# IS INCOME FROM CAPITAL SUBJECT TO INDIVIDUAL INCOME TAXATION?

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ABSTRACT

Although real capital income from certain sources may be subject to tax at very high rates in an inflationary economy, this paper suggests that individuals avoid individual income taxation on most capital income by saving in tax-preferred assets, and by not realizing or not reporting capital income. It is found that the average marginal rate of Federal individual income tax on all capital income is about 10 percent. Additionally, the net amount of income from capital reported on individual returns is less than one-third of net income from capital (excluding inflationary returns) in the economy.

# IS INCOME FROM CAPITAL SUBJECT TO INDIVIDUAL INCOME TAXATION?*

## I. INTRODUCTION

In an income tax system that taxed all income equally, capital income from one source would be treated similarly to capital income from another source and to wage income as well. In the individual income tax, however, the tax treatment of capital income varies widely according to source and differs substantially from the tax treatment of wage income.

Because of the disparate treatment of various types of capital income, considerable debate has arisen over the extent to which income from capital is actually taxed under the individual income tax. Recent studies have highlighted how individuals are taxed on the inflationary component of interest income and increases in the value of assets due to inflation (see, for instance, Feldstein and Slemrod, 1978). On the other hand, other analyses have emphasized that various exclusions and deductions allow individuals to avoid taxation on income from capital (see, for instance, Pechman and Okner, 1974). Additionally, much capital income is not recognized immediately and is therefore deferred from

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taxation because of the requirement (adopted primarily for ease of administration) that taxes be based upon realized rather than accrued income. Finally, a recent study by the Internal Revenue Service found a much larger rate of non-compliance by taxpayers in reporting income from capital than in reporting wage income. 1/

The purpose of this note is to provide empirical estimates of the extent to which income from capital is subject to individual income taxation. While some individuals do face extraordinarily high rates of tax on real income from certain assets (e.g., individuals who save through passbook savings accounts in period of high inflation), the results of this paper suggest that most income from capital, whether nominal or real, is simply not subject to individual income taxation. Indeed, about 80 percent of the assets held by individuals are in forms for which there is a tax preference arising from either deferral, capital gains tax rates, exclusions, or some other means of non-taxation of some or all of the income from the asset.

These results do not imply that income from capital is taxed too lightly or too heavily. Substantial amounts of corporate and property taxes are also paid on property or

1/ See Estimates of Income Unreported on Individual Income Tax Returns. Amount of income reported on tax returns as a percent of amount reportable equaled 97-98 percent for wages and salaries, but averaged only 80-88 percent for interest, dividends, capital gains, and rents and royalties.

income from property. Moreover, when income from capital is realized for tax purposes, it may face a substantial penalty tax on any inflationary component. The incidence of these taxes and penalties may be borne by all capital owners, for instance, through a lower pre-tax rate of return on tax-preferred assets. The results do imply that most capital income is not taxed through the one tax -- the individual income tax -- in which tax rates are related to the ability to pay of the taxpayer. In addition, the economy may suffer a substantial welfare loss from the misallocation of investment and savings which results when the tax system combines substantial incentives for ownership of certain types of assets with substantial penalties for recognition of income from other assets.

## II. AMOUNT OF INCOME FROM CAPITAL SUBJECT TO TAX

### A. Net Income from Capital

National income data 2/ can be used to provide rough estimates of the amount of net income from capital in the economy. These estimates are presented in the left-hand side of Table 1. Total net income from capital for 1979 is estimated at $305.5 billion. Sources of income include: corporate profits, proprietors' income, rental income, net interest income, and income from consumer durables.

2/ Source: Survey of Current Business, May, 1980, and Bureau of Economic Analysis, Department of Commerce (for unpublished estimates).

