquired control of wealth and his new production for the wealth controlled by others and the new production of others.

Consequently, while social income can increase only by means of an increase in the net social product, an individual may gain in control of commodities and services, independently of a gain in the net social product, by a transfer of control from other individuals. This fact gives rise to some questions as to the proper procedure with reference to the definition of individual income. Gifts, inheritance, fraudulent or predatory activity, and deliberately created scarcities (e.g., monopoly) all illustrate economic gains on the part of individuals that do not represent real increases in the net social product. If such items are considered items of individual income, then it would apparently be impossible to consider social income as equal to the total of all individual incomes, and a statistician making an estimate of the net social product would be unable to utilize individual income totals as acceptable data. However, in the taxation of citizens in accordance with the ability to pay principle, the identity of social income with the total of all individual incomes is immaterial and irrelevant; any increase in control over economic goods constitutes an increase in the ability to pay taxes.

From the theoretical viewpoint, these discrepancies can be completely resolved by considering all items of individual gain that do not have their origin in a net increase in economic goods as transfers of rights to property or income. If we imagine that every individual keeps a set of books in which all transfers of rights to economic goods to other persons are classified as disbursements or outgo, then a consolidation of individual accounts would give a net income aggregate equal to social income defined as a net product.[32] In actual practice, however, no such accounting procedure is, or can be, followed. Therefore, the use of individual income accounts in estimating social income must introduce serious errors and arbitrary conventions must be accepted as the only possible way out. It may be that the degree of uncertainty thus introduced into social income estimates is so great that a strong case may be built for the abandonment of any attempt to resolve individual income data into equivalent economic goods. The present writers do not agree with this negative conclusion. In the remaining portion of the theoretical analysis of capital gains in relation to social income an effort will be made to interpret the significance of property value changes in terms of underlying economic goods. But we agree that the definition of personal income as a basis for taxation must disregard the origin of a particular income item. This point will be further developed in the section concerned with tax policy.

[32] See Irving Fisher, *Nature of Capital and Income*, Ch. VIII and IX, for the application of this idea to his concept of income.

3 PROPERTY VALUE CHANGES AND THE INCOME CONCEPT

a) *A classification of property*

To what extent are property value appreciations a part of social income defined in terms of economic goods—the social net product? When does a property value gain represent a real gain in commodities and services for society (or a nation) as a whole? The answer is complicated by two facts: (1) property, while in all cases a bundle of rights, is of different kinds depending on what the rights relate to; (2) gains may arise from several quite different sources. As to the *kind* of property, the following classfication is followed in the discussion.[33]

PROPERTY CLASSIFIED AS TO KIND

1) *Tangible property*, that is property in which the legal right attaches to capital as we have defined that term. Houses, machines, automobiles, hats, are examples of wealth to which such property rights are attached.
2) *Intangible property*, that is, property in which the legal right does not attach to capital as here defined. This group of assets includes:
a) Assets representing the capitalization of expected income in excess of the normal earnings of capital, such as income due to monopoly or imperfect competition. Examples are legal monopolies such as franchises, patents, copyrights; trade secrets; and goodwill such as trademarks and personal goodwill.
b) Promises to pay, such as the promissory note. In general these assets derive their value from the legal claim to expected future earnings, which may be purely personal in character. However, if they derive their value from existing wealth, they constitute indirect titles. Mortgages are often of this character.
c) Indirect titles to tangible property and the preceding types of intangible property. Changes in the underlying tangible or intangible property in these cases will affect the value of the indirect title. Corporate stocks are perhaps the best example, although trust certificates are also in this class. Mortgage bonds may also at times be classified here, as their value may be determined in considerable part by their conditional title to existing wealth.

When the principles already developed are applied, three conclusions are reached concerning the extent to which changes in

[33] For a somewhat different classification see Kuznets, Part One, Sec. II, 1 and 2.

the value of these classes of property reflect changes in social income. First, changes in the value of indirect titles reflect gains or losses in capital only as the underlying property reflects such changes. Second, changes in the value of intangible property other than indirect titles are based upon expected future incomes rather than on existing incomes and thus do not constitute an increase or decrease in existing capital. Third, increases in the value of tangible property are part of social income only if they reflect increase in the stock of wealth. An examination must accordingly be made of the sources of changes in the value of tangible property.

Property value changes arise from four general types of sources: (1) production; (2) changes in the rate of capitalization; (3) changes in the prospective income stream capitalized; (4) changes in the level of prices.

b) *Property value changes and the process of production*

In the ordinary production process, goods appreciate in value by the addition of form, time, place, and possession utilities. These goods are also the object of property rights, the total of which must similarly appreciate in value. This appreciation in value accumulates as a commodity moves forward through the productive process. For example, a retail store in Chicago buys a hat for two dollars in Philadelphia and sells the hat to a consumer in Chicago for five dollars. Is this three dollars increase in price, income? The concept of production with reference to material objects is not restricted to the addition of *form* utilities; the addition of time, place, and possession utilities is also production. A careless definition of income as a 'flow of commodities and services' might have the effect of excluding all but form utilities. A hat is a hat, whether it be in Chicago or Philadelphia, and the quantity of hats is not altered by the act of transportation. However, when income is so defined, there is always the tacit assumption that changes in the value of a commodity, if they represent additional utilities, shall be counted as a change in the volume of production and therefore income.

Although as suggested earlier, all increases in the value of property may in the broad sense be included in the term 'capital gains', the term has not customarily been used to include the increase in the value of goods as they move through the stages of production. What law makers and statisticians seem to be concerned about is how to treat shifts in the value of fixed capital as contrasted with circulating capital (including thereunder consumers' goods)—not the increasing value of a peach as it ripens, is boxed, shipped, and sold over the counter, but the change in the *value of the tree*; not the growing value of goods as they move through a plant, but the change in the *value of the plant* itself. The definition of capital gains in taxation and in measurement tends to be a very close approximation to an *increase in the value of fixed capital assets.*

c) *The problem of scarcity values*

One of the most difficult issues is property value appreciation due to natural or man-made restrictions in supply. The first case is illustrated by appreciating land values.[34] So far as an increase in population results in a property value appreciation because of the fixed amount of land, it would appear obvious that the value increase does not represent an increase in social income; a transfer of rights to income has taken place. But there are other causes of land value appreciation, such as the discovery of new resources, the discovery of new production techniques that make resources previously impossible of economic recovery valuable, and improvements in transportation. In all the latter cases the total of utilities has clearly been increased. In the opinion of the present writers, the difficulty of demarking the different kinds of land value appreciation warrants the conventional assumption tnat all such increasc arc part of social incomc. Differentiation of value appreciations by source seems a hopeless task; attempts at estimate may increase rather than decrease the error in social income figures. It must be remembered also, that these scarcity value increases will affect the distribution of social income, even if the effect on the total is disputed.

Increases in scarcity arising from the pecuniary activities of individuals present much the same problem. Increases in property values as a result of franchises, patents, copyrights, monopoly, and imperfect competition cannot be construed as additions to

[34] See M. A. Copeland, 'Problems in the Theory of National Income', *Journal of Political Economy*, Vol. XL (1932), pp. 12 and 13.

the 'national heap'; the very intent of each individual act is the restriction of output rather than its increase. In some individual cases property value appreciation of this sort can be isolated, and if this is possible, a deduction should be made before reaching a final estimate of aggregate social income, but such instances are probably few. It must be frankly admitted that the inability to separate out man-made increases in scarcity values gives considerable ammunition to those who object to a definition of social income that requires going behind value items in search of 'real' income. Future experience with actual income measurement investigations may force the conclusion that, with the exception of a few clear-cut income categories, an improved production index is as close as we can get to an accurate measure of the degree of achievement in the production of economic goods through time.

d) *Changes in the rate of capitalization*

Increases in the value of a property asset resulting from a change in the interest rate are not evidences of the creation of income. If, for example, the rate of interest should fall from 10 to 5 per cent, indicating an increase in the valuation of future goods as compared with present goods, property values would tend to increase, that is, the present market value of rights to possess, enjoy, and dispose of goods in the future will have increased. However, no immediate alteration has taken place in the stock of wealth, or the flow of income, and such a value appreciation is therefore not properly classified as an addition to income. To the extent that sales of such property take place, there is a shift of rights to national income rather than a change in its size. The purchaser gives up rights to commodities and services, equal to the gain in such rights obtained by the seller. The real significance of the drop in the rate of interest will be found in its effect upon the future income flow.

e) *Changes in the prospective income stream capitalized*

The reasoning with respect to changes in the rate of capitalization is directly applicable to changes in the prospective income stream to which that capitalization rate is to be applied. When the causes of the appreciation accruing out of shifts in demand or conditions of supply become common elements to all producers, such value gains will disappear, but for short periods (in the Marshallian sense) or for the life of a patent, copyright, or franchise, considerable value appreciation may arise. As an illustration of such a shift in demand, assume that a machine used in the manufacture of a certain type of hat cost $500. If a marked increase in the demand for these hats developed, raising the price, the machine might be recapitalized at, say $1,000, for a short period at least. The sale of the plant at that moment would bring a higher price because of this increased valuation. Is such an increase to be included as part of social income?

The answer must be in the negative since there has been no change in the quantity of commodities and services; the increased value of future commodities has been capitalized.

From the supply side an interesting problem is presented by changes in the technique of production. Such developments alter the prospective income stream capitalized and may cause an appreciation in the value of property assets.

Let us assume three plants, A, B, and C. Plant A puts one hundred days' labor (we shall ignore other costs) into the making of a machine worth $1,000 on a cost basis. Plant B puts one hundred days' labor into the development of a new (patented) process that will add to the plant output an amount just equal to the increase in output obtained by plant A with the operation of its new machine. Plant C has an engineer who, while engaged in his regular duties, suddenly has an inspiration as to a new (patented) method of production that will, without additional cost to the firm, increase the output of the plant in the future by the same amount as the increase obtained from the new machine in plant A.

We have here three cases: (1) new material producers' goods; (2) a new process developed after considerable research; (3) a new process that is virtually costless. In the case of each plant, has social income been produced, and has individual gain been received that does not represent social income? A variety of answers is presented under different income theories. Under Fisher's definition of income as a flow of services no social income at all has appeared; it will appear in the future as a new flow of commodities and services. If the payment of $1,000 to workers in Plants A and B resulted in a larger flow of consumption, income to the extent of that flow would appear, but the creation of the machine or process itself would not become income. Under the accounting definition there has been no individual income to Plant A or Plant B, for the capital and process, respectively, have presumably cost all they were worth. However, the $1,000 paid is income to the workers receiving it, so that total income has been increased $1,000 in each case. In the case of Plant C, if unrealized proper value increases are recognized, there has been an income of $1,000 to the plant, while if only realized income is recognized, there has been no income to the plant. Under the commodity and service definition, the value increment due to the production of the machine in Plant A is social income (or rather represents social income). The value increments in Plants B and C are not income. This conclusion follows from the fact that under the commodity and service definition of social income, income must consist of either services or an increase in wealth. Techniques and the state of the arts are not considered capital,[35] and the variations in the capitalized value of the asset are not social income items. Accordingly an improvement in technique cannot be income. The creation of social income in Plant A is not represented by an equivalent individual income received by the plant, but by the $1,000 payment to the workers. In the case of Plant B there also has been the payment of $1,000 to the workers; the result being that the plant has suffered, under the commodity and service definition, a loss in control over existing wealth, which was transferred to the workers as individual income. In the case of Plant C no social income in the net product sense has been added to the wealth of the nation.

If care is taken to write off all cost, whether depreciation or otherwise, no real difficulty should be encountered in theory or in measurement under the commodity and service definition.

[35] An interesting collateral problem is here raised. Should development of technique, business organization, education, a fund of knowledge, be included within the definition of capital? It might well be argued that since in each case labor has been used for more remote rather than immediate ends, the round-about process of production is involved just as truly as in the case of an extension in physical equipment. A good case can be made for defining capital in such a manner as to include such intangible improvements. Thus, Kuznets, Part One, Sec. I, includes human skills in his definition of 'wealth'.

