

IN DEFENSE OF CARTER: A PERSONAL OVERVIEW

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I. HIS original charge to me, the editor of this symposium invited me to range freely and at will over the subject matter treated in the other papers, to underline particular points that I thought were especially important, to differ with statements that I felt merited criticism, to "take off" on the basis of issues raised in the papers and add points of my own, and to feel free to refrain from comment where I had little to say or to add. In the present paper, I feel that, for better or worse, I have done all these things. I have chosen as my major theme "In Defense of Carter" in part because that is where I have stood ever since my first immersion in the massive six-volume report in the Spring of 1967, and in part to try to counterbalance the natural inclination of participants in a symposium such as this to do something other than just shower fulsome praise on the object of their study—an inclination which leads quite naturally to criticism of one kind or another.

In Section II I put on the stand my main "witnesses for the defense," Peckman and Okner are there to testify to the wisdom of the Carter system and to reveal the many ways in which applying it in the United States would improve the equity of our personal income tax structure. Stone takes the stand to state how the adoption of something like the Carter proposals in the U.S. would greatly reduce costs of administration and compliance. Break appears in order to underline the important contributions that the Carter system would make to economic efficiency.

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In Section III I cross-examine two prosecution witnesses—Shior for his somewhat qualified but nonetheless apparent approval of a series of traditional arguments favoring the differential tax treatment of capital gains, and Lynch and Withersell for what appears to me to be an unwarranted concern that corporate retentions would fall markedly if Canada were to adopt the Carter integration proposals. In between these two cross-examinations there is a brief peroration by the defense attorney to the effect that nearly everybody, in considering the question of Carter's effects on savings, seems to have concentrated on the impact of the redistributions of income that the proposals would imply, and to have totally ignored the potential increase in savings via the substitution effect response of individuals to the higher after-tax yield on savings that would certainly result from the move.

Section IV contains another peroration, this one arising out of the subject-matter of the Mieszkowski and Tillinghast papers. Rather than deal as they do with the international legal, national revenue-loss and similar issues surrounding the proposal to in effect eliminate the corporation income tax for Canadians but not for foreigners, I try to reach a rough estimate of the capital-market effects of full elimination of the corporation tax as compared to those of the partial elimination proposed by Carter. I find the capital-market effects of full elimination to be so dramatically disruptive, and those of the Carter proposal to be so benign, as to warrant the conclusion that partial integration can be more than adequately defended on this ground alone.

In Section V the last prosecution witness, Albert Breton, is cross-examined. His weighty case in favor of measuring

the combined degree of progression of taxes and expenditures, rather than of taxes alone, is accepted in principle, but it is argued that the Carter Commission did essentially this on the implicit assumption that the expenditure patterns would continue to resemble that which prevailed when the Commission did its work. Having accepted this, I take issue with Breton concerning his assertions as to the way in which expenditures on public goods should optimally be financed, and concerning what he alleges to be the non-neutrality of head taxes. Finally, I juxtapose to Breton's welfare approach an explicit statement of the schema of postulates underlying most traditional tax and expenditure analyses, and I attempt to show that the approach reflected in the Carter Report appears to be based on this schema.

No reference is made in this paper to the studies by Groves, Jantscher and Lent. My neglect in these cases is solely due to my own lack of expertise in the particular areas which each of them explores with such apparent command over his material.

II.

Perhaps the best way to launch my defense of Carter is on a positive note. It would be difficult to imagine a more telling testimony to the power of the Carter proposals to greatly foster the avowed goals of vertical and horizontal equity, than is provided by the impressive paper by Peckman and Okner. Despite the differences in size, in economic and demographic structure, and in the current legal systems and tax frameworks of the two countries, it is indeed surprising to find that a careful simulation of the effects that the Carter proposals would have in the United States (with rates adjusted proportionately so as to produce a yield approximately equal to that currently obtained), would be to increase moderately the degree of equality in the after-tax distribution of income (see Figure I and Table V) and

to phenomenally improve the degree of horizontal equity as among different sources of income (see Figure II and Table VI). And this results not from the assumption that the corporation income tax is shifted (in which case its elimination would not be expected to significantly reduce the degree of progression), but rather from the assumption that this tax is borne by income groups in proportion to their dividend receipts.¹ (An assumption which, given the concentra-