Table 1

INCOME FROM CAPITAL 1979
($billions)

| Income from Capital | | | | Income from Capital Subject to (Individual Income) Taxation | | |
|---|---|---|---|---|---|---|
| Total Income from Capital | | | 305.5 | Total Income from Capital Subject to Tax | | 96.6 |
| Corporate Profits a/ with Inventory Valuation and Capital Consumption Adjustments, Less Profits Tax Liability | | | 85.6 | Dividend and Capital Gain Income Declared | | 57.9 |
| Dividends | | 52.7 | | Dividends | 34.1 | |
| Retained Earnings (Adjusted) | | 32.9 | | Gross Dividends Before Exclusion | 35.8 | |
| | | | | Less Dividend Exclusion | -1.7 | |
| Profits Before Tax | 236.6 | | | Net Realized Capital Gains in Adjusted Gross Income | 23.8 | |
| Less Profits Tax Liability | -92.5 | | | | | |
| Less Dividends | -52.7 | | | | | |
| Less Inventory Valuation Adjustment | -41.8 | | | | | |
| Less Capital Consumption Adjustment | -16.7 | | | | | |
| One-third of Proprietors' Income with Inventory Valuation and Capital Consumption Adjustments | | | 43.6 | One-third of Proprietors' Income Declared | | 24.3 |
| Proprietors Income Before Inventory Valuation and Capital Consumption Adjustments and Imputed Return to Labor | 141.8 | | | Proprietors' Income Declared | 72.8 | |
| | | | | Less Return to Labor | -48.5 | |
| Less Inventory Valuation Adjustment | -3.0 | | | | | |
| Less Capital Consumption Adjustment | -8.1 | | | | | |
| Less Return to Labor | -87.1 | | | | | |
| Rental Income b/ of Persons with Capital Consumption Adjustment | | | 26.9 | Rental Income Declared plus 90 Percent of Royalty Income Declared Less Real Estate Tax Deduction | | -16.9 |
| Rental Income of Persons | | 55.1 | | Rental Income Declared | 5.1 | |
| Less Capital Consumption Adjustment | | 28.2 | | 90 Percent of Royalty Income Declared | 2.2 | |
| | | | | Less Real Estate Tax Deduction | -24.2 | |
| Net Interest Income Less Services Furnished Without Payment by Financial Intermediaries | | | 117.7 | Net Interest Declared | | 4.4 |
| Personal Interest Income | | 192.1 | | Interest Income Declared | 72.9 | |
| Less Interest Paid by Consumers to Business | | -39.6 | | Less Interest Deductions | -68.5 | |
| Less Services Furnished w/o Payment by Financial Intermediaries c/ | | -34.8 | | | | |
| Income from Consumer Durables | | | 31.7 | Income from Durables Less Personal Property Property Tax Deductions | | -1.6 |
| | | | | Income from Durables Declared | 0 | |
| | | | | Personal Property Tax Deductions | -1.6 | |
| | | | | Other Income Received by or through Intermediaries | | 28.5 |
| | | | | Small Business Corporation Income | 3.2 | |
| | | | | Estate and Trust Income | 4.3 | |
| | | | | One-half of Pension and Annuity Income | 21.0 | |

a. Corporate profits after indirect business taxes, transfer payments and subsidies.
b. Rental Income includes imputed rent to owner occupied housing. Real estate taxes and interest expenses are effectively subtracted from gross rental income in the rental income figure reported here.
c. The Value of Financial Intermediary Services may under alternative assumptions be counted as income to capital.
d. Net Income from durables after personal property tax payments. The estimate assumes a six percent real rate of return to the stock of consumer durables as reported in Balance Sheets for the U.S. Economy.

The method of estimation used in this paper is to measure capital income net of inflationary returns (such as inflationary increases in the value of inventories), corporate income taxes and property taxes, interest payments from individuals to business, and the value of financial services (e.g., on checking accounts) furnished by financial intermediaries.

Thus, corporate profits of $85.6 billion are reported net of inventory valuation and capital consumption adjustments in order to exclude profits resulting from the inflationary increase in value of inventories and equipment, and the corresponding overstatement of inventory profits and understatement of depreciation. For purposes of calculating income from capital subject to the individual income tax, income from ownership of corporate stock is measured net of $92.5 billion of corporate profits tax liability, leaving dividends and retained earnings (adjusted), as the estimate of income from capital arising from corporate stock ownership.

Net rental income of $26.9 billion is also estimated net of capital consumption adjustment. As reported both in Table 1 and in the national income accounts, rental income includes imputed rent to owner-occupied housing and is estimated net of costs such as real estate taxes and interest.