Plant A has invested $1,000 in improvements and betterments, and if the depreciation of the new equipment is deducted by proper accounting methods, the true income, present and future, will be correctly obtained. No net income element will be counted twice. Plant B, on the other hand, can follow either of two accounting procedures. Since no material good has been produced, the additional cost of development can be lumped with general cost, and, since there is nothing to depreciate, no depreciation deduction must be made. Rights to present income have been given up for the privilege of securing future income. The alternative procedure would be to set up a thousand dollar asset on the books as evidence of an investment made in the interests of future production. Here the thousand dollar investment could be liquidated over a period of years by a species of depreciation account. The latter procedure would, however, overestimate the income in early years and underestimate it in later years. Plant C has no cost to write off and, consequently, its true net product is unchanged until the future additional flow of goods and services appears. No deduction for depreciation, or liquidation of investment, is involved.[36]

f) *Changes in the price level*

When the source of a property value increase is a change in the price level, the gain is nominal rather than real, since all prices increase. The owner of property possesses the equivalent of more dollars, but he may be no richer or poorer in command of commodities and services than before the price rise. The variation in the value of money—the counter used in the exchange—must not be mistaken for variation in the values of goods in exchange. Although price level fluctuations are often accompanied by changes in income through a partial redistribution of income

[36] Decreases or in some cases increases, in the value of existing fixed capital due to technological developments also represent a problem of some importance. Is partial or total 'economic destruction' of a machine due to technological improvement analagous to partial or total physical destruction through depreciation? If so, is the possible increase in the productivity and value of a machine due to such an improvement analagous to production? The whole question of obsolescence seems to the writers to be in a somewhat confused state. Cf. Fabricant, *Volume One*, Part Three, pp. 132-4.

among various classes of society, the fluctuations themselves do not constitute income.

It should be noted that if one desires to eliminate from property value changes the effect of a shift in the price level through the application of price index numbers, the desired result will not be achieved by applying an index number to the amount of the change. Rather, an index of prices at the beginning of the income period must be applied to the price of property at that time, an index of prices at the end of the period applied to the then existing price, and the gain or loss between the two calculated.[37] Mere application of an index number to the value change not only fails to adjust the amount of the change for price level variations but such a procedure may show the change as occurring in an erroneous direction.

g) *The special case of corporate securities*

The heat with which the capital gains controversy is debated is undoubtedly attributable in large degree to the special problem presented by corporate securities, principally stocks. These securities, as noted above, fall in the classification of indirect titles. The capital value of such titles will vary with the value of the tangible and intangible property (including the goodwill of the going concern) that they represent, and with the prospect of receiving as dividends the property or the earnings thereon. To the extent that gains in stock prices are due to reinvested earnings, they represent real capital increases. To the extent they are due to the capitalization of expected future earnings the gains do not represent real capital increases.

The difficulties raised by corporate securities are almost entirely in the field of taxation. Individuals are not taxed on the earnings of the corporation or the increase in security values resulting therefrom unless dividends are paid or the stock is sold. Failure to pay dividends may have the effect of postponing the individual income tax, which thus is a motivating factor in determining dividend policies. This problem is discussed in the section on taxation.

[37] See Maurice Leven, *Income in the Various States* (National Bureau of Economic Research, 1925), 'Preliminary Statement' by W. I. King, p. 31; Copeland and Martin, Part Two, Secs. I and II.

In the measurement of national income, double counting may conceivably result if both the income reinvested by the corporation *and* the consequent increase in value of stocks are included. However, by eliminating one of them, usually the latter, the duplication is avoided.

4 SUMMARY

The two questions around which this section has centered are: what is the nature of so-called 'capital gains', and, to what extent are 'capital gains' part of income under the principal income concepts?

The analysis has led to the conclusion that 'capital gains' in the broadest sense are property value changes, realized or unrealized. Although some persons would limit the term gains to include only those on so-called 'capital assets' as distinguished from stock-in-trade, and some would limit the term to realized gains, the present writers consider the broad definition the most useful.

Property value changes are in a different category from true changes in capital, since capital is the total existing stock of wealth, while property consists both of rights to that wealth and intangible rights to future anticipated income.

Property value changes are income under an accounting definition, since accounting deals with property rather than wealth. However, the treatment by accountants of unrealized property gains is not uniform. Under the commodity and service definition, property gains are income to the individual since they transfer control over income. So far as social income is concerned, however, only those gains that reflect production are a part of income. This eliminates property value changes due to variations in (a) the interest rate, (b) the income to be capitalized, (c) the price level. Corporate stocks and other indirect titles are in a special position since changes in their values represent income only to the extent that value changes in underlying property represent income. Under the consumption type of definition of income, property value increases are not income at all; while property value decreases would reflect income to the extent that they yield a flow of directly consumable services.

III The Taxation of Capital Gains

I OUTLINE OF THE PROBLEM

In a broad sense current usage classifies all property value appreciations as capital gains, and all decreases in property values as capital losses. To what extent should these gains or losses be recognized as elements in the determination of taxable income? The tax policy issue rarely arises between the alternatives of complete exemption and of complete taxation. Gains obtained by manufacturers, merchants, dealers in securities, and even professional speculators are all capital gains since they arise from the sale of goods for more than they cost; such gains are taxed as income as a matter of course. It is with respect to gains in the value of property that is not part of one's stock-in-trade held for sale that the issue of taxability comes to the front. Attention will therefore be chiefly centered in this section upon the taxation of capital gains in that more restricted sense.

In the preceding section the relativity of income definitions to the functions they are expected to perform was noted. Now, the objective of the personal income tax is presumably to apportion the tax burden according to personal ability to pay. Among the various taxes in our present system the income tax comes nearest to being a purely personal tax, that is, a tax that measures the personal situations of individuals and imposes burdens in accordance with these situations. Other considerations may require some deviation from the principle of taxation in accordance with personal situation, but to the extent that deviations occur, the personal character of the income tax is reduced.

Accordingly, the concept of taxable income should be one that comes nearest to reflecting ability to pay. For administrative reasons the income concept must also be one subject to reasonably accurate measurement from the financial accounts of the taxpayer. Three substantially different concepts of individual income based on accounts may be distinguished. One is an adaptation of the consumption concept. Professor Fisher has formulated a detailed plan for a tax of this type.[38] In effect it is a kind

[38] Irving Fisher, 'Income in Theory and Income Taxation in Practice', *Econometrica*, Vol. V, No. 1 (1937), pp. 42-53.

of expenditure tax, rather than a tax on earnings or total net gains received. Such a tax must not be confused with a 'sales' tax, for progressive rates can be applied to a spendings tax.

A second concept of income based on accounts is that of individual economic power.[39] Its figures would be drawn from the balance sheet and would comprise the change in net worth (assets minus liabilities) from the beginning to the end of the year plus the expenditures for consumption during the year. Calculation of income according to this concept would require the annual revaluation of all assets on the basis of market value.

A third concept that corresponds more closely to actual accounting practice is the realization concept, in which increases in the values of assets do not constitute income until they are realized by sale or exchange. Income is thus substantially a net flow (after deducting expenses and costs) of purchasing power through the hands of the individual and subject to his disposition.[40]

Increases in property values do not become income until the sale or exchange of the asset. As previously indicated, the emphasis on the realization concept by accountants, who are the custodians of the measurement of individual incomes, is apparently a matter of caution and conservatism. The use of the realization concept helps to protect persons against their own excessive optimism and against the financial manipulations of others. The policy is a pragmatic one based on a balance of considerations rather than on an internally consistent income theory. The attitudes of the courts and Congress in defining taxable income have been affected by and have in turn affected accounting concepts of income.

In some definitions of income for taxation, certain types of realized gain or profit are not included. Frequently the term income has been limited to gains that are recurring[41] and to gains

[39] As previously mentioned, this is R. M. Haig's concept of income as "the money value of the net accretion to economic power between two points of time" (*The Federal Income Tax*, p. 27).

[40] Accounting profit is not always truly realized in the economic sense, in that it is not always in form for free disposition during the fiscal period in which it is recognized. However, these exceptions may be waived for the present discussion.

[41] Recurrence has been emphasized frequently by German writers, beginning with Herman. See Wueller, *op. cit.*, pp. 89 ff. Professor C. C. Plehn made it an element in his income definition. See his article 'Income as Recurrent, Consumable Receipts,' *American Economic Review*, Vol. XIV (March 1924), p. 5. It is part of the con-

that arise from services rendered.[42] The present writers consider these limitations untenable from the viewpoint of individual taxable income. Certainly such gains contribute no less to individual ability to pay taxes than do recurrent, earned gains.[43]

a) *Differences in income concepts*

The principal difference among the three concepts of individual income, and one of vital significance in the taxation of capital gains, concerns whether a person always receives income when he grows rich. Can an individual grow rich without having received income, or does the act of growing rich constitute the receipt of income? Growing rich does not constitute income, however it takes place, according to Professor Fisher's concept. A person can grow rich without having income both by the reinvestment of earnings from whatever source derived and by the unrealized increase in the value of property. Indeed, under this concept growing rich is the negation of income. To the extent that an individual applies his earnings or gains to growing richer he does not have income, while if he consumes them and consequently does not grow rich, he has income. If he grows poorer, owing to consumption, he receives income as a correlative of growing poorer. Under the economic power concept, growing rich in any manner and from any source is income, since economic power is identical with personal riches. Under the realization concept a person may grow rich without income through the increase in the unrealized accrued value of assets, but realized gains are income whether or not they are saved, so that growing rich through saving is not tax free.

In the opinion of the writers, growing rich implies the receipt of income, however the riches are secured. Accordingly, the economic power concept of income seems basically the soundest and the one on which tax policy should rest, except as various

cept of taxable income in the British tax; for example, see *Ryall v. Hoars*, 2 KB 447 (1923).

[42] Income as a payment for services rendered is emphasized in the definitions of Biersack and Schmoller (Wueller, *op. cit.*, pp. 89-93). It appears also to be an element in the British definition (*Ryall v. Hoars*). While not a part of income definition in the American law, it has probably been influential in the distinction between capital gains and ordinary business income.

[43] Except as they are more likely to arise from price level changes. Adjustment of income for such changes is discussed below.

considerations may require departure from it. The consumption concept utterly misses the mark of measuring personal ability, for it taxes a person when he is losing his ability and exempts him when his ability is increasing. The realization concept, although admittedly more practical than the economic power concept,[44] is illogical, in that, whereas the person who owns freely reproducible goods directly must ordinarily realize income and reinvest it to grow rich, the person who owns non-reproducible goods such as land, or who owns indirect titles, such as corporate stocks, may grow rich without realizing income.

b) *Considerations for tax policy*

As previously indicated, the writers believe that, considered purely as a tax on personal situation, the personal income tax should be imposed on all increases in economic power and should allow the deduction as losses of all decreases. However, the determination of policy must rest on a balancing of many considerations and cannot be controlled solely by a theory of personal tax justice. A great variety of considerations have some bearing on the method of taxing capital gains, but among them the ones that seem most important may be summarized in the following questions:

1) To what extent is the tax levied in accordance with principles of justice?
2) In what directions and to what extent does the tax have economic effects, especially with reference to:
   a) The payment of corporate dividends?
   b) The price and volume of sales (and exchanges) of securities and other 'capital assets'?
   c) The proportion of national income saved?
   d) Accounting and business practices?
3) Is the tax feasible to administer?
4) What is the effect on the volume and stability of revenue?
5) Is the tax constitutional?

c) *Possible treatments of capital gains*

Possible treatments of capital gains and losses in taxation are almost infinite in their variety. Gains may not be taxed at all and

[44] See the discussion of administrative feasibility in Sec. 2 (g) below.

losses not be allowed as deductions. Gains may be taxed and losses not allowed as deductions. Conceivably losses may be allowed as deductions and gains not taxed.[45] Taxes may be imposed on property value increases when they occur or only when gains are realized. Realization may be recognized only when a sale is made for cash, or also upon exchange, or, still further, at death or at the time a gift is made. Capital gains and losses may be segregated completely from other income and subjected to some special form of tax, or they may be completely integrated with other income (as they were in effect under the 1918 law), or they may be partly integrated (as they have been since 1921). Partial integration may be by a variety of devices, of which two importantly different ones have been used since 1921. Gains on assets held for a long time may be subjected to a lower tax than gains on assets recently purchased, as is the case under the existing step-scale arrangement; or conceivably the opposite policy might be adopted on the ground that the owner has in effect been 'earning on the tax', as he has had the use of a larger earning asset than if he had been taxed on his accrued gain year by year.

