Short History of the US Personal Income Tax
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Seven decades of creeping regress

If the capital gains exclusion is revived it will nearly complete an anti-Physiocratic transformation of the income tax from its original form, the handiwork of Physiocrat Warren Worth Bailey, to a tax on work and enterprise of the median citizen. The transformation will never be literally "complete": property never sleeps. Already the road leading down to McKinley is posted and blazed all the way with the "cash flow tax,[1]" and VAT. Here, however, we just look at anti-Physiocratic changes to date. They are enough to make a Physiocrat feel like a chess player facing mate.

a. Wage and salary witholding came in 1941, along with higher rates in lower brackets, converting a tax primarily on property income into a mass payroll tax. State and local public employees, previously exempt, were added to the base in 1939.

b. "Bracket creep" during inflation has pushed most workers into higher rate brackets, with no increase of real income.

c. The effect of bracket creep has been reinforced at the bottom, where most wage and salary income is found. The real value of personal exemptions has fallen, as the dollar allowances have fallen behind inflation. Labor-oriented favors to earned income have been all but wiped out.

d. The effect of bracket creep has been offset at the top, where most rents and capital gains are, by lowering the top rate from 70% to 28%.

e. Bracket creep has raised the average tax rate applied to personal income, because of the graduated rate structure. At the same time it has not raised the average rate applied to corporations, which are immune to bracket creep because the corporate rate is basically flat (with trivial exceptions at the bottom). The corporate share of total tax revenues has fallen sharply. Now, in addition, Congress has lowered the flat corporate rate from 46% to 34%.

f. The high, rising payroll tax (FICA) today raises more

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[1]Aaron and Galper actually propose expensing all land purchases under such a tax. This is proposing to exempt land 100%. An owner is only taxed if he cashes out, at which time the buyer expenses the purchase so the exemption is passed on to each successive landowner, and land as such is never taxable. Henry Aaron and Harvey Galper, Assessing Tax Reform. Washington: The Brookings Institution, 1985, p.76.

money than the corporate income tax, which originally dwarfed it. FICA takes over 14% off payrolls, adding the employer and employee portions.

g. Preferential treatment of land rents and gains has grown in several dimensions. This entails much more than the partial exclusion of gains from taxable income. The details comprise most of what follows.

The cumulative effect of those seven changes in federal taxation is totally to transform the income tax from the original ideas voters had before them in 1913, and what Congress had in mind in 1916 when it passed the first important revenue measure following the 16th Amendment. A tax on the privileges of the idle rich ("idle" meaning with unearned income) has become a tax on the necessities and earnings of the working poor.

The shift of taxes off rent-yielding property is the more striking when we add in the States. In 1920 fully 50% of State revenues came from State property taxes; today hardly any. Almost all local revenues were then from property; today much less than half. Sales and income taxes have replaced them.

One bright, or at least light gray spot in this dark history is the relief of new investment from taxation under JFK, in a compact known as "business Keynesianism." Walter Heller was Chair of the CEA, perhaps the only really influential Chair that group ever had. Heller sold the idea of offsetting the effect of high income tax rates by allowing fast write-off of most new investments, plus an investment tax credit (ITC).

The policy is effective in theory, and proved so in practice. The high tax rate applies in full force to land rents; new investment gets major relief. Net result: an income tax that achieves nationally the same goal property tax reformers have to chip at laboriously from town to town. America actually had a species of national "graded tax plan," uptaxing land and downtaxing capital. It was not a golden age, but neither was it an age of rust. It was a time when the economy refused to take its expected dive.

Active Physiocrats were playing on a different court and missed this game, unless we see the Physiocrat in Heller himself. Investors who responded to the lures of accelerated depreciation, and lawyers who worked on intricate moves to exploit them, never dreamed they were responding to ideas originating with a radical reformer from the 19th century. They may not have cared, but we do: let's have a look.

The provenance of Heller's idea shows the influence of a Physiocratic academic, John R. Commons (1862-1945). If W.W. Bailey left his tracks on the Internal Revenue Code, Commons left his on thinking in economics at The University of Wisconsin. Commons was the leading "institutionalist" thinker; the Economics

Department at Wisconsin-Madison was the leading institutionalist center. "Institutionalist" translates roughly as "relevant," from which it follows that Madison produced much more than its share of the country's practising tax economists -- including Walter Heller.