Subtracted from personal interest income of $192.1 billion is the value of interest paid by consumers to business and the value of services furnished without payment by financial intermediaries. Thus, interest income received by individuals is measured net of interest payments (other interest payments are effectively subtracted in the estimate of net rental income) and excludes non-monetary returns to deposits in financial institutions. 3/ The estimate of interest income is not adjusted downward for inflation. Rather, it is assumed that the overstatement of interest income by individuals as creditors (and owners of debt instruments) is exactly offset by the understatement of their income as debtors (and owners of institutions with outstanding debt). In estimating national income, the Bureau of Economic Analysis uses a similar procedure; for instance, real, current-dollar, national income includes net interest flowing from the corporate sector, without any inflation adjustment.

Imputations are added in two areas. First, one third of proprietors' income is counted as income from capital, while two-thirds of proprietors' income is treated as wage income. Second, a modest estimate of 4.0 percent real rate of return was used to make the $31.7 billion imputation of income from consumer durables.

3/ These non-monetary returns can be treated as part of return to capital; however, this would imply that the return to deposits include both the stated interest payments and the cost to the financial institutions for handling the deposits.

Although the estimated total net income from capital figure of $305.5 billion represents real income from capital, the tax system is actually based upon nominal rather than real income. In an inflationary environment such as existed in 1979, nominal income from capital would be significantly larger than real income. Adding back the inventory and capital consumption adjustments alone would increase income from capital by $69.6 billion (see Table 1). The largest addition, however, would arise from the nominal capital gains on the assets held by individuals. Increases in the value of land, residential housing, and other physical assets would add several hundred billion dollars annually to the nominal amount of income from capital. For instance, capital gains on physical farm assets, mainly real estate, equaled $102 billion in 1978. 4/

## B. Net Income From Capital Reported on Individual Income Tax Returns

Using a sample of 1975 tax returns with data aged to 1979, 5/ it is estimated that only $96.6 billion in net income from capital was reported on individual income tax

4/ Balance Sheet of the Farming Sector, 1979, Supplement, p. 40. Data for 1979 are not yet available.

5/ Estimates of income reported on tax returns and taxes on income are estimated using the Treasury Tax Model. For a discussion of this model, see Wyscarver, 1978.

returns in 1979. A summary of the amount of capital income reported on individual income tax returns is presented on the right-hand side of Table 1.

Because the estimates of income from capital in the economy are net of interest, real estate taxes and personal property taxes, consistency requires that the estimate of income from capital subject to individual income taxation also be reported net of deductions for such expenses. The largest deduction is for interest payments; interest deductions reported by itemizers are almost equal in size to interest receipts reported on all returns.

In apportioning out the amount of capital income reported on individual income tax returns, two-thirds of proprietorship and partnership income is again assumed to be income from wages. Ninety percent of royalty income is treated as income from capital, thus allowing a small portion of royalty income to be treated as wages of authors and similar persons. One-half of reported pension and annuity income 6/ is also included as capital income subject to

6/ Using the figure "one-half" is only partly arbitrary. Consider an employer who contributed a fixed percentage of wages to an employee's pension plan for the past 25 years. If the employee's wages had grown at 4 percent a year and the rate of return on assets had equaled 6 percent, then the portion of the capital accumulation after 25 years attributable to the sum of employer contributions would be 51 percent and the portion attributable to earnings on the employer contributions would be 49 percent.

individual income tax, although this estimate probably errs on the side of overstating the amount of capital income from pensions. 7/

The $96.6 billion of net income from capital reported on individual income tax returns 8/ represents only 32 percent of the $305.5 billion of net capital income in the economy. If income from capital in the economy had been measured on a nominal basis similar to that used to report income on tax returns -- for instance, if capital gains were included in the estimate of income from capital in the economy -- then the percentage of capital income reported on individual tax returns would have been smaller still.

7/ Because many pension plans are inadequately funded, many pensioners effectively are paid out of current employer contributions rather than earnings on past contributions. More importantly, if one were to attribute the tax subsidy to pension deposits as applying entirely to capital income rather than both capital and wage income, then the amount of capital income from pensions subject to tax would be listed at zero. Further discussion of the amount of subsidy to pension income is contained in Section IV.