This multitude of ways in which capital gains may be taxed differ primarily in four respects:

1) Extent of taxability,
2) Requirement of realization,
3) Deductibility of losses,
4) Adjustment of rate for time assets are held.

Extent of taxability refers to the degree to which the gains are taxable or exempt. It may range from complete taxability, as in the federal income tax law prior to 1921, to complete exemption, as in the case of some gains under the British income tax law. Requirement of realization concerns whether capital gains are taxable when the increase in the value of an asset takes place, or only when that gain is realized by sale or exchange of the asset. It also concerns whether a realization policy, if adopted, should include the recognition of realization of capital gains by the

[45] Something of this nature occurs (at least temporarily) in the valuation of inventories at 'cost or market whichever is lower' and in allowing obsolescence, etc., while not taxing increases in the values of assets.

donor at the time a gift is made and by the decedent at death. Deductibility of losses concerns whether capital losses should be fully, or partly, deductible from other income, deductible only from capital gains, or not deductible at all. The question of carryover of losses as a deduction against future income is also involved. Allowance for time held relates to whether, if a realization policy is followed, some recognition should be given, in the tax rate, for the period during which the asset has been held, in order to avoid taxing the captial gain in a bracket higher than it would otherwise be taxed. A variety of ways of making this time allowance have been applied or suggested.

2 FACTORS AFFECTING THE POLICY OF TAXING CAPITAL GAINS

In this section the various factors previously mentioned as important in determining the policy of taxing capital gains are discussed with reference to differences of the four kinds just mentioned.[46]

a) *Ability to pay and the taxation of capital gains*

From the viewpoint of tax justice there appears to be little reason for discriminating between capital gains and other income. Capital gains increase the ability to pay taxes, a fact that is frequently recognized by opponents of capital gains taxation.[47] To a public that considers such gains income, which is clearly the situation in the United States, failure to tax them would be a serious departure from the ability standard. To tax them under a separate scheme of taxation, as was practically the case for persons having large incomes from 1921 to 1933, is likewise a departure, since the ability of an individual cannot be broken into pieces if progressive income tax rates are to be applied equitably.

The logical conclusion from the definition of income previously accepted is that ability to pay is not delayed until realization, but arises when the property value increase occurs. However,

[46] The writers are greatly indebted to Carl Shoup for the opportunity to use an unpublished manuscript in the preparation of this report. Many of the ideas are attributable to Professor Shoup or were worked out in conjunction with him. The writers, of course, assume full responsibility for the material as it appears here.

[47] For example, see H. B. Spaulding, *The Income Tax in Great Britain and the United States* (London, 1927), p. 140.

considerations other than the basic income concept are involved. One concerns the existence of a source of tax payment. Under the accrual or realizability standard the funds for tax payment have not passed through the hands of the taxpayer at the time income is recognized and have thus not been made available for tax payment.[48] Although such taxation is of course common with taxes other than the income tax, this fact is often used as a basis for criticising them. From the viewpoint of ability to pay, the seriousness of taxing without a source of payment varies with circumstances. Persons with realized incomes of such size that the portion not spent for consumption goods equals or exceeds the tax imposed would not be obliged to sell any assets to pay the tax. However, where the actually realized income is insufficient to finance consumption and also pay the tax, the sale of assets may be necessary. No injustice need result from this necessity in case the property owned is divisible into relatively small pieces and its sale would not mean loss of control. Where the property is not readily divisible or where the sale of part might result in loss of control over the whole—as might occur in selling corporate securities—the tax may give rise to serious injustices.

An argument made against taxing accrued gains before realization is that they represent merely paper profits and are likely to be wiped out by declines in value. This situation, however, is likely to happen also in the case of realized income. For example, suppose a person owns one share of stock in XYZ Corporation, which he purchased at $75 and which is now selling at $100. Suppose, further, that he takes $75 of savings plus $25 of current income from other sources and buys another share at $100. Since the shares are identical, the $25 gained on the first share is in just as precarious a position as the $25 current income invested in the second share. One gain is just as safe as the other.

Declines in values result in injustices due to incompleteness of loss deductions. If an asset increases in value in one year and de-

[48] It is also true, of course, that under the Supreme Court's definitions of income, some forms of realized income do not carry with them funds for tax payment. Thus, taxable stock dividends and certain exchanges, although producing taxable income, do not give liquid funds for payment; further realization may be necessary to furnish funds for tax payment. This consideration has not deterred either Congress from making such income taxable or the Court from upholding the tax.

clines the next year, there may be insufficient other income in the latter year against which to offset the loss. While the application of an averaging system or of a carryover of losses to future years would remedy the injustice in many cases, it would not do so in all. Furthermore, the tax decrease due to deducting the loss would ordinarily be less than the tax increase resulting from an equal amount of gain, since the gain would be taxed at higher rates than those avoided by the loss deduction.

Somewhat the same difficulties with loss deduction arise when gains are taxed and losses allowed at the time of realization. The provision of the present law, allowing deduction of capital losses only from capital gains (plus $2000 of ordinary income) in the same year, gives rise to serious injustice, since in numerous cases the government in effect taxes the gain but does not allow deduction of the loss. However, recognition of capital gains and losses at the time of realization allows the taxpayer to choose the period during which the income or loss will be recognized for tax purposes, a discretion that he lacks, at least to the same extent, in the case of other income. If the income tax rates remained unchanged from year to year and if the law provided that all property value increases would eventually be taxed,[49] then capital losses should from the viewpoint of justice be deducted from ordinary income as well as from capital gains. The taxpayer could not in general reduce his taxes as much by choosing a particular year in which to take his losses as he probably would if the losses were deducted year by year as they accrued, since the more evenly spread the losses, the higher the tax brackets in which the offset income would fall and the larger the amount of the tax saved. Unfortunately for this argument, property value increases may, at the option of the property owner, never be subject to income tax, while at the same time he has the option of realizing his losses whenever he wishes. Furthermore, income tax rates probably tend to be higher in years of low capital values and lower in years of high capital values, thus allowing in effect an avoidance of part of the tax by paying a

[49] The possibility of entirely avoiding tax on the gain through transfer at death or by gift means that many gains are never taxed. The use of the taxable basis of the original owner, in case of the later sale of a gift of property by the donee, does not ordinarily yield a tax equivalent to the tax avoided.

lower rate on capital gains than is avoided through capital losses. For these reasons justice under the realization system of taxation may require some limitation on the offsetting of capital losses against ordinary income, although the application of specific rules to produce a maximum of justice would appear to be very difficult. More simple would be the extension of realization to include capital gains accrued on assets at the time of gift or of death. This extension, to be sure, rests upon a far-fetched interpretation of realization. It may not be unreasonable to assume that the donor of property realizes the capital gain accrued on it at the time he makes the gift, but applying the same doctrine to property transferred at death would involve a strange notion of gain. However, there is good reason for contending that the injustices that might result from applying such a plan would be more than offset by the increase in justice that it would give to the realization method in general.

As previously indicated, one reason why taxing realized gains and allowing deduction of realized losses in the year of realization does not correspond to the ability standard of tax justice is that an income that may have been earned over many years is concentrated in one year and is thus taxed in higher brackets than it would otherwise have been. Capital gains are not unique in this respect. The concentration in a year or two of royalties on a book that took many years to write, the concentration of the lifetime earnings of an artist or actor in a few years, and the possible concentration of business earnings in relatively few years are in the same category. The problem is the general one of irregular incomes. In all such cases there is a failure to recognize that one year is not a satisfactory income period. The situation is perhaps most acute in the case of capital gains because it probably affects more people. It will be observed that this problem does not arise if gains are taxed when they occur without waiting for realization.

Various methods of adjusting realized gains for the time element have been tried or proposed. Most nearly accurate would be apportioning the income or loss over the period during which the asset was held, calculating the amount of increase or decrease in tax that the receipt of such income or loss would have produced in each year, and collecting the sum (algebraic) of these amounts. The method does not give equitable results in the case of an asset whose value changed in one or a very few years, and does not change further during the rest of the period. This difficulty might be met by apportioning the realized gain among the years according to the actual change in value during them. The enormous administrative difficulties of such a process will be clear from later discussion.

The application of a moving average of perhaps five years to capital gains and losses, taxing the average amount as part of ordinary income, would perhaps, next to the apportionment just described, reduce most effectively the injustice of taxing realized gain in a single year. Better still, perhaps, would be an averaging of all income, although the resistance of taxpayers to paying a tax in a year of loss has made averaging systems unpopular.

The present step-scale system for adjusting for the period assets are held is less satisfactory than the methods just described from the viewpoint of justice. The amount of reduction granted in the present step-scale system is excessive in most circumstances, and results in unequal treatment of persons with and persons without capital gains. Moreover, the benefits are unequal, being greater to a person with a large volume of capital gains than to one with a small volume, and greater to a person with income in the range of steeply rising surtax brackets than either to persons with low incomes not subject to surtax or to persons with very high incomes at or near the top of the surtax schedule. This inequality could be eliminated by a very complex step-scale system which would take into consideration the amount of ordinary income and the total amount of property gains, as well as the number of years the property was held.

Another possible method involves the following steps: (1) divide capital gains and losses by the number of years the asset was held; (2) determine the difference in tax (either increase or decrease) that the amount of the resulting quotient would make in the tax on the income of the current year; (3) multiply such difference by the number of years held. If the taxpayer's other income and the tax rates were the same for each of the years during which the asset was held, the tax computed by this method would be equal to the tax resulting when the capital gain or loss was divided among the years held and added to the actual incomes of those years. However, uniformity in rates and incomes is not likely to exist; and of the incomes for the different years only that of the year of realization has any effect on the tax on capital gains under this method. The tax on capital gains will be reduced if the income of the current year is lower than average, and will be raised if it is higher, since the surtax rates applied will vary.

Capital gains or losses that are due to, or accompanied by, corresponding increases or decreases in the general price level do not represent economic power or ability to pay. Bringing capital gains taxation into harmony with an ability to pay principle would require that, in computing such property gains, the values of property involved in the computation should be corrected for changes in the price level.[50]

The problem of price change requires research into its many complications, including the choice of a satisfactory official index of prices. The writers have not gone into the question and accordingly have no recommendation as to method.[51]

b) *Effects on the retention of corporate earnings*

Perhaps no demonstration is needed of the proposition that if taxes can be reduced by retaining corporate earnings rather than paying them out as dividends there will be a tendency to withhold them. That substantial savings are possible, especially to persons whose incomes extend into the higher rate brackets, has been frequently pointed out. The tax saving possible at present is mainly from three sources: (1) permanent avoidance of realization through transfer of capital assets by gift or at death; (2) lower rates on capital gains than on other income; (3) earnings on assets financed by the postponed tax. The third is more precisely a gain from tax postponement than a tax saving.[52]

More debatable is the question of the actual effectiveness of the tendency to withhold corporate earnings. The advantage to the stockholder of not receiving dividends is most likely to result in withholding earnings in closely held corporations where con-

[50] Of course, the problem of price level changes arises in other cases than capital gains. For example, a creditor who receives payment of a debt incurred at a substantially higher price level has increased economic power even though no monetary income is received.

[51] See Copeland and Martin, Part Two.

[52] For greater elaboration of the tax saving through dividend retention, see Carl Shoup, Roy Blough and Mabel Newcomer, *Facing the Tax Problem*, (Twentieth Century Fund, 1937) pp. 160, 170.

trol is direct. In widely held corporations where directors do not represent a single person, or small group, stockholders who would benefit by the withholding of earnings may not be able to impose the desired policy on the corporation. However, the substitution of pressure to withhold earnings for the normal stockholder pressure to distribute them is likely to result in more earnings being withheld than would otherwise occur.[53]

Corporation earnings can be realized by stockholders in two ways: through cash dividends and through sale of stock to others at prices that are higher on account of the accumulated earnings.[54] If everyone desired to realize his earnings currently the method of realization through sale would not be available, since it rests on the existence of a body of persons who have the desire and ability to invest and accumulate rather than to spend. Since such persons would in any case save and reinvest their dividends, the current payment of such dividends—aside from the factor of tax saving—is immaterial, assuming the specific corporation is a satisfactory place for reinvestment.