Commons views on taxing land and exempting capital and wages are set forth strongly in his Institutional Economics[2]. There is little difference between Commons' views and Henry George's, except the style, date, and a more tempered view of things. Here is Commons: "... the man who gets his wealth by mere rise in site-values should pay proportionately higher taxes than the one who gets his wealth by industry or agriculture. In the one case he extracts wealth from the commonwealth without adding to it. In the other case he contributes directly to an increase in both private wealth and commonwealth."[3]

Commons was politically active. His Physiocratic commitment was overt. He helped write and campaigned for the Grimstad Bill of 1921, to exempt capital from the property tax in Wisconsin, and raise the rate on land values.[4] The Keller Bill, H.R. 5733, Jan. 1924, was in part modeled on Grimstad.[5]

Commons did not limit himself to state and local politics, he also addressed the income tax. He wanted capital taxed less than land. The device he favored is fast write-off of new investments[6], the very idea Walter Heller put across in Washington. His purpose is overtly, explicitly to make the income tax bear heavier on land rents than on the returns to capital.

The link between Commons and Heller is Professor Harold Groves, a beloved avuncular figure who taught public finance at Madison and inspired many careers. Groves worked in tandem with Commons in the Wisconsin State Legislature, where Groves was an

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[2]Madison: University of Wisconsin Press, 1961; first published by The Macmillan Company, 1934. Volume Two, Chapter X, pp. 815-40 expound Commons' tax theory. It is almost pure Henry George, rephrased in Commons' distinctive lexicon.

[3]Commons, op cit., p. 819.

[4]John R. Commons, "A Progressive Tax on Bare Land Value". Political Science Quarterly XXXVII (1), March 1922, pp. 41-68. Also see Harold Groves, Financing Government. New York: Henry Holt and Company, 1945, p. 380.

[5]Commons, op cit., pp. 823-24.

[6]Commons, op cit., p. 833.

Assemblyman.[7] Heller took his degree and worked closely with Groves, who launched him professionally. Groves was well disposed to Commons' views, as evidence by his writings[8] and by his joining TRED, the Committee on Taxation, Resources and Economic Development. TRED at that time was fully committed to forwarding the ideas of Henry George.[9] Groves thoroughly approved, and supported us warmly. Only his failing health and early death kept him from leading the group.

Heller himself, before heading The CEA, wrote favorably (if diffusely) of using land taxation more heavily in what were then called less developed countries[10]. Heller's striking achievement, however, was stimulating investment by applying and developing the idea of fast write-off for new capital. This is the idea that Commons saw could do through the income tax what George would do through the property tax.

Fast write-off comes and goes. Reaganites revived it for a time as part of "supply-side economics." They often cited the Heller precedent as their authority. So Heller lives; Commons lives; George lives: you just need to look in the right places.

1986: retrogression dressed as The Tax Reform Act

In 1986 Congress eliminated the most Physiocratic feature of income taxation, viz. the preferential treatment of new investment in real capital formation. The three changes were:

1. Repeal of Investment Tax Credit (ITC).

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[7]Commons, op cit, p.841.

[8]Harold Groves, Financing Government, Chapter XVII, "Taxation of Natural Resources", pp. 362-84. This chapter draws heavily on Commons. It devotes more space to George and land taxation, and treats it more sympathetically, than any other standard text. See also "The Property Tax in Canada and the United States", Land Economics 24, pp. 23-30, and 120-28, 1948. See also "Impressions of Property Taxation in Australia and New Zealand", Land Economics 25, pp. 22-28.

[9]One cannot say the same of today's TRED. It has regressed toward the mean since Groves' time. Groves himself avoided that fate, in part thanks to Mrs. Groves, the former Helen Hoopes, an ardent single-taxer.

[10]Walter Heller, four chapters in Haskell Wald and Joseph Froomkin (eds.), Papers and Proceedings of the Conference on Agricultural Taxation and Economic Development. Cambridge, Mass.: Harvard Law School, 1954. The Introduction by Stanley Surrey credits Heller with additional major contributions to the overall research.

2. Lengthening tax lives.

3. Decelerating depreciation pathways.

These changes have raised the effective tax rate on most new investment. Traditional liberals applaud them as closing loopholes[11]. Economists, conservative or liberal, have been enchanted by "uniformity." Even Citizens for Tax Justice, a labor union tax lobby, has chimed in with praise and support for the 1986 reform[12]. Their zest for taxing new investment seems now to override their former support of a progressive rate structure.

Uniformity is a good rule as between mutually convertible things. Land and capital are inconvertible, so incentive taxation may treat them differently. Incentive taxation is not uniform, it is -- pardon the ancient expression -- Keynesian. Why Keynesian? Keynes always focused on the "marginal efficiency of capital," which in modern business lingo translates into the rate of return at the margin. The average rate of return includes rents; the marginal rate of return does not, it is the incentive to invest, the pure return to new capital as such. Incentive taxation distinguishes new assets from old. It takes a smaller bite from new investment and a larger bite from old, especially from land, the oldest of all.

The effect of closing these three loopholes for new investment is much the same as the local anti-Physiocratic action of broadening the property tax base to include buildings, plant and equipment, etc. When combined with lowering the maximum tax rate, it also shifts the tax off land, which is the purpose. Conversely, fast write-off (accelerated depreciation, expensing, et al.) is a Physiocratic action. It equals tax relief to stimulate investment in, and creation of, real new capital. It lets the basic tax rate be higher, thus taking more land rent.