8/ A small amount of income of individuals is also taxed as undistributed income on fiduciary tax returns. Estates and trusts reported $2.4 billion of taxable income for 1974, the last full year for which details are available. Most of this taxable income represented income from capital. See Statistics of Income -- 1974, Fiduciary Income Tax Returns.

## III. INCOME TAX COLLECTIONS ON CAPITAL INCOME

Some revenue and distributional effects of the individual taxation of income from capital are shown in Table 2. Breakdowns are provided for 1) income from capital gross of deductions for interest, real estate taxes and personal property taxes and 2) income from capital net of these deductions.

The change in tax reported for each of these income measures is the "average marginal" rate on capital income. That is, the tax estimate is the difference between the tax that is currently collected and the tax that would be collected if the income from capital were excluded from taxation. Measuring at the margin is a useful means of examining the economic impact of capital income taxation. However, it does not allow a comparison of the taxes on capital with the taxes on wages. If capital income had been treated as the base, with wage income as marginal income, the estimate of the amount of tax paid by capital would be significantly lower.

Dividing tax revenues of $30.6 billion on net income from capital by the amount of net capital income in the economy yields an effective "average marginal" rate of

Table 2

INCOME FROM CAPITAL REPORTED AND TAXED ON INDIVIDUAL INCOME TAX RETURNS
(1979)
($billions)

| Expanded Income Class | Total Tax | Income from Capital Gross of Interest and Tax Deductions | | | | Net Income from Capital | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Total Claimed | Income Taxable at a Positive Rate[a] | Tax on Capital[b] Amount | Tax on Capital[b] Percent of Total Tax | Total Claimed | Income Taxable at a Positive Rate[a] | Tax on Capital[c] Amount | Tax on Capital[c] Percent of Total Tax |
| $0-$5,000 | -.2 | 4.1 | .1 | -.4 | N/A | 3.1 | 0.0 | -.1 | N/A |
| $5,000-$10,000 | 6.8 | 18.4 | 7.3 | 1.0 | 14.8 | 15.2 | 6.3 | .8 | 12.5 |
| $10,000-$15,000 | 17.4 | 19.2 | 13.7 | 2.3 | 13.5 | 11.7 | 9.8 | 1.6 | 9.3 |
| $15,000-$20,000 | 24.2 | 17.1 | 14.0 | 2.7 | 11.1 | 4.9 | 6.9 | 1.2 | 4.9 |
| $20,000-$30,000 | 52.6 | 29.4 | 25.9 | 5.9 | 11.3 | 0.6 | 6.1 | .9 | 1.7 |
| $30,000-$50,000 | 50.9 | 31.3 | 28.6 | 8.5 | 16.6 | 5.7 | 7.5 | 1.3 | 2.5 |
| $50,000-$100,000 | 31.0 | 31.6 | 28.8 | 11.5 | 37.2 | 21.1 | 19.6 | 7.5 | 24.3 |
| $100,000-$200,000 | 14.2 | 15.8 | 14.0 | 7.0 | 49.0 | 12.6 | 11.5 | 5.8 | 40.6 |
| $200,000 or more | 15.7 | 24.3 | 17.9 | 11.9 | 76.0 | 21.8 | 17.0 | 11.4 | 73.1 |
| Total | 212.5 | 191.0 | 150.3 | 50.8 | 23.9 | 96.6 | 84.7 | 30.6 | 14.4 |

a/ Change in taxable income less zero bracket amount (taxable income less zero bracket amount constrained to be zero or greater) if all reported capital income were excluded from taxation.

b/ Difference in total tax actually collected and tax that would be collected if the income were not subject to tax, but the deductions were still taken.

c/ Difference in total tax actually collected and tax that would be collected if the income were not subject to tax.