As previously indicated, high taxes on dividends add to the desirability to persons with incomes in the higher tax brackets, of non-dividend-paying stocks (in strong corporations). The exemption of capital gains or their taxation at lower rates than are applied to dividends makes realization through sale relatively attractive to the stockholder who wishes to spend his share of corporation earnings for consumption goods or to reinvest them in some other concern or industry. Accordingly such exemption or favored taxation would have a distinct tendency to encourage dividend withholding. Other devices could undoubtedly be invented to save by the capital gains route. For example, a corporation might accumulate earnings for some time and then announce that they would be distributed on a certain date. Stockholders in the higher income brackets could then sell, perhaps at a small sacrifice, to persons with smaller incomes who would then receive, subject to little tax liability, the accumulated dividends. Another method would be for a corporation to finance itself by selling bonds bearing no interest or a nominal rate of interest.

[53] *Ibid.*, p. 174.

[54] We are here concerned with *economic* realization. *Legal* realization as interpreted by the courts includes some non-cash dividends such as dividends in bonds or in the stock of a corporation other than that of issue.

Such bonds would sell at a heavy discount. When redeemed at maturity the bonds would give their holders a capital gain representing the interest for the period, but subject to the lower taxes. Redeemable or convertible preferred stock could be sold on similar terms.[55]

Taxation of capital gains when they occur rather than at realization would remove the tendency to withhold earnings, since the increase in stock values due to the accumulation of reinvested earnings would then be taxed as it took place. Indeed, taxation by this method would probably encourage the payment of dividends, at least in a quantity sufficient to pay the tax on the gains.

Removing the incentive to withhold earnings is difficult when only realized gains are taxed. The loopholes of transfer by gift or at death make possible a permanent avoidance. The recognition of realization in such transfers would substantially reduce the incentive to withhold earnings although it would not remove it entirely. Postponement of taxes is psychologically attractive, as the hope is continuous, that future tax rates may be lower than present rates. The opportunity of realizing gains at a time when they will result in the least tax is a factor, as is the opportunity of earning on the postponed tax.

In summary, the present (1937 law) system[56] of taxing capital gains offers substantial inducements to retain earnings. These inducements would be enhanced by exempting capital gains, taxing them at a low flat rate, or reducing the percentages taxed under the step-scale system. They would be reduced by recognizing realization at the time property is transferred by gift or at death, and by increasing the percentage taxed under the step-scale system. They would be eliminated by taxing capital gains at the time the value increases took place instead of at the time of realization.

c) *Effects on security markets*

The actions of buyers and sellers of securities in response to the taxation of capital gains may be rational or irrational. The irra-

[55] For British experience in transforming taxable income into exempt capital gains, see R. M. Haig, *Wall Street Journal*, March 29, 1937. His series of articles in this periodical for March 23, 25, 29, April 2, 8, and 13 comprise a valuable treatment of capital gains in foreign tax systems.

[56] The undistributed profits tax is disregarded here. One of its purposes was to discourage tax avoidance through withholding earnings. To the extent that this tax remains in the tax system it is an inducement to immediate divident payment.

tional actions may be quickly noted. People dislike to pay taxes and often prefer where possible to postpose them to the future regardless of long run interests. Likewise they dislike to see the apparent capital values of the securities they own reduced by sale and tax payment, even when a loss greater than the tax will occur if they do not sell.

There are, however, rational effects also. The capital value of assets remaining to the individual is decreased when he sells a security at a gain and pays the tax. Securities are held both for changes in value and for their annual yield. If assets were held purely for their change in value and yielded no current income the rational action would be to sell when the peak in price is reached. Unfortunately, whether the price of a security has reached its peak is often, perhaps always, uncertain, and when uncertainty exists the tax tends to deter the holder from selling, since after paying the tax his assets for speculation are reduced. Perhaps more important is the fact that securities are held both for changes in value and for their annual yield. When a security is yielding an annual income the effect of the sale of the security on this income must be considered. Reduction in the value of assets due to the tax decreases annual earnings. Such decrease in annual earnings resulting from realization must be offset against the probable loss in the value of an asset if it is retained. The rational action would be to sell when the probable loss in value from failure to sell is greater than the probable loss in income due to the reduction of assets by the tax. The tendency to retain the asset is greater the higher the proportion of capital gains to selling price and the higher the rate bracket in which the person's income falls.

Aside from these basic effects probably associated with any method of taxing realized gains are others growing out of specific methods. When, as under the present law, capital gains are integrated with other income in determining the tax rates to be applied, the taxpayer tends to realize his capital gains in years when his other income is small. When, similarly, capital losses are deductible from other income he tends to realize his losses in years when such other income is large. When capital losses are deductible only from capital gains he tends to realize losses when possible in years in which he has also gains. The step-scale plan of the present law encourages taxpayers to hold securities on which they have gains for a longer period (up to 10 years) in order to reduce the portion of the income taxable. There is a similar encouragement to sell in an early year securities on which losses would be realized in order to secure the maximum deduction of such losses. Frequent changes in income tax rates also encourage the holding of securities on which capital gains would be realized, since there is hope that the rates may be lowered. The lower the rates applied to capital gains the less the effects.

The taxation of increases in security values when they occur rather than when realized would remove the incentives to hold assets, since the act of sale would have no effect on the amount of the tax. A mild incentive to sell securities that had gained in value would be present since some persons would sell in order to realize funds with which to pay the tax.

Exempting capital gains would remove the effects discussed above, which would, however, be replaced by others. There would undoubtedly be a considerable increase in the amount of selling as a means of realizing income in conjunction with the withholding of corporate earnings discussed in a preceding section.

This is not the place to attempt an evaluation of the social importance of the effects of taxing realized gains. It may be desirable, however, to mention briefly some of the more significant results that are alleged. One is that boom markets are prolonged and intensified because persons with paper profits will not realize them by selling. Another is that falling markets are likewise intensified by the desire to realize losses for tax purposes. Still another is that the securities market is made very thin by the refusal of wealthy individuals to take the risks of loss when so large a tax on gains is imposed and so inadequate a deduction on losses is allowed. Perhaps most important is the contention that the tax on realized capital gains deters the passage of securities from the hand of risk-taking speculators to conservative investors as the securities become sounder and more mature. That is, persons who would otherwise sell seasoned securities that had been purchased when the securities were of a more speculative character cannot, because of the tax, afford to sell them to more conservative investors and reinvest the proceeds in newly issued securities, thus placing new capital in industries. Another, contrary allegation, is that stock speculation is of doubtful value to the economic community and that a force, such as the capital gains tax, that may decrease the volume of such speculation may help transform American speculators into investors, with desirable social results.

In summary, the taxation of realized gains tends under some circumstances to discourage the sale of securities that have increased in value. Taxation when the increases in value occur instead of at the time of realization would remove the incentive not to sell and replace it with a mild incentive to realize enough profits to pay the tax. Exemption of capital gains from taxation would remove the incentive not to sell and replace it with an incentive to devise ways and means to use sale as a method of realizing current income in the form of capital gains. Partial exemption would have partial effects of both kinds and the net result is perhaps unpredictable. Important alleged social results from the effects of capital gains taxation on security markets are not evaluated here.

d) *Effects on the saving process*

An important question of policy in the taxing of capital gains is the effect of such taxation on saving. The argument is sometimes made that although capital gains are income to the individual they are not to society, so that a tax on such gains must be a tax on capital, which, it is alleged, reduces the volume of saving. Doubtless, as previously explained, to the extent that capital gains represent mere transfers of legal titles they do not represent additions to social income (defined as a social net product), and a tax on such gains is in the social sense a tax on capital. However, the proposition that taxes on capital necessarily reduce the volume of saving cannot be accepted. In general all taxes, whether imposed on individual income or capital are paid out of social income; a so-called capital tax simply utilizes capital as a measure of the tax. Broadly speaking, the effect upon saving of a tax, whether it is imposed on income or on capital, will depend upon the size of the total income from all sources of the individual on whom the tax is imposed. This conclusion rests on the apparently demonstrated fact that the ratio of saving to total income received tends to increase as total income increases. Accordingly, taxes on people in low income groups can have little effect upon the volume of saving since such persons save little, whether taxed or not. Taxes on people in high income groups, however, tend to reduce the amount of funds available to the taxpayer and therefore total social saving. Where the income is very large, a large percentage of the tax paid (if not the entire amount) will probably come from funds that would otherwise be saved. It is not probable that a taxpayer whose income falls in the higher surtax brackets would diminish his consumption materially to avoid a reduction in his rate of wealth accumulation.

If the individual subject to tax is obliged to sell his capital to get funds for paying the tax, the asset is purchased with funds representing current or saved income.[57] The asset is not destroyed and the real source of the tax payment is social income.

The effect on personal savings of a tax on capital gains is determined by the same factors that determine the effect of an income tax or any other kind of tax. If the capital gains are received by persons with incomes in the higher rate brackets the tax will have a more repressive effect on savings than if the gains are received by persons in the lower brackets. This problem is, however, much broader than the problem of taxing capital gains for it is involved in all progressive taxation. The net effect on saving resulting from tax exemption or a reduction in tax rates depends on the source from which the lost revenue would be replaced. If the revenue losses were replaced by the imposition of increased rates affecting persons with incomes as large as those of the individuals who received the capital gains, there would presumably be little or no effect on saving. If revenues are restored by additional taxation in even higher brackets, presumably saving would be discouraged; if by additional taxation in lower brackets, or by regressive taxes, presumably saving would be encouraged. Available figures present a strong presumption that the rich are the major recipients of capital gains. Accordingly it is probable that complete exemption or a low tax on

[57] Over a period it is immaterial whether the income was received within the current fiscal period or not. No attempt has been made in this analysis to grapple with the problem of whether saving necessarily results in investment and whether various levels of taxation affect the completeness with which this result occurs. This problem is much broader than the question of capital gains taxation. The writers feel that a discussion of arguments such as that made by J. M. Keynes would carry the analysis too far from the central topics.

capital gains would tend to result in a net increase in saving. But, to repeat, this is a problem not so much of capital gains as of the rate of progressive income taxation.

Another way in which exemption or lower taxation of capital gains would probably promote saving is through the incentive, previously discussed, to withhold and reinvest corporation earnings. One result of retaining corporate earnings is that such gains are usually invested in full. If dividends were paid, some would surely be spent, since not all the stockholders would reinvest all dividends in the same or other businesses. Accordingly factors that encourage the retention of earnings in the hands of the corporation tend to increase saving, while factors that discourage retention tend to bring the saving of incomes earned through corporations more nearly in line with the saving of incomes earned through partnerships and proprietorships.[58]

Some observers take the position that regardless of the effects of capital gains taxation upon the volume of saving, it must be admitted that the process of investment is partly disrupted. The argument is based on the idea that different security purchasers desire different types of securities. Some investors buy nothing but thoroughly seasoned securities. Others, more willing to take risks, buy the securities of new and speculative enterprises. Between these two extremes are all varieties of investors. The process of investment involves placing new capital in industries by speculative purchasers of new securities. As the securities become seasoned and their return more certain, they are shifted to the more conservative investors, thus releasing the funds of the speculative purchasers for further new investments. The capital gains tax, as previously pointed out, is believed to impede the passing along of such securities and the reinvestment of the proceeds in new securities by speculative investors, by making it unprofitable for investors to sell securities on which they have made a gain. To the extent that this argument is sound the reduction of capital gains taxation, or the substitution of taxation of the unrealized gains for taxation of realized gains, would reduce the obstacles to a free movement of saving into investment channels.

[58] This statement is subject to the exception that in lower income brackets corporation taxes equal or exceed individual taxes so that the effects on saving may differ somewhat.

To summarize, capital gains taxation apparently does not, so far as individuals are concerned, affect saving any more than would other taxes applying to the same levels of income. The incentive given by capital gains taxation to withhold corporate earnings from dividends probably increases saving. Taxation of realized gains may interfere with the process by which saving is allocated to various industries by investment.

e) *Effects on accounting and business practice*

The generally accepted accounting and business practice at present is to recognize property value appreciations only when they are realized through sale or exchange. Decreases in property values through depreciation are recognized, and inventories are frequently valued at the lower of cost or market. Decreases in the value of capital assets may or may not be recognized on the books when they result merely from changes in market values of such assets.