¹ This particular allocation of corporation income taxes represents the one favor (other than those acknowledged by the authors as stemming from inadequate data) in an otherwise elegantly designed statistical simulation. At issue is whether the burden of the corporation income tax strikes owners of capital generally or somehow is confined just to the owners of equity shares in corporations. To the extent that the capital market functions well, it is to be presumed that the net-of-tax yield on corporation equities cannot be driven down by the corporation income tax without (after a plausible adjustment period) the rates of return to capital in non-corporate enterprises and the yields on interest-bearing obligations suffering also. (See my TAXATION: Corporation Income Taxes, *International Encyclopedia of the Social Sciences* (New York, 1968, Vol. 15, p. 541).) Treating dividends as the appropriate base on which to allocate corporation income taxes to individuals implicitly embraces the idea that it is shareholders alone who bear the burden. Even though the authors in a sense cover themselves by a footnote stating that their study is confined to first order effects, I cannot avoid concluding that an allocation based on "dividend plus interest income," or even better, on "dividend plus interest income plus a plausible fraction (attributed as earnings of noncorporate equity) of noncorporate business income" would be a far more satisfactory reflection of the fundamental economic processes underlying their basic assumption that "the corporation tax is not shifted forward to consumers or backwards to employees" (p. 4).

I doubt very much, however, that such a correction would have any significant effect on the general tenor of the results that Peckman and Okner report. If anything, their findings that the Carter proposals would increase the progressivity of the U.S. tax system would be strengthened, for interest income and the income from capital in non-corporate enterprises are not as strongly concentrated toward the top of the income distribution as are dividend receipts.

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tion of dividends in the upper brackets, implies that Carter's proposed effective repeal of the corporation income tax for Canadians would by itself have a very strongly regressive effect).

It is also, of course, an additional indictment of the many loopholes of the U.S. tax system that closing them along Carter's lines would produce enough revenue to permit a) the elimination of that \$30-billion-a-year anomaly called the corporation income tax, b) a substantial increase in the progressiveness of the tax system, and c) a marked reduction in the top bracket personal tax rate, *all* without loss of revenue!

While Pechman-Okner attract us to the Carter system by displaying a very appealing vision of how it would influence vertical and horizontal equity in the broad, Stone concentrates on a multitude of detailed ways in which horizontal equity could be improved and on a variety of problems of administration. As an economist who has studied the Carter proposals in some detail, I was pleased but not surprised that the equity goals embodied in them would also gain enthusiastic approval from a lawyer. But I was totally unprepared to find the proposals winning the battle of administrative simplicity and feasibility by a wide margin.

On Integration: "[Its] effects . . . from a lawyer's viewpoint, would be an enormous simplification. . . . The elimination of a separate corporation tax would immediately wipe out much of the relevance of [some of] the most complex provisions of our [corporation] law" (p. 29). "In sum [on integration in general] any new problems would be swapped by those eliminated by the Commission's recommendations" (p. 29).

On Capital Gains: "To say that [the Carter-proposed] change would simplify the U.S. income-[tax] picture . . . would be a gross understatement. . . . The theoretical distinction between capital and income . . . disintegrates on close inspection. . . . The removal of the capital gains

distinction and the separate corporate tax together with the reduction of the highest personal rate to 50 per cent, the same as the corporate withholding rate, would end most of today's intricate income tax planning involving corporations. . . . [and] would go a long way toward ending the real estate tax shelter, which depends on [a preferential] . . . capital gains tax" (p. 30).

On Gifts and Inheritances: "The Royal Commission's recommendation that gifts and inheritances be included in income could thus be accomplished by a simple repeal of Section 102 of the Internal Revenue Code . . . ; indicating congressional intent to have [them] taxed. . . . While some relatively minor complexities would be added to the income tax system as a result . . . , the simplification that would result overall would be enormous."

Though the above citations accurately reflect, I believe, Stone's enthusiasm for the Report from an administrative and legal point of view, it would be unfair to leave unmentioned that he is anything but sanguine about the chances of drastic reform in the political arena.