Federal individual income tax of 10.0 percent on all capital income. This number should not be interpreted as the effective rate of tax for all taxes on income from capital. Corporate tax liability of $92.5 billion (see Table 1) on corporate income alone is over three times the $30.6 billion estimate of individual tax liability on all capital income. Adding this corporate tax liability to both the estimate of income from capital and to the individual tax liability yields an effective Federal tax rate for both corporate and individual income taxes of 30.9 percent. 9/ State and local income taxes, as well as property and indirect business taxes (to the extent they are considered a tax on capital income), would raise the number even higher.

9/ Note again that this rate of tax is based upon taxes actually paid on all capital income and is not a marginal rate of tax on capital income from certain sources alone, e.g., income of the corporate sector. Taxes paid are reduced by noncompliance and interest deductions, as well as tax preferences, and income includes income to housing and durables.

## IV. ASSETS AND LIABILITIES OF INDIVIDUALS

An easy means to see why so much income from capital is not subject to the individual income tax is to examine the portfolio of assets and liabilities held by individuals in the United States.

Individual net worth at the beginning of 1979 is estimated by the Board of Governors of the Federal Reserve System at $6.5 billion (see Table 3). Of some $8 trillion in assets held by individuals, $4.5 trillion are in tangible assets such as housing, durables, and land, and $3.5 trillion are in financial assets. Very little income from tangible assets is reported on individual tax returns. Benefits provided by owner-occupied residential housing and durables are not subject to tax (although interest payments on mortages and installment debt are deductible, as are property taxes). Neither is income from investment real estate taxed fully, in part because owners of these assets are allowed generous depreciation allowances. Very little capital gains tax is collected on land, not only because of the capital gains exclusion but, more importantly, because increases in value of land are deferred from taxation until realized or

Table 3

ASSETS AND LIABILITIES OF INDIVIDUALS IN THE UNITED STATES -- 1979
Outstandings at Beginning of Year
($ billion)

| | | |
|---|---|---|
| TANGIBLE ASSETS | | $4,514 |
| Reproducible Assets | $3,230 | |
| Owner-Occupied Housing | 1,448 | |
| Other Residential Structures | 395 | |
| Consumer Durables | 793 | |
| Inventories and Non-residential Plant & Equipment | 594 | |
| Land | $1,283 | |
| Residential | 517 | |
| Nonresidential | 567 | |
| Vacant | 200 | |
| TOTAL FINANCIAL ASSETS | | $3,491 |
| Currency, Savings Accounts & Money Market Funds | $1,349 | |
| Demand Deposits & Currency | 242 | |
| Time and Savings Accounts | 1,096 | |
| Money Market Fund Shares | 11 | |
| Securities | $1,188 | |
| U.S. Savings Bonds | 81 | |
| Other U.S. Government Securities | 123 | |
| State & Local Obligations | 75 | |
| Corporate & Foreign Bonds | 65 | |
| Open-Market Paper | 36 | |
| Corporate Equities | 809 | |
| Pension & Life Insurance Reserves | $729 | |
| Private Life Insurance Reserves | 190 | |
| Private Insured Pension Reserves | 119 | |
| Private Noninsured Pension Reserves | 199 | |
| Government Insurance & Pension Reserves | 221 | |
| Miscellaneous Assets | $225 | |
| TOTAL ASSETS..... | | $8,004 |
| TOTAL LIABILITIES..... | | $1,503 |
| Mortgages, Owner-occupied Nonfarm Homes | $738 | |
| Consumer Credit | $340 | |
| Non-corporate Business Mortgage Debt | $213 | |
| Security Credit & Policy Loans | $ 53 | |
| Other Debt | $159 | |
| NET WORTH..... | | $6,501 |

Source: Balance Sheets of the U.S. Economy, (Washington: Board of Governors of the Federal Reserve System, 1979).

are excluded completely from taxation in the event of death. 10/ Compliance data also indicate substantial amount of under-reporting of rental income and self-employment income. 11/

Of the $3.5 trillion held in financial assets, some 20 percent of that total, or $729 billion, is in the form of life insurance and pension reserves. Earnings on savings in life insurance and annuities are usually deferred, often permanently, from taxation. The current tax treatment of an individual's retirement savings in a qualified plan is equivalent to complete exemption of the earnings on that savings if the taxpayer is in the same tax bracket when he receives his pension as when his employer (or, in the case of an IRA or Keogh plan, the individual) deposits money in a pension plan. 12/ If the taxpayer is in lower tax bracket, as is usually the case, the tax treatment is equivalent to a subsidy for deferred wages in addition to non-taxation of the income from savings.