The opposition to revaluing capital assets when they appreciate in value, or of recognizing such appreciation as income, appears to be based on several considerations. Accrual revaluation produces an income that is not connected with operations of the business, thus giving an incorrect impression of the success of the business. A going concern does not dispose of its assets but keeps them for use. Accordingly, value changes in assets do not produce income that can be paid out in dividends. Also, the calculation of depreciation is greatly complicated by changing the values of capital assets.

Business men are tempted to revalue their assets upward in order to give investors the best possible impression of the business. However, such an impression is misleading since the average investor is interested not so much in the fluctuating value of assets as in the continuity of annual earnings. Income or loss reflecting changes in the values of capital assets does not give the investor a correct impression.

The danger arises that if the government, through its tax laws, made the revaluation of unsold assets part of the common practise, even through a voluntary or optional plan, such action would have a strong enough influence on business practice to make such revaluation common, with possible harmful results to investors.

f) *Effects on Revenues*

The writers have not studied whether the full taxation of capital gains and full deduction of property losses would yield a net income or not, nor have they tried to ascertain the relative productivity of low or high rates.[59] The following appear to be the arguments pro and con on this question. In favor is the record of increasing values of wealth in this country and the fact that substantial amounts of corporation income are reinvested directly without distribution to stockholders, thus increasing the value of the stock and yielding a property gain at its sale. Opposed are the tendencies: (1) to report losses and hide gains, (2) for much of the gain in one asset to be accompanied by losses in others, (3) for both gains and losses to be caused in large degree by changes in price levels, which, theoretically, should be eliminated in computing taxable property gains and losses.

Although the revenue effect of eliminating the taxation of capital gains and losses may be uncertain, some fairly obvious observations on the probable revenue effects of certain methods of taxation may be stated. The allowance of full deduction of capital losses against ordinary income would cause a very serious reduction in the revenue derived from the income tax as compared to the present provisions. The present system of allowing capital losses to be deducted only to the extent of capital gains plus $2,000 virtually ensures a net revenue from capital gains. The tendency to realize during life on assets showing loss and not to realize on assets showing gain is, however, present under the existing law, partly because of the deduction of property losses against $2,000 or ordinary income and partly because a taxpayer in need of cash will likely sell assets showing loss or no gain since his tax liability is thereby not increased. For this reason, the extension of the concept of realization to include transfer at death and by gift would undoubtedly increase the revenue, as would also the substitution of the accrual method of taxation.

Stability of revenue would undoubtedly be increased by abolishing the tax on capital gains.[60] The greatest instability would result from taxing realized capital gains in full and allowing

[59] See in this connection Haig, 'Capital Gains and How They Should Be Taxed', *op. cit.*, p. 137, and Spaulding, *op. cit.*, p. 143.
[60] See Shoup, etc., *op. cit.*, p. 83.

full deduction of capital losses against all income. Experience indicates that in many years very large net losses from sale of capital assets would substantially reduce the total revenue from the income tax. The present system of allowing the deduction of capital losses only against capital gains (plus $2,000) tends to reduce the instability. Methods of averaging gains and losses over a period of years should reduce instability still more, as would to somewhat less degree the carrying forward of excess losses to future years. The plan of taxing accrued gains would no doubt give less instability than full taxation of realized gains and deduction of losses, but whether more than other plans is uncertain. Instability would undoubtedly be reduced if price level adjustments were made in computing property gains and losses.

g) *Administrative feasibility*

The present system of taxing capital gains has proved to be administratively feasible, although numerous detailed provisions in the law and its administration have been necessary to make the system workable. The exemption of capital gains from taxation would eliminate many of the difficult administrative problems of income taxation. Problems of March 1, 1913 valuation, of the determination of taxable basis, of wash sales, and of other exchanges to establish deductible losses would be reduced or disappear. However, the distinction between capital gains and other income would become more important; and the administration of borderline cases correspondingly more difficult. British experience with borderline cases demonstrates the force of this objection.

Inventorying of unrealized property value changes would eliminate many of the present administrative difficulties but other more serious problems would be raised. The wealth of every person subject to tax would have to be appraised every year—a tremendous task. Not only would the kinds of property now subject to assessment for purposes of the general property tax be involved but also patents, trademarks, goodwill, and other intangible property would have to be valued annually. The high rates of the income tax would make accuracy important, and accuracy would be entirely impossible with many types of property. However, in some respects the unavoidable errors would be less important than the similar errors now existing in assessments for property taxation, since, while errors in property assessment are cumulative, errors in valuation for income tax purposes in any one year would tend to be compensated or corrected in future years. This would be especially true if incomes of several years were averaged.

Greater difficulties would be met in the case of some intangible assets than of others. Listed securities, especially those with an active market, would perhaps not be difficult to value. Unlisted securities, however, especially those of closed corporations, would be virtually impossible to value on a market quotation basis. Patents, trademarks, goodwill, and similar assets would likewise be hard to value. The numerous problems of equitable assessment that have been encountered in the taxation of the more easily discovered real estate and personal property force us to view with caution any extension of property valuation taxation into new and more difficult fields.

The taxation of accrued gains in market values could be avoided by taxing security owners on their allocated shares of the undistributed earnings of the corporation. This method also gives rise to administrative difficulties. Where non-cumulative preferred stock is outstanding it may be impossible to allocate ownership of the equity in corporation earnings. Once allocated, the equities would often have to be traced through intricate holding company arrangements to the final individual shareholders. The obstacles to efficient and equitable administration that would necessarily be encountered are perhaps obvious.

In taxing realized gains the administration is least complicated when the gains and losses are fully incorporated with other income, or are taxed at flat rates. Less simple is the present step-scale system, although the increase in the complexity of computation is perhaps not serious. Other methods of adjusting capital gains, or the taxes assessed against such gains, for the period during which they are held involve much greater administrative problems.

If realization at the time a gift is made were recognized, the taxable basis for every gift of property would have to be determined at the time the gift is made, whereas under the present method the basis need be determined only for the property subsequently sold by the donee. Furthermore, while the evaluation of gifts at the time they are made under the present gift tax reaches only the more wealthy taxpayers, the recognition of realization at the time that the gift is made would necessitate valuing every gift.

Recognition of realization at death would require valuing the property at the time of death and also determining the cost or other basis of the property. An appraisal of property at the time of death must be made for most property under existing death tax laws. The determination of the taxable basis would be an added difficulty of some magnitude. Since the person best able to furnish needed information is the decedent, the problem of determining the proper basis might be difficult.

In summary it appears that: (1) the fewest administrative difficulties are present when there is no tax at all on capital gains, although even then there is a serious problem of distinguishing a capital gain from other income; (2) full taxation at realization is the next simplest method administratively; (3) of the plans requiring adjustments for the period the asset is held, the present step-scale plan is perhaps the most simple; (4) recognition of realization at death and by gift will necessarily involve many administrative difficulties; (5) taxation of unrealized gains is administratively impracticable for most kinds of property.

h) *The constitutionality issue*

In considering the abstract desirability of a tax policy no attention need be paid to its constitutionality. But in practical application unconstitutionality is a very important obstacle, since only the most powerful public demand is likely to result in a constitutional amendment.

The repeal of the tax on 'capital gains' would undoubtedly be constitutional. The 16th amendment makes no requirement of uniformity in taxing income. The Supreme Court has allowed wide latitude to Congress in determining deductions and exemptions. Likewise perhaps any of the plans whereby the tax is adjusted with respect to the time an asset is held would be considered constitutional.

No plan of taxing unrealized property value gains is likely to prove constitutional. The Supreme Court has consistently stressed the necessity of realization. In the absence of a major change of heart by the Court any hope that compulsory accrual plans would be constitutional seems doomed to disappointment. The same is probably true of any method of taxation that would include within a stockholder's taxable income an allocation of the distributive share of undistributed corporation profits.

There appear to be few cases that can be used as a basis for forecasting the constitutionality of the taxation of gains to the decedent or his estate at the time of death or to the donor at the time of making a gift. The commonsense notion of realization is against it. Realization is what one receives, not what one transfers. With gifts, a defense might be made for the argument that the donor receives the value of the gift in some way or other, otherwise he would not make it. A similar argument seems difficult with respect to transfer of property at death. It is perhaps too much to expect that extending the concept of realization in these ways would be upheld. However, it seems to the writers that the plan is definitely worth trying. There is much to gain if it succeeds and perhaps nothing to lose if it fails.

3 CONCLUSIONS

From the preceding analysis it becomes clear why the taxation of 'capital gains' is a matter of so much controversy. There is no method either of taxing them or of exempting them that is superior in all respects to all other methods. As the emphasis varies from justice to effects on security markets, to non-payment of dividends, to revenue, and so on, the preference for different taxing methods varies. Accordingly, the final choice of policy is clearly a matter of subjective evaluation in which wide differences of opinion even among disinterested students of the subject must be expected. Furthermore, although among the possible alternatives for taxing property gains some may seem more attractive than others, additional study of practical administration is essential before a satisfactory method of taxation can be formulated.

Discussion

I M. A. COPELAND

Messrs. Blough and Hewett state that "the definition of income in terms of the production of economic goods has been generally accepted by the students of social or national income". As they use this definition it stands in contrast with an accounting type definition in terms of "earnings, gains, or profits from any source". There is, I think, some confusion involved in the antithesis so set up. The words quoted in connection with the former of these concepts ('the production of economic goods') characterize the so-called ultimate products method of measuring income. The words quoted to characterize the latter concept of income ('earnings, gains, or profits') might be applied to what has been called the debit net value product method of measuring income. If these two methods are employed consistently they should yield a single result—the total obtained by the debit method should equal the total obtained by the credit ultimate products method. Moreover, the latter is quite as much an accounting concept as the former. Both methods involve consolidation either of the accounts of ultimate income recipients or else of the enterprises employing their labor and property.

The writers seem to offer these two concepts (methods of measurement) of income with the thought that they will yield divergent results. They suggest [in II, 2(g)] that if we are to obtain a correct total of national income from individual accounts it would be necessary for such accounts to show separately "all items of individual gain that do not have their origin in a net increase in economic goods". They further urge that since "in actual practice . . . no such accounting procedure is, or can be, followed . . . the use of individual income accounts in estimating social income must introduce serious errors". I urge that this statement involves a misconception of the process of estimating national income through the consolidation of the accounts of the various enterprises that compose the economic system or through a consolidation of the accounts of ultimate income recipients. There is no need to identify the contribution to social income made by any laborer or piece of property in order to determine whether to include the item of labor or property income in total national income. Net value products of monopolies and predatory institutions, of factories and churches are all included. The total of primary distributive shares—payroll, interest, profits, etc.—derived from all types of enterprise should equal the total value of goods and services produced after allowance for replacement. If this equality has not yet been fully established empirically there is no reason to assume a discrepancy between the two methods of the sort Messrs. Blough and Hewett seem to assume. The authors are partly right, however, when of "gifts, inheritances, fraudulent or predatory activity, and deliberately created scarcities (e.g., monopoly)" they say: "If such items are considered items of individual income, then it would apparently be impossible to consider social income as equal to the total of all individual incomes, and a statistician making an estimate of the net social product would be unable to utilize individual income totals as acceptable data." Monopoly and racketeering profits should be counted when income is measured in current dollars. But the inclusion of such secondary distribution items (transfer items) as gifts and inheritances would, of course, involve double counting. Admittedly, to draw a sharp line between primary and secondary distribution items involves some problems. There are cases such as WPA wages where it is difficult to determine how far they are primary distributive shares and how far mere transfer payments. But these cases make equal difficulties for the valuation of ultimate products and for the determination of primary distributive shares. I urge, therefore, that the two definitions of income be thought of as yielding identical totals if consistently applied and that distributive share items, such as monopoly profits, and transfer items, such as bequests and gifts, be sharply distinguished.

If this conclusion is accepted, it eliminates the basis for the argument of the authors that some capital gains are unproductive and, therefore, not part of national income—"only those gains that reflect production are a part of income". The authors have, in any event, fully recognized that there are various capital gains which must be included in national income even if we try to apply a productivity criterion, i.e., to ask whether the distributive shares involve a contribution to the social output.