The discussion of integration by Break is largely centered on market efficiency. He emphasizes that the Carter proposals would essentially eliminate existing discrimination a) as between the corporate and the non corporate sectors, b) as between dividend payout and retention, and c) as between debt and equity financing. In addition, after a careful series of estimates attempting to quantify the possible degree of lock-in effects under Carter, Break notes that the inclusion of undistributed profits in personal taxable income (with a corresponding writup of the shareholder's basis for the calculation of capital gains) "would make a very significant contribution to the minimization of future lock-in effects" (p. 48).

In one summary paragraph, Break states: "On the whole, then, with the full Carter integration plan in operation, the risks of unfavorable investor reactions

seen minimal, and the promise of improving the fluidity of securities markets seems considerable. In addition, there would be the greatly increased equity of the income tax system, as well as the efficiency gains to be realized by removing some of the major tax barriers to the optimal allocation of resources."

He alerts the reader to three possible unfavorable effects of the adoption of the Carter proposals in the United States, but he does not assert that they are likely. In fact the two studies already reviewed seem to alleviate two of his three worries. The Pechman-Okner study suggests that there is no good empirical reason to expect that the application of Carter principles in the U.S. would result in an excessively large revenue loss. And the Stone paper seems authoritatively to lay to rest any fears that administrative and compliance costs would be higher.

Break's only remaining worry is that full integration would "reduce the effectiveness of such federal policy tools as tax credits, accelerated depreciation and similar devices." But he goes on to say that the importance of this last worry is moot, and to suggest some possible solutions should it turn out to be important.

III.

Richard Sittor's study of the capital gains provisions of the Carter Report reflects an eclectic's concern with regard to the Commission's zealous and single-minded application of the Haig-Simons principle that all accretions to wealth are income and should be taxed as such. He lists, with varying degrees of approval, nine traditional arguments supporting the preferential taxation of capital gains. Some of these (e.g. the "psychological argument," "the balance between corporate and personal capital accumulation," and the "divergence between capital gains and the national income concept") would appear to imply a significant degree of irrationality on the part of individuals in their economic actions. With

respect to the first, which asserts that capital gains are somehow treated by individuals as being in principle different from income, I would not argue that the nature of an individual's response to a particular type of capital gain should not be different from that to a rise in his salary. Rather, I would distinguish between the ways in which these changes alter his view of his present worth. The capital gain may (but need not) be treated as a once-and-for-all windfall, and the salary rise may be taken as portending a generally higher income stream for years to come. But on the other hand, as the market for IBM stock indicates, capital gains are in that and similar cases quite confidently projected into the future, while on the other hand the earnings of many self-employed often display movements that must be regarded as of a transitory or windfall nature. I would contend that a rational individual would react similarly to a pure windfall, regardless of whether it came under the label of capital gain or of ordinary income (assuming equal tax treatment), and that he would likewise react similarly to a given change in the expectation and variance of future accretions, again regardless of whether ordinary income or capital gains were involved.

Similarly, one is on rather shaky theoretical ground in treating corporate and individual saving as fundamentally different things. So long as corporate saving tends to be reflected in capital gains, individual shareholders can decide to save more or less than their companies have saved for them, simply by consuming less or more than their ordinary income computed without regard to capital gains. This is not the place to try to set out all the capital-market ramifications of this principle. Suffice it to say that at least in Canada and the United States it appears that all important segments of the investing public have tended in the past to undertake significant savings

above and beyond what corporations have saved for them. More will be said on this issue below.

Thirdly, the divergence between capital gains and the national income concept should not itself be grounds for the preferential treatment of real as distinct from artificial gains. One doesn't have to concede the day to Henry George in order to subject accretions in real property values to income taxation! And, of course, to the extent that capital gains reflect corporate saving, they are already captured in the national income.

Three other arguments cited by Sliitor are, I believe, reasonably adequately covered in the Carter package. These include the issues of adequate provision for capital loss offsets, of the necessity for sufficient averaging possibilities when the tax structure is progressive, and of the lock-in effect. One additional argument—the "safety valve" theory—may or may not fall into this category. Under this view capital gains preferences provide an escape from the perils of excessive progression in the tax structure and give a sometimes vital incentive to investment. In a sense, this is Carter's view of the current Canadian system. Capital gains taxation at full rates is justified not within the present context but as part of a package which essentially eliminates the corporation income tax as far as Canadian investors are concerned and substantially reduces the personal tax rate structure as well.