10/ The exclusion applies to heirs as well as decedents and is achieved by means of an adjustment which increases an heir's basis for selling an asset to its value at time of death of the decedent.

11/ Estimates of Income Unreported on Individual Income Tax Returns, 1979, p.8. Rental income and self-employment income reported on tax returns equal less than 65 percent of the amount reportable.

12/ See Sunley, 1977

Another $809 billion of the financial assets of individuals are held directly in corporate stock. In the individual income tax, corporate stock is given favorable tax treatment through the exclusion of 60 percent of long-term gains from tax, the dividend exclusion, and, most importantly, the combination of deferral of taxation of any gains until realized and the exclusion from taxation of all gains unrealized at the time of death.

Individuals also hold $75 billion worth of State and local obligations, the income from which is generally non-taxable, and $81 billion worth of U.S. Savings Bonds, the income from which can be deferred from taxation until the bonds are sold. For calendar years 1981 and 1982 there will also be an interest and dividend exclusion for the first $200 of interest and dividends earned by a taxpayer ($400 per joint return) or for about 8 percent of total interest and dividends. 13/ Of the $8 trillion in individual assets, then, about 80 percent is in a form for which some or all related income can be excluded or deferred from taxation.

On the liability side of the ledger, much of the interest paid on individual liabilities of $1.5 billion is deductible immediately. In fact, it is quite common for individuals to borrow and take deductions at the same time that they invest in assets (pensions, annuities, land,

13/ For years before 1980, there is a maximum exclusion of $100 per taxpayer ($200 per joint return) for dividends only.

housing, corporate stock) for which income is deferred. The tax laws do place some limits on investment deductions in excess of investment receipts, but even these limitations can be avoided easily by borrowing on equity in housing or assets used in business or by increasing consumer debt.

## V. TAX EXPENDITURES FOR INDIVIDUAL SAVING AND INVESTMENT

As a final means of examining the extent to which income from capital is subject to individual income taxation, Table 4 presents estimates of tax expenditures 14/ which apply to saving and investment by individuals. These figures indicate that, disregarding interaction, tax expenditures over $65 billion in fiscal 1980 are provided for income from capital earned by individuals. 15/ The amount of tax expenditures is about twice the actual amount of individual tax collections on income from capital. The major tax expenditures are for capital gains (including non-realization at death),

14/ Tax expenditures are defined by the Congressional Budget Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." See "Tax Expenditures," The Budget of the U.S. Government, Fiscal Year, 1981.

15/ In the tax expenditure budget, each expenditure is estimated independently, that is, without accounting for interaction with other expenditures. Tax expenditures are published only on a fiscal year basis. Tax expenditures for calendar 1979 income would fall between fiscal 1979 and fiscal 1980 expenditures.

Table 4

TAX EXPENDITURES FOR SAVINGS AND INVESTMENTS BY INDIVIDUALS a/

Fiscal Year 1980 b/

($ millions)

| Description | Amount of tax expenditures |
|---|---|
| **Expenditures Related Primarily to Financial and Nonbusiness Tangible Assets of Individuals** | |
| Exclusion of interest on state and local debt | 3,090 |
| Nonrealization of capital gains at death | 4,750 |
| Capital gains exclusion and tax-free rollover of personal residences | 1,545 |
| Sixty percent exclusion of long-term capital gains | 13,855 |
| Deductibility of interest on home mortgages and consumer credit | 16,100 |
| Exclusion of pension contributions and earnings | 15,050 |
| Exclusion of interest on life insurance earnings | 3,365 |
| Dividend exclusion | 490 |
| Deferral of interest on United States savings bonds | 290 |
| **Expenditures Related Primarily to Noncorporate Business Assets Held by Individuals** | |
| Capital gains treatment for agriculture, timber, coal and iron ore | 590 |
| Special provisions for depreciation and rapid amortization | 700 |
| Investment Credit | 2,970 |
| Expensing of capital outlays: agriculture, construction, research, exploration and development | 1,215 |
| Excess of percentage over cost depletion | 1,150 |
| Tax incentives for preservation of historic structures | 25 |
| Total, disregarding interaction | 65,185 |