If it is agreed that (1) some capital gains derive from increases in the known stock of physical wealth and some capital losses derive from decreases therein, (2) the absence of a contribution to the social output is not a basis for excluding, from national income, the individual income from a transaction, we may still consistently hold that practically, because of difficulties in the valuation of capital gains and losses and in assigning them to any particular year, it is wise to set up a concept of national income that excludes all such gains and losses. But clearly for some purposes capital gains must be included in national income. Taxation problems may call for such inclusion; so may other questions involving the distribution of wealth and income.

The authors note that the connection between their examination of capital gains in income theory and their examination of capital gains in the theory of taxation policy is tenuous (I). I think this unfortunate situation results in part from their conception of income just discussed. But even that conception might have suggested one line of investigation that involves a definite connection. The view that some capital gains are unproductive strongly suggests to me a relationship between the concepts of capital gains and losses on the one hand and a pair of concepts that historically have played an important role in taxation theory, namely, unearned increments and decrements. While clearly a capital gain as usually conceived is not by any means the same as an unearned increment even if we exclude 'those gains that reflect production', nonetheless I submit that there is a close relationship between the two concepts and one that might be worth investigating.

Measurements of national income require us to draw a sharp line between the accounts of ultimate income recipients on the one hand and the accounts of business and other enterprises on the other. The accounts of business corporations fall entirely in the second category (accounts of business and other enterprises). A part of the accounts reported on personal income tax returns fall in the former category (accounts of ultimate income recipients).

There is, I think, some reason to believe that our scheme of taxation would be improved by a sharper differentiation between business accounts and indirect taxes on the one hand and ultimate income recipients' accounts and direct taxes on the other. Most of the discussion of capital gains and taxation policy by Messrs. Blough and Hewett appears to me to contemplate chiefly the taxation of capital gains received by individuals. Thus it is stated in Section III, 2(d) that "all taxes, whether imposed on individual income or capital, are paid out of social income"; as applied to taxes falling immediately on business this seems to me to oversimplify the incidence of taxation. Again, it is argued that taxation of capital gains needs to be integrated with the taxation of other forms of individual income if a satisfactory progressive system of taxation is to be had. It seems to me that in discussing such matters as the advisability of separating taxation of capital gains from taxation of other forms of income a more definite separation of the problem as applied to corporations and as applied to individuals is called for. Differences of administrative problems in the two cases would certainly seem to me to warrant such a separate treatment.[1]

Particularly in the case of the taxation of corporate income it seems to me that it would be worth while to consider the implications of the present definition of capital gains and losses as applied to mineral properties where depletion is reckoned on a discovery-value basis or on a percentage-of-gross basis.[2]

II HAROLD GROVES

The authors conceive of wealth and capital as a stock, and of income as a flow of utilities resulting from production alone. It seems to the discussant that this conception of wealth and income

[1] Mr. Martin calls my attention to the fact that in the taxation of personal incomes the problem of separation of capital gains under the present law is complicated by the fact that partnership income, unlike corporation income, is not subject to separate taxation and consequently that some capital gains on personal income tax returns are included under partnership income.

[2] This question was touched on in Carl Shoup's able paper, *Volume One*, Part Six, pp. 272 ff, but not elaborated because he was not directly concerned with capital gains.

gives inadequate consideration and weight to scarcity as an economic factor. It would be admitted, of course, that the utilities mentioned are not utilities in the abstract, but in relation to scarcities. It could be said, probably, that an individual who reaps a gain by simply holding a commodity until increased demand results in higher prices is producing a time utility. If so, does not the individual who becomes rich by the increase in the value of the land that he owns also render a utility? And if he renders a utility, why is the realized profit from the sale of such land not income?

It seems to the discussant that the authors' treatment of real estate values is unsatisfactory. Apparently unwilling to consider the large part of our national income that flows to the owners of scarce natural resources as mere transfer, they suggest that we cast scruples aside and assume that real estate values are capital values and the receipts therefrom are income. They also consent to the assumption that increases in real estate values are income. Why distinguish in this respect between real estate values and all other values that result from an increased demand? The authors say that some natural resources are discovered and represent a real increase in wealth. Real estate values are but the present estimate of their future income yields. The discovery or the arrival of new significance in a capital good is quite as productive as the discovery of natural resources.

It may be observed also that it is not entirely possible to avoid the economic power concept in the application of the production-of-utilities theory of income. The limitation of output by monopolies and semi-monopolies is a very important element in our economic life and no calculation of income in practice can isolate the reward that flows because of the utilities created and that which flows because of the utilities not created. From the economic point of view and for all practical purposes, a flood or a drought may mean increased income for farmers and possibly for the nation. Has it increased the total flow of utilities?

Goods have value because of both their utility and their scarcity. Values are appropriated as well as created. And when they are created, it is sometimes through the negative channel of restricting output rather than the positive one of augmenting utilities. These scarcity values are in the income and wealth picture.

They are there not because of the production of utilities, but because they give both their owners and the nation some economic power.

It is said that certain capital gains represent the present prospect of future income and that to count both the prospect and the realization is double counting. Smith goes into business and incurs an average annual operating loss of $20,000. But by the end of five years he has built up sufficient business prospects so that the business can be sold to Jones for $100,000 more than Smith originally invested. The layman would certainly conclude that Smith had come out even on his five years' business and that *at the moment of sale*, neither Smith nor Jones nor the country was any poorer as a result of the venture. Yet as I understand it, the authors would consider it double counting to offset Smith's capital gain against his operating loss.

This is the same double counting to which some economists object in treating saving as income. Yet the authors accept saving as income. Suppose Smith saves $100,000 from his salary and buys a factory with it. Jones discovers a mine worth $100,000. Is there any good reason why the first is income and the second is not? Cannot fortune add to economic power as well as labor? And does the fact that present values depend upon future prospects make it objectionable double counting to reckon the acquisition of such values as income?

The authors say that "increases in the value of a property resulting from a change in the interest rate are not evidences of the creation of income". Perhaps such changes in economic power are not creative. Neither is the increased economic power that goes to farmers when a spurt in the demand for wheat occurs as a result of a war. Can we exclude changes in demand from all consideration in calculating wealth and income?

Discovery, appropriation of scarcity values, limitation of output, the current realization of values representing future prospects, fortunate changes in demand, are all important sources of individual economic power. They are also important sources of national economic power. We ought to have definitions of income, capital, and wealth that include these sources of economic power.

Throughout the first half of their paper the authors think of income as achievement or accomplishment; in the second half they think of income as economic power. Considering the limitations of the market—limitations as to freedom and intelligence—and considering that our economy is more a power-economy than a welfare-economy, perhaps it would be more realistic even in the field of income measurement to think of income as economic power. At the very least, it seems, those measuring national income should recognize that accomplishment under our present institutions is not susceptible to accurate measurement and that both the breakdown and the totals of income contain many elements of economic power.

From the theoretical standpoint there seems to be at least as good grounds for including capital gains in national income and wealth as for excluding them. When it comes to the practical jobs of measuring and taxing national income, major weight should be given to pragmatic considerations. How can the job of measurement be done so as to furnish the most useful data for comparisons? Or in the case of taxes, how can the law be written so that it is most equitable among taxpayers, produces the steadiest and most adequate revenue, encounters fewest difficulties of administration, and so forth?

Among the pragmatic considerations that bear on the inclusion or exclusion of capital gains in income measurement are the following:

1) No adequate data are available to measure changes in capital values (realized and unrealized) from year to year.

2) Realized capital gains and losses often have a longer periodicity than one year; they may have been accruing over a decade or more.

3) Realized capital gains and losses are not regularly recurrent as is most other income. One may have a substantial capital gain or loss this year and never again during one's life. For an owner of many securities, or a group of people, there is some degree of recurrence, but the pattern is far from regular.

4) Realized capital gains and losses are not used (as a rule) to support the standard of living of the recipients.

5) Realized capital gains and losses are artificially manipulated (to some extent) to suit the taxpaying interests of the recipient.

6) Realized capital gains and losses do not figure, I believe, in many of the income calculations made for other countries.

There is little reason to discuss here the relation of each of these points to the problem of measurement, but the bearing is fairly obvious. For example, national income figures are used to compare the economic activity and well-being of the nation from year to year. Gains that have accumulated over a decade, if allowed to enter the picture, may vitiate the basis of comparison.

On the other side of the issue the following may be cited:

1) It is exceedingly difficult to draw the line between business gains and losses and capital gains and losses. Is a man who buys and sells securities for others any more properly considered in business than one who enters extensively into these operations, but only for himself?

2) Is the picture presented not a very partial one when so many of the factors that make men and nations 'wealthy' are ignored?

In the discussant's opinion, this is not a one-sided argument, but the balance on the whole seems to favor ignoring capital gains and losses in the measurement of national income.

The authors have presented thoroughly the pragmatic considerations involved in the treatment of capital gains and losses in taxation. In general, the discussant agrees with their analysis and their conclusions.

It seems that the authors might have given additional consideration to the pragmatic grounds for avoiding the indiscriminate mixture (in the tax base) of capital gains and losses with other income. (In practice this problem takes the form of whether net capital losses should be deductible from other income.) The reasons for avoiding indiscriminate mixture are in the main the ones cited above for excluding capital gains and losses in income measurement: long periodicity, irregular recurrence, artificial manipulation, small reliance as support for the standard of living. In addition, the indiscriminate mixture of these kinds of income results in a very irregular revenue. These differences appear sufficiently important to warrant special treatment.

It would be possible, of course, to set up two entirely separate taxes—one on capital gains and the other on 'ordinary' income. This has much to recommend it. However, there is a general feeling that the two taxes should be integrated to some extent. Otherwise one category of ability to pay is measured without any regard to the status of the other. Some kind of a compromise seems advisable. The present federal law allows capital losses to be offset only against capital gains (with a minor exception). If the law were modified to permit losses to be carried forward over a considerable period—say three, five, or even seven years—it would, in the discussant's opinion, represent a reasonable compromise between integration and separation.

The discussion of the proposition that taxation of capital gains and losses accentuate stock market booms might call for a supplementary observation. It seems quite plausible to argue that owners of stock are reluctant to sell stocks (especially those held for a relatively short time) because of the heavy tax on the realized capital gain that results. This influence tends artificially to limit the supply of stocks available for purchase. But may not the tax also have a somewhat commensurate effect upon the demand for stocks, especially for those stocks which are expected to yield a quick speculative profit? People will hesitate to buy in anticipation of the tax and there will be fewer people with ready money derived from other sales. Thus the effect of the capital gains tax may be fewer transactions upon the stock exchange. Whether there is a social interest in a large volume of transactions in the securities field is a matter to which the discussant has given no serious study, but on the surface it seems doubtful. Very likely the social interest lies in the opposite direction.

It is on pragmatic grounds that the proposal to disregard saving in income taxation is most open to attack. It will never seem equitable to the average citizen to place a heavier tax on a man with a large family who incurs large expenditure for the education of his children than upon the bachelor who puts his money into bonds. The important fact in income taxation to most people is not what the taxpayer does with his money, but the money he has to do with. The proposal, if adopted, would greatly change the incidence of the income tax and would largely eliminate its use for the non-fiscal purpose of preventing what is regarded as an undue concentration of wealth and power. Whether this is for or against the proposal is, of course, a matter of opinion, but the issue cannot be disregarded.

The authors have discussed thoroughly and ably the proposal to tax capital gains and losses upon an accrual basis. The hazards and difficulties are undoubtedly great. But it should be remembered that a very large part of our income tax problem arises from the attempt to apply a personal tax to an economic world in which much of the realized economic power is confined to impersonal institutions. The accrual method of taxing capital gains and losses cuts straight through this Gordian knot. Because of this outstanding point in its favor, the proposal should not be dismissed lightly in spite of the overwhelming legal and administrative difficulties that can readily be cited against it.

It will be said, of course, that procedure in the fields of measurement and taxation must be based upon sound theory regardless of pragmatic considerations. But there is no clear consensus of expert or inexpert opinion as to what is sound theory in this connection. For this reason and because the practical problems are so important, income should be given a definition (for measurement and tax purposes) that will lead to the most useful results.