To go beyond this and argue for preferential taxation of capital gains even under Carter's integration scheme leads us to the two final arguments listed by Sliitor. These are "capital gains as prepayment of ordinary tax" and "illusory capital gains." The first of these is nothing more nor less than the reflection, in the capital-gains area, of the general proposition that an income tax is a double tax on savings. There can be no doubt that a progressive expenditure tax of the Kaldor type, perhaps combined with a value-added tax of the consumption

type, is—on grounds of its neutrality vis-à-vis the saving decision—theoretically more attractive than an income tax of the Haig-Simons-Carter type. Whether there is much practical difference between the two is mainly a matter of the (compensated) elasticity of savings with respect to the interest rate. If this elasticity is very low, the path of saving through time will be much the same for a Kaldor system and a Carter system of approximately equivalent overall progressivity and yield. If the elasticity is high, the Kaldor system will produce significantly more savings.

On "illusory" capital gains (i.e. those stemming from inflation or from changes in the rate of discount of future income streams), I am afraid I must take a stand with Carter and against Sliitor's solicitude for the equity holder, reflected in his concern about taxing illusory gains on equity "even if it is not possible to go all the way and tax real gains of debtors and allow real losses of bondholders and other creditors." Consider first the case of expected inflation. If with zero expected inflation the before-tax yields on all types of instruments would be 6 per cent, then with a three per cent expected inflation, they would tend to be around 9 per cent. For bondholders and stockholders alike the real yield will be $9(1-f)-3f$ per cent, where f is the relevant marginal tax rate. For the case of a previously unexpected inflation, bondholders are clearly worse off than stockholders. The holder of a six per cent consol would have his annual real yield fall from $6(1-f)$ to $6(1-f)-3f$, at the same time as the capital value of the instrument fell from 100 to 67. On the other hand equity holders would accrue capital gains stemming from the fact that the real assets "financed" by "old" 6-per cent bonds were now yielding 9 per cent, while the interest payments on the old debt remained at 6 per cent. Under all circumstances holders of cash would tend to suffer most of all.

Thus, granting preferred treatment to

inflationary capital gains amounts to preferentially relieving precisely that group (i.e. equity holders) which suffers least from inflation and may (with adequate leverage in the form of old debt) even benefit absolutely.

Even more important, perhaps, than the above considerations is the fact that one of the best guarantees against inflation's becoming a permanent part of the system is the built-in stabilizing power that is provided by the taxation of nominal capital gains as income.

In his discussion of the economic effects of the Carter proposals, Sliitor presents an extended treatment of their possible impact upon savings. In it he cites the estimates of the Carter report itself, that as a result of the proposed reforms there would be a \$65 million increase in savings, consisting of a \$135 million decrease in personal savings and a \$200 million increase in government savings, with corporate savings remaining essentially unchanged. Sliitor concludes his analysis with the statement that the "substantial cuts in personal saving are the result of the capital gains component of the reform package" (p. 74) and expresses his concern for this fact.

Without attempting to treat Sliitor's discussion on its merits, I would like to seize upon this opportunity to point out a much-neglected aspect of the savings effects of the Carter proposals. In a word, the Carter report's estimates of savings effects are based on the anticipated redistribution of income that the proposals would bring about; they include no allowance for the substitution effects that would flow from the anticipated overall increase in net-of-tax rates of return to saving. Whether much or little should be made of this point depends upon one's judgment of the compensated elasticity of savings with respect to the rate of interest. How large this elasticity is is certainly still an open question. But the fact that total revenues

under Carter will be approximately the same as under the present system means that the compensated elasticity is to be preferred to the uncompensated one as the relevant measure—and the compensated elasticity is necessarily positive (or zero in the limit).

A second point is that the only study which explicitly sets out to measure the compensated elasticity finds, for two sets of data covering the periods 1897-1949 and 1929-59 in the United States, an elasticity of approximately 0.2.² This is not a negligible figure; to indicate its possible meaning for Canadian saving under the Carter proposals, I will present some estimates based on the capital-market-equilibrium assumptions used in the concluding section of my "A Landmark in the Annals of Taxation."³ These

² See Colin Wright, "Some Evidence on the Interest Elasticity of Consumption," *American Economic Review*, LVIII (September, 1967), pp. 850-855.

³ *Canadian Journal of Economics*, Vol. I (Supplement), 1968, pp. 