SOURCE: Special Analysis, Budget of the United States Government, Fiscal Year 1981, Appendix G.

a/ Excludes corporate tax expenditures.

deductibility of interest, and special treatment of pensions and life insurance. Caution, however, must be used when interpreting these figures. In the tax expenditure budget, the expenditure for capital gains results from the exclusion from taxation of 60 percent of realized, long-term gains and of gains accrued at death, but not from the deferral of tax for gains accrued, but not realized, in the current year. Also not counted is the tax benefit arising from tax exemption of the income from housing and durables, although interest deductions are included if they arise from the purchase of these assets. On the other hand, tax expenditure estimates are based upon nominal rather than real income. Finally, the tax expenditure estimates are made by estimating the increase in tax that would arise if each item of excluded income were added to income subject to the tax on individual income tax returns. If all were added together at the same time, some of the income would be subject to tax at even higher marginal tax rates, and the estimate of total tax expenditures for savings and investment would be larger. 16/

16/ In cases where several itemized deductions are eliminated simultaneously, the total increase in revenue may be less than the sum of the estimates derived as if each deduction were eliminated by itself. Since total deductions generally cannot be reduced below the zero bracket amount (standard deduction), only deductions above that amount can effectively be added to income in estimating the tax expenditure. However, the only itemized deduction in Table 4 is the deduction for interest paid.

## VI. SOME IMPLICATIONS FOR EQUITY AND EFFICIENCY

Although the individual income tax is in principle a progressive tax on all income, in fact, as discussed above, only a small portion of capital income is reported on tax returns. Of income that is reported, much reflects nominal income due to inflation rather than any real return to capital. In particular, interest recipients, who have little choice as to the timing of the realization of interest income, include substantial amounts of nominal income due to inflation in income subject to tax. Conversely, substantial deductions are allowed for interest payments and for other taxes paid on assets even though income from those assets may not be subject to taxation. In the case of interest payments, the deduction of the nominal interest is in excess of the real amount of interest paid, resulting in a tax subsidy for borrowing which is the opposite of the tax penalty for holding interest-bearing assets.

With respect to capital income, there is little adherence to the principle that all income should be equally subject to tax. There exist few, if any, assets (or liabilities) for which the related real income, and only the real income, is subject to individual income taxation. Of course, to the extent that owners of capital have equal opportunities to make shifts in the asset composition of their portfolios, there is a decreased probability that

taxpayers with equal ability to pay will bear different tax burdens. 17/ However, it is highly improbable that such opportunities, and the capability or knowledge to take advantage of them, are equal across capital owners. Moreover, at least in the individual income tax, the wage income of taxpayers is treated quite differently from capital income (despite the recent growth in the amount of nontaxable fringe benefits received by workers, most employee compensation is still subject to taxation). As currently designed, therefore, the individual income tax is best characterized as a progressive wage tax, accompanied by a penalty tax on the realization of a small amount of nominal income from capital.

The efficiency implications are equally serious. Much has been written about the inefficient allocation of investment in the economy because of the additional taxation of corporate sector capital vis-a-vis non-corporate capital (Harberger, 1962; McClure, 1975). In an inflationary economy, the relative tax on corporate capital income may be raised even higher because of the understatement of the real value of depreciation (Feldstein and Summers, 1979) or the overstatement of real capital gains for assets which are sold (Feldstein and Slemrod, 1978).

17/ See Feldstein (1976) for the view that "in the long-run steady state there are no horizontal equalities if all tastes are identical and there is a single type of ability."

Inefficiency caused by varying tax rates across assets, however, is a two-edged sword. While tax "penalties" are placed on the realization of income from some assets or on particular uses of capital, tax "subsidies" are granted other capital income. Indeed, there are a whole host of tax penalties and subsidies, not only in the individual income tax, but in corporate and property taxes, as well. To the extent that the penalties and the subsidies are placed on the same assets, they may partially offset each other, but, to the extent that the penalties and subsidies apply to different assets, the allocation of investment in the economy may become even more inefficient. 18/ Additionally, if purchases of certain assets receive preferential treatent in the loan market, the subsidy arising from the deduction of the inflationary component of interest payments may also cause inefficient investment by encouraging the purchase of assets with economic rates of return lower than alternative assets.