III SIMON KUZNETS

The authors state that "in the taxation of citizens in accordance with the ability to pay principle, the identity of social income with the total of all individual incomes is immaterial and irrelevant" [II, 2(g)], and in the discussion of factors affecting the policy of taxing capital gains, ability to pay is treated exclusively with reference to the individual's rather than the nation's ability. In this connection I should like to raise a question as to the possible relation between social income as a partial measure of the nation's ability to pay and those taxes which, like the one on capital gains, are levied on receipts that constitute transfers rather than items in a properly defined total of social income.

This relation may best be set out in a series of brief statements: 1) Social income, or rather that part of it which is produced in the non-government sector of the economy, is one of the important factors that must be considered by governments in a rational determination of the total that is to be collected as taxes. This does not mean that the volume of taxes collected should bear a constant ratio to the privately produced social income, even though variations in this ratio over short periods would be within fairly narrow limits. But it does suggest that in a rational consideration of taxation policy, the volume of tax collections would be some clearly formulated function of the volume of social income arising in the economic system.

2) Were the governments so rational in their taxation policy as actually to consider the expected national income (as well as other factors) in determining the amount of taxes to be collected, the fact that such taxes might be imposed upon transfers, such as capital gains, or even upon non-receipt items, such as property, would be immaterial. But so far as such rational consideration of social income expected to originate in the private sector of the economy is absent, the peculiarities of tax administration become a separate factor in determining the volume of tax collections. Under such conditions, governments are likely to adhere to taxes and rates once established and thus permit the administrative system to affect, even if only partly, the amount of taxes to be collected. Consequently, the volume of tax collections might, under such conditions, be in excess or fall short of the amount that would be collected upon a rational consideration of taxation policy, based partly upon a forecast of social income.

3) In the light of the possibility stated under (2), it may make a difference whether taxes are levied on the individual incomes that comprise social income properly defined; or on receipts, like capital gains, that should be treated as transfers. In general, the relation of tax collection to social income is clearly perceptible and determinate within narrow limits when taxes are based upon receipts that comprise the social income total. But if the tax system is largely based upon taxes that refer to transfers and other items that are not part of the social income total, the total of collections bears only a distant and a highly variable relation to social income.

4) If we can assume that: (a) in the consideration of social income in a rational planning of taxation policy the ratio of tax collection to expected social income varies over short time spans only within narrow limits; (b) there is, in actual government policy, lack of rational consideration of this ratio in pre-establishing the total yield of all taxes, no matter how levied—then it is of advantage to have a tax system based almost exclusively upon receipts that comprise the social income total (or are very closley and simply related to them). For under such conditions, basing the taxes upon receipts that comprise the social income total

would limit the extent to which the administrative peculiarities of the tax system might, in the absence of rational considerations, produce a yield that is larger or smaller than that called for by a rational policy.

5) On the contrary, under conditions set forth under (4), it is dangerous to have a tax system that for a large part of its yield depends upon taxes levied on transfers, gifts, and other items that are not part of the social income total and bear a highly variable relation to the latter. For, as a consequence, the tax system might yield a volume of collections greatly in excess or greatly short of the amounts that would be determined by a direct rational consideration.

The point raised above may be too abstract to require serious thought, especially in view of the multitude of factors besides the social income total that should be allowed to determine the volume of tax collections. But the main purpose here is to urge the importance of considering taxable capacity not only of individuals but also of the nation as a whole; and of studying the effects of the administrative features of the tax system on its ability to adapt the volume of government charges to the nation's capacity to pay. Such an analysis would necessitate a careful review of the relation between individual income and social income, since the nation's ability to pay depends in part upon the *social income* total and tax administration relates almost exclusively to the *individual's* ability to pay.

IV GEORGE O. MAY

While I presided at the round table at which Messrs. Blough and Hewett presented their paper, the portion which I then had in mind to discuss has been eliminated and my present comment is, therefore, solely that of a Director of the National Bureau of Economic Research—an accountant interested in taxation, not an economist.[1]

1) I entirely agree with one important conclusion expressed by the authors—the conclusion that the taxation of unrealized capi-

[1] Mr. May's comments were received after the preparation of the reply by Messers. Blough and Hewett to the other commentators, Discussion VI. Their reply thus does not deal with Mr. May's comments (Editor).

tal gains is administratively impracticable. There seem to me to be two other relevant facts of almost equal significance. One is, that the inclusion of realized gains and losses in full in the computation of taxable income is likely to produce results that will be unsatisfactory to the revenue, especially as social legislation tends progressively to limit the opportunities for unearned increment and to restrict the rights attaching to the ownership of property. The other is, that as the authors recognize, taxation of capital gains without equivalent relief in respect of capital losses is unjust. The three facts together seem to me to make the taxation of capital gains as part of an income tax impracticable on any logical basis, and to account for the facts that most countries exclude capital gains and losses from such computations and that we have been forced to adopt empirical methods for including a part of them.

I think treatment of gifts as a deduction from the gross income of the donor and an addition to that of the recipient would not be appropriate in an income tax law and would be unwise.

2) As an accountant, I offer the following comments:

a) In accounting, income is a gain derived from a transaction with a person (natural or artificial) external to the accounting unit. A transaction between two companies may produce income to one of them, but if they are both members of the same group and subsidiaries of a common parent, it cannot produce income to the parent (even though made the basis of a dividend payment by the subsidiary to it) or to the group as a whole. This being so, there is no natural or direct relation between the accounting concept of business income and the notion of social income.

b) Whatever may be the merits of Professor Haig's definition of income as the money value of the net accretion to one's economic power, it cannot properly be presented as an accounting type of definition. The statement made and repeated by the authors, that this is a balance sheet concept, is in my judgment erroneous and based on the common but mistaken idea that balance sheets are intended to represent present values and net worth. When we emerged from the stage of single-entry bookkeeping into the double-entry accounting system which produced the balance sheet, we definitely abandoned the old corner-grocery-store method of determining gains by comparative statements of net worth. As the authors recognize, the application of that obsolete method to individuals and corporations in the present state of society would present great if not unsurmountable administrative difficulties and it would be open to other very great objections even if this were not the case.

While aberrations in practice, especially during the 'twenties, may well have created a different impression, accounting is based (more firmly, perhaps, today than ever before) on cost, amortization of cost and completed transactions, though resort is sometimes had to valuation for purposes of conservatism.

c) The definition of income quoted by the authors from Preinreich is not, in my opinion, a typical or accurate accounting definition, but as they recognize that this definition, as interpreted by them, is not followed in accounting, it is unnecessary for me to do more than note my unwillingness to accept it.

d) When the authors speak [Sec. II, 1 (a)] of an appreciation arising as a consequence of additional equipment purchased out of earnings, and call it a capital gain; when they speak of appreciation of industrial fixed property as the converse of depreciation; and when, as in the illustration on page 222, they assume that part of the money received in an income-producing transaction remains earmarked as income, they indicate that their point of view is remote from that of the accountant, and their exposition of the accounting aspect of any question should be read in the light of this fact.

3) The following comments are offered with the natural diffidence of a layman:

a) I regret the persistent tendency of economists to torture words such as 'income' into meanings at variance with common usage. 'Net accretion to economic power' seems to me too abstract and vague a concept to form the basis of a serviceable definition of income.

b) Upon the question of the inclusion of unrealized appreciation in estimates of national income I desire to express my dissent from Professor King and my agreement with Mr. Soule (*Income in the Various States*, note, p. 38) and Lord Stamp (*Journal of the Royal Statistical Society*, 1934, pp. 449-50).

c) To tax in accordance with ability to pay may properly be the object of a tax system as a whole or of a personal tax, or the guiding principle in framing an income tax law, but it is not, I think, a legitimate or desirable corollary that the word 'income' should be distorted by definition out of its common meaning in order to make the tax more nearly one on supposed new abilities to pay. This consideration has special weight where the tax is levied under a specific constitutional provision.

d) The authors seem to me to fail to distinguish between a tax levied according to ability to pay and a tax on newly arising abilities to pay—surely two materially different concepts.

e) I think the authors err in regarding the position as being that the ability to pay of an individual is a single thing which "cannot be broken into pieces if progressive income tax rates are to be applied equitably". The position seems to me, rather, to be that abilities to pay exist separately, and that the problem is to aggregate them. The heart of this problem—that of reducing them to a common denominator—seems to me to be almost if not completely ignored by the authors, and this is the more curious in view of their comments on the need of further study of the problem involved in reducing "automobiles, radios, and felt hats" to a common denominator by expressing them in terms of money value. The problem is not merely that of irregular income, which the authors do discuss.

f) I am convinced that the change in the capitalized value of an income stream due to a change in the amount of the expected stream or in the current rate of discount applicable thereto is of a different order from the current income itself, even if both are to be regarded as new abilities to pay, or accretions to economic power, or income. I do not see, moreover, how a widow living on an annuity receives any accretion to her economic power or any income according to common usage when the capital value of that annuity increases as a result of a fall of interest rates (she might, of course, gain in economic power from a fall in prices).

The author's statement regarding capital gains, that "certainly such gains contribute no less to individual ability to pay taxes than do recurrent, earned gains" seems to me to illustrate the common device of asserting as obvious what it is difficult to prove.

g) The authors also seem to me to ignore the problem of the relation between abilities to which a capital value is not commonly assigned—such as the ability to render valuable personal service—and those which have a recognized capital value—such as ownership of stocks, bonds, annuities, etc. According to them, a person who acquires an ability which has a capital value in connection with the termination of one that has none would apparently receive income to the amount of the capital value of the new ability; thus a disabled young aviator who received under his contract a life annuity of a fraction of his former compensation might find his income multiplied by his disablement (a commoner though less striking case is that of an employee who retires and is granted a small pension).

V H. C. SIMONS

My assignment is to discuss the first part of the Blough-Hewett paper. This part, in spite of the authors' effort "to retain the clash of ideas with the discussants" (footnote 1), has been substantially changed from the original or preliminary draft and has been, I think, greatly improved. The most important of my original objections cannot now be raised; and, relatively minor matters apart, I am now inclined to endorse the authors' general position. In short discussion, however, one may properly focus attention on differences of opinion. So, I shall confine my remarks to matters of disagreement. Actually I thoroughly approve what the authors have said about taxation; and the things I shall criticize in the first part of the paper are distinctly less important than those which on occasion I should warmly commend and support.

I am still dissatisfied with the authors' basic definition of income [II, 2(d)]. The word "flow" is loosely figurative; "available" is ambiguous; "distribution" is more ambiguous; and the last phrase, "maintaining the capital fund intact", introduces a pure value magnitude into an expression whose other terms are treated as physical quantities. Income, in the only meaningful sense, is a mere value fact or value estimate. Schaffle's observation, "Das Einkommen hat nur buchhalterische Existenz", suggets the proper point of departure for definitional inquiry. The authors, like most economists before them, are trying to discuss accounting concepts without recourse to accounting language.

They propose to deduct depreciation from a "flow of commodities and services", and "costs of production" from a "physical heap". Their effort to reify or hypostatize income invites comparison with the common misconceptions about the meaning of the balance-sheet item, surplus. When a concept is really definable only in terms of a complex procedure of calculation, the ends of simplicity and accuracy are ill-served by attempts at definition in terms of concrete denotations. The authors' language is perhaps suitable for defining income in accordance with Irving Fisher's special usage; but it simply cannot be employed in defining a concept that includes wealth changes and connotes measurement of net total production.

There is, I think, no real difference between us as to the real meaning of income. Except for vested interest in an unhappy phrasing, the authors presumably would not object to a definition expressed in terms of consumption and accumulation, i.e., in terms of the total value of goods and services (without double counting) utilized in consumption and (plus or minus) net change in wealth during the period. (The terms of this definition, while connoting inventories of physical things, are inherently value magnitudes—the dividends and equity accretions of national accounting, if you please.) However, while most of the paper is compatible with this definition, the authors time and again resort to expressions in physical terms which, to me, are either meaningless or wrong.

I am exceedingly unclear about the real meaning of social income, wealth, and capital, and of value aggregates generally; and useful discussion must emphasize the inescapable ambiguity of the concepts in question.[1] One readily shares the authors' desire for clearer distinction between mere changes in market values and 'real' changes in wealth; but the criteria they propose for such distinction are seldom satisfactory. The repeated implication that distinction can usefully be drawn between value changes and physical changes is simply mistaken. Wealth and income have no significant physical dimensions. Changes in real

[1] "Nach unserer Ansicht gehört der Einkommenbegriff aber überhaupt streng genommen nur der Einzelwirtschaft an, der Volkswirtschaft nur in bildlich analoger Ausdehnung" G. Schmoller, 'Die Lehre vom Einkommen . . .', *Zeitschrift f.d.g. Staatsw.*, 1863, p. 78.

income and real capital, while different from and transcending market-value changes, are still value magnitudes inherently. Such changes connote movement toward or away from the good life; or perhaps they connote accretions of 'welfare'. Meaning can be given to such terms and to their dimensions (if at all) only by plunging into the (bottomless?) depths of moral, ethical, or esthetic speculation. Granting this, one must regard as naive the attempt to identify real-value changes with changes in "physical quantities" (p. 203, line 33), with "net additions to the flow of economic goods" (p. 204, lines 7 and 22; p. 206, line 15; p. 211, line 12); and the argument in terms of "the total of utilities" (p. 209, line 22) is hardly sophisticated.

Venturing into discussion that better informed students would approach more cautiously, I should suggest that this treacherous business of getting behind money values ought to be limited narrowly to the application of index numbers. The authors, I think, have shown how much confusion can result from looking behind market values, and from introducing physical terms in lieu of pecuniary terms, at many different levels of inquiry. Correction for price-level changes need occasion no serious misinterpretation; but, beyond that, one wisely may avoid promiscuous, casuistic tinkering with original data and then carefully explain the inevitable limitations of the statistical results.

I am especially perplexed by the effort to rule out increases in capital values that arise merely from increases in the prospective 'incomes' (meaning yields or productivities) capitalized. Surely the authors would stop short of including newly constructed capital assets whose future yields promise, as a matter of general consensus, to be zero. It is hard to see why one need worry about including capital appreciation, due to unexpected changes in product-demand conditions, if the corresponding decreases in other asset values also come into the accounting; and the results might be curious if such value changes, in both directions, were disregarded. Moreover, after taking a categorical position about such appreciation, the authors are hardly entitled to the privilege of suspending judgment on the corollary questions of obsolescence (footnote 36).[2]

[2] The issues raised by the three cases discussed in Sec. II, 3(e) are too involved for brief comment. However, I must remark that the last paragraph of this section seems

In the case of land, the authors wisely warn against attempts to go behind the market-value facts and, especially, against "differentiation of value appreciations by source' [II, 3(c)]. It is surprising to find here a sharp distinction between land and capital assets, and especially surprising that the authors should use the distinction as they do. Certainly the considerations that can be urged in support of their position regarding land are as strong, if not stronger, in the case of other capital assets.

I do not see how, as a practical matter, capital value changes could be corrected with any precision for changes in rates of interest or why, in principle, such correction is desirable; and the authors' argument does not get close to the issue. If this were an economy where one might reasonably assume a change in interest rates from 10 to 5 per cent [II, 3(d)], there would indeed be a serious problem here for income estimation. But, by itself, such an assumption is almost meaningless. One must make careful assumptions regarding the basic origins of such change if there is to be any significant discussion; and the authors' suggestion of increase in the relative valuation of future goods merely makes matters worse. Incidentally, one wonders if they seriously mean to propose a twofold correction of data, for interest-rate changes and for price-level changes as well.

Over the short periods for which income comparisons may have meaning, it is to be expected that interest rates and prevailing expectations as to yield or productivity of existing capital assets generally will move in the same direction. The one change will therefore serve in the main to modify the influence of the other upon market values. Thus, one may argue that correction for changes in interest rates would serve to increase, rather than to diminish, the 'fictitious' element in capital-value changes.

In conclusion, I should suggest that discussion of income estimation should be oriented explicitly with reference to the purposes the estimates may serve. We need, first, an index of net 'real' production that is reliable for purposes of year-to-year comparisons. We need, second, for each year separately, a basis

to involve an unannounced and unwitting digression into the Fisher terminology and to introduce arguments that are appropriate only to the Fisher usage of the term 'income'. The statement about overestimating income in the early years simply begs all the questions at issue, here and by implication at the beginning of the section as well.

against which other statistical aggregates (taxes, government expenditures, farm income, dividends, wages and salaries, savings, etc.) may be interpreted. That these two purposes can properly be served by the same kind of estimate is very unlikely. In the one case, our interest is in real income, in the 'material' basis of welfare, and in its changes through time. In the other, we are interested in contemporary distribution and, therefore in property (not wealth) concepts. So, we probably need two very different kinds of estimate. Of these, one would be what is not very happily described as an index of physical production. The other would purport to be nothing but a pecuniary aggregate of net accretions of property rights (including those exercised in consumption). While I have little conception of the problems involved in the more straightforward measurement of changes in real production, I am confident that much might be gained by abandoning the quest for an all-purpose income estimate.[3] Incidentally, neither estimate proposed would be likely to serve its own purposes very well if it were constructed with much regard for its use as a check against the other.

I trust that no one will construe these remarks as an appraisal of the paper by Professors Blough and Hewett. The many important points on which there is no disagreement between us have not been mentioned. Seeking to emphasize differences of opinion, I have not been careful to avoid unfairness to the authors; and it is in the best academic tradition for criticism to be most ungenerous between persons whose fundamental views are nearly identical.

VI ROY BLOUGH AND W. W. HEWETT

We are grateful for the thoughtful comments of Messrs. Copeland, Groves, Kuznets, and Simons.[1] Many of the suggestions we gladly accept; with others we find ourselves unable to agree.

[3] I am also confident that, if the problems discussed in the paper were broken down along the lines here proposed, most of the apparent disagreement between the authors and the discussant would disappear. Indeed, if I were obliged to discuss the problems involved in constructing a production index, I might soon find myself saying things not very different from what I have criticized the authors for saying.

[1] Mr. May's comments, Discussion IV, were received after the preparation of the authors' reply, and are therefore not considered in it (Editor).

Time does not allow an attempt to discuss all the latter, and we shall endeavor merely to state our position with respect to a few.

Though in certain other respects their comments lead to divergent conclusions, Messrs. Simons, Groves, and Copeland apparently agree in attacking our definition of social income on the ground that it attempts to go behind value changes in search of some measure of the productive achievements of the economy. Professor Simons says: "Income, in the only meaningful sense, is a mere value fact or value estimate." Professor Groves, by emphasizing scarcity and demand and by challenging the exclusion from social income of certain types of value change, would seem to reach the same conclusion although he does not state it definitely. Dr. Copeland appears to accept income as a value fact in his statement that "the absence of a contribution to the social output is not a basis for excluding, from the national income, the individual income from a transaction", and by stressing the usability of the definition of income as "earnings, gains, or profits from any source".

To this contention that one cannot and perhaps should not pierce the veil of value to reach a concept more closely related to welfare we can only reaffirm the position taken, namely, that while from the viewpoint of income distribution a definition based solely on value is appropriate, such a definition is not suitable as an instrument for measuring the change in well-being that is achieved through time by the economy as a whole. Perhaps the idea of attempting to make such a measurement is bound to be abortive. Certainly there are aspects of well-being in general, and perhaps even of material well-being, that cannot be comprehended in an income concept. However, we are not ready to accept partial failure as complete failure, or partial results as no better than none at all. Success in measurement is a matter of degree. Failure even to attempt to look behind value facts to something more nearly approaching the welfare concept means surrender. Incomes as pure value facts reflect relative economic powers of persons and groups; the summation of such incomes may be far from representing the economic power of a society either absolutely or relatively through time.

Professor Simons, who makes perhaps the most vigorous attack on the attempt to find income behind value facts, nevertheless proposes a measurement of 'production' that, we fancy, is not distant in meaning from the social income concept we employed. In his index he would superficially avoid the problem of going behind value facts by starting with physical production, but in reality the problem is not avoided, since the only basis thus far developed for combining physical production of different services and commodities is in terms of their values. We seek substantially the same destination as Professor Simons, but the route is different. He presumably would classify activities into productive and non-productive, construct specific indices of production, and combine these into a final index on the basis of value. We would start with a value sum and seek through the elimination of nonproductive elements and the application of index numbers to arrive at the productive achievement of the economy. We pass no judgment as to which method may prove the more practicable, but we believe the basic theoretical difficulties are unchanged whichever one is followed.

Professor Groves takes the position that, among other items, "appropriation of scarcity values, limitation of output, the current realization of values representing future prospects, fortunate changes in demand" are sources not only of individual economic power but also of national economic power. We would agree that these are significant elements in determining the economic power of the nation over the rest of the world. The nation from this viewpoint is in the same position as a person who has economic power over other persons. However, so far as the internal economy of the nation is concerned, we must disagree. It may be admitted that limitation of output, for example, may, if judiciously employed, lead to a greater balance in the economy and thus may make possible larger employment, greater production and, accordingly, greater social income. However, the increased economic power arising from limitation of output is individual power. It is not in itself increased social power, since the achievement of the economic system consists in its output.

Similarly, we are unable to agree that the appropriation of 'scarcity values' increases the power of the nation as a whole, for the reason that the power one person thereby gains over his fellows is correlative to a loss of power by them, and this loss may not be included in summating national income.

Dr. Copeland seems to have overlooked the distinction between economic power arising from current production and economic power arising from the capitalization of expected future income. He points out that the monopoly profit of a concern is part of national income. With this we agree, since the monopoly profit enters into prices and into the determination of the price index by means of which money income will be deflated. The capitalization of expected future income is quite different. Assume that company X secures a monopoly and that as a result its prospect of future profits is such that its going concern value is increased from $1,000,000 to $2,000,000. This increase due to the capitalization of expected monopoly profits constitutes a capital gain that is not a contribution to the power of the economy to produce. This gain is not, or at least may not be, offset on the accounts, or otherwise, anywhere else in the economic system.

In his discussion of the relation of the volume of social income to the volume of tax collections Dr. Kuznets opens up a new basis for judging the desirability of taxing capital gains. His argument appears to be as follows. Over short periods the volume of tax collections should be a clearly formulated function of the volume of social income arising in the economic system. This function may be expressed as a ratio between taxes and income that should vary only within fairly narrow limits from year to year. In a government that considered the problem of tax policy rationally, the actual bases on which taxes were imposed would be immaterial so far as the ratio of taxes to social income was concerned, since the volume of taxes would be continually adjusted to maintain the desired ratio. In the absence of such rationality, taxes and rates once established are likely to be adhered to and may produce yields in excess or short of amounts that would be collected upon rational grounds. Therefore, runs the argument, the taxation of transfer income and other elements that are not social income presents dangers of variations in volume of revenue that are not present when only items of social income are taxed.

Although we have not given the matter much thought we are inclined to agree that in any particular stage of industrial and governmental development, that is, in the short run, one important consideration in determining the desirable volume of tax collections should be the volume of social income arising in the economic system. However, we suggest that, concerning the conclusions drawn by Dr. Kuznets, the following difficulties may be met. The proper functional relation may not be the one suggested, that is, the ratio of taxes collected to social income should perhaps not fluctuate within 'narrow' limits (although the question may perhaps be one of defining 'narrow'). Just as an individual can afford to pay in taxes a larger proportion of a large income than of a small income, so a nation can perhaps similarly afford to pay a larger ratio of its income in prosperity than in depression. The result would be deficit financing in depression and paying off of the deficit in prosperity. On the other hand, emphasis on annual budget balancing and the subordination to it of other considerations would lead to a larger ratio of taxes to social income in depression than prosperity unless Dr. Kuznets is prepared to take the position that the volume of government services and costs should vary over the short run in direct (and fairly exact) proportion to the volume of social income. Just what the 'functional relationship' should be is thus questionable: it might be a substantially uniform percentage of social income or a varying one in either of two directions. The rest of his remarks seem to be based on the assumption that the functional relationship should be a uniform ratio of tax collections to social income over business cycles, an assumption we are not willing to make.

Whatever the functional relationship decided upon, the construction of a rate structure that will produce predictable results with merely minor variations of percentage of national income seems difficult. Progressiveness and exemptions in tax rates comprise one problem. The small proportion of taxes imposed on the income base is another. So long as taxes imposed on income constitute as small a percentage of total taxes as at present, the taxation of transfer items, though unpredictable in any given year, may over the period of the cycle actually improve the relationship between tax collections and social income. Whether this would be the result is largely dependent on what functional relationship between the volume of taxes and social income is conceived to be socially desirable.