Before 1986 a high-bracket professional -- physician, lawyer or actor -- could avoid the effects of high marginal tax rates by investing in certain kinds of real new capital: buildings, equipment, machines, rolling stock, furnishings and fixtures, trees, vines, or livestock. This did, it is true, make for overcapacity in certain kinds of capital, e.g. avocado trees in California, offices in Texas. Some forms of capital received

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[11]Walter Heller's son, Professor Walter P. Heller of U.C. San Diego, tells me that in 1986 Walter Heller opposed accelerated depreciation because it was used too much to shelter income from old assets. He continued to favor ITC, his "baby," because it can only be applied to new capital.

[12]Bruce Fisher, "Bush Crowd has a Plan", L.A. Times, 2 Oct 89, Section II p. 5. Fisher is research Director, Citizens for Tax Justice, Washington D.C.

much more exemption than others. I will not defend the abuse. But today that professional is better off buying up old capital and land. Corporations are moved to join the merger-mania which creates no new wealth at all.

This poses worse problems, like overpricing land, and pricing median investors out of the market. It also tends to reduce saving and domestic capital formation. This is the message of many new economists like James Poterba[13], whose chapter is in these covers.

What are "capital gains"?

The 1986 tax reform was a massive shift of income tax liabilities off land (by lowering the top rates), and onto new investment (by decelerating write-off). Its only saving grace, from the viewpoint of Physiocratic incentive and redistributive taxation, was eliminating the preferential lower tax rate on capital gains. (Technically, it eliminates the exclusion of part of long-term gains from the base). The "saving grace" was a political bargain, to maintain some of the social compact while lowering the top rates from 70% to 28% in history's most massive shift toward a flat rate income tax. Now one side of the bargain is being reneged, "driving a stake in the heart" of the 1986 compact[14]. The Administration knowingly lost much goodwill with Congress on this single issue, even risking its ability to govern in 1989. What are capital gains to warrant such hazards?

The term "capital gains" is a disguise, artfully contrived, growing more obfuscatory with long usage and growing complexity. It is the nature of most actual capital to depreciate, usually fast. There are few true resale gains to capital as such. It is rather land, irreproducible and limited, whose nature is to appreciate and yield unearned increments. There are exceptions, which the champions of downtaxing gains may use in debate; but exceptions are no basis for framing generalities or public policy. As a broad rule we are on the mark to read "land gains" where the world writes "capital gains."

As Lester Thurow wrote, "If lower capital gains taxes were limited to plant and equipment investment in new, high-risk venture capital situations, one could understand the proposal ... But the lower ... rates will also apply to antiques, ... land, ... assets that have nothing to do with reindustrialization. For every dollar's worth of reindustrialization incentives offered, several dollars worth of incentives will be provided for

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[13]George Hatsopoulos, Paul Krugman and James Poterba, Overconsumption. Waltham, Mass.: American Business Conference and Thermo Electron Corporation, 1989.

[14]Tom Redburn, loc. cit.

nonproductive investments."[15] James Poterba, as we have seen, estimates a very small share of capital gains derive from "venture capital"[16]

Corporate shares also yield "capital" gains. What makes these shares rise is the rise in value of corporate assets. The writer has shown elsewhere[17] that a large share of corporate assets consist of land (in the generic sense of natural resources).

The strongest reason for favoring capital gains is this. Another source of the rise in stock prices is the plowback of undistributed profits. Some of this actually does go to create real capital. (The rest goes to acquire old capital and land.) By this indirect route, a portion of any cut in capital gains taxes does actually foster real investment, as claimed. But the portion is too small, and the productivity of the investment often low, because this captive internalized undistributed profit comes to management free of any competitive market cost or test.

When the purpose of Congress is really to encourage new investment, fast write-off of new capital is the obvious tool. The tool was highly developed and applied during the 1960s, as noted above. It would also help to allow full deduction of capital losses, a provision conspicuously missing from current proposals, and indeed all reform proposals since 1932 or so.

The main effect of untaxing land gains, on the other hand, is simply to redistribute wealth and overprice land. When tax benefits go to land, the word "incentive" takes on a new and lesser meaning. Land, by definition, is not created by capital formation. Incentives to buy and hold land will raise the demand, not the supply. The incentives created are not the kind that produce anything or employ anyone. They simply raise asking price and exclude marginal buyers from the market.

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[15]Lester Thurow, "Getting Serious about Tax Reform". Atlantic M? date? Thurow's later endorsement of VAT does not seem very consistent with this passage.

[16]James Poterba, loc cit.

[17]Mason Gaffney, "Adequacy of Land as a Tax Base". In Daniel Holland (ed.) The Assessment of Land Value (1969). Madison: University of Wisconsin Press.