18/ If a subsidy, e.g., for pension savings, is neutral with respect to the eventual investment resulting from a dollar of savings, then that subsidy may only distort the choice of savings medium and not the allocation of investment in the economy.

As an example of how these varying tax penalties and subsidies may combine together in distoring investment decisions, assume an economy with a rate of inflation of 10 percent and a taxpayer with a 50 percent marginal rate of tax. Suppose the taxpayer desires to save in order to leave some wealth to his children. Consider then his choice between investing in a savings account and purchasing some vacant land. To produce a 2 percent, real, after-tax rate of return, the savings account would have to yield an interest rate of 24 percent, while the land would only have to increase in value by 12 percent a year. 19/ Let us suppose further that the rate of interest for both savings and borrowing is 12 percent. The taxpayer could not gain by borrowing to invest in a savings account and, after tax, would lose 4 percent a year in real terms for direct investment of his savings in the account. However, if he could borrow 90 percent of the value of the investment in the land, then he could achieve at least a 2 percent real rate of return on his equity as long as the land did not decrease in real value by more than 3.4 percent a year (or increase in nominal value by less than 6.6 percent). 20/ Ironically, the

19/ Of course, to the extent there are property taxes on the land, the nominal rate of return necessary to achieve a 2 percent real rate of return is increased.

20/ One dollar of equity involves ten dollars of investment earning a nominal rate, "r," and nine dollars of debt, for which tax savings equals half of the interest rate of 12 percent. Thus $1.12 = $10(1+r) - ($9x.5x.12), or r = .066.

greater the proportion of his own savings invested in the land (or the less he borrows), the lower the rate of return on his equity.

The system of myriad tax penalties and subsidies for income from various assets not only distorts the overall allocation of investment in an economy; it also affects the distribution of assets and liabilities among individuals. The penalty arising from the taxation of the inflationary component of capital income, for instance, increases as the marginal rate of tax increases, while the inherent subsidy arising from deduction of the inflationary component of interest expense also increases with marginal tax rates. Similarly, exclusions and deferrals are of no value to the nontaxable individuals, but increase in value as marginal tax rates increase. As individuals with high tax rates shift their portfolios to take advantage of the exclusions and deferrals, they bid up the relative prices of the assets with deferred or excluded income. Individuals with lower tax rates, being less willing to "pay" for the exclusions and deferrals, then shift into alternative assets. At higher rates of inflation, the amount of induced shifting is even greater. Thus, low-income individuals will tend to hold a relatively greater share of interest-bearing assets, and high-income individuals will increase their share of both borrowing and assets such as farm land, which yields much of its return through increases in value.

## VII. SUMMARY

Only a small portion of real income from capital is subject to individual income taxation. While some persons may be taxed at very high rates on certain types of income, individuals generally avoid direct taxation by saving in tax-preferred assets and by not realizing or not reporting capital income. At the same time that much capital income is deferred or excluded from taxation, interest expenses are often deducted (or realized) immediately as a business expense or an itemized deduction.

The net effect of the different treatment of various forms of capital income is an average marginal rate of Federal individual income tax on all capital income of about 10 percent. The net amount of income from capital reported on individual income tax returns is less than one-third of net income from capital in the economy.

As a result, the individual income tax can be best characterized a progressive wage tax, accompanied by a penalty tax on the realization of a small amount of nominal income from capital. Since the penalty tax is assessed on the realization of nominal income from certain assets rather than the accrual of real income on all assets, its relationship to a progressive tax on all income is minimal.

Moreover, the disparate treatment of various assets results in substantial inefficiency in the allocation of resources in the economy. The economy not only suffers from too much investment in some assets and not enough in others, but there is also an inducement toward concentration in higher income classes of assets producing income which is excluded from taxation and in lower-income classes of assets producing income which is taxed most heavily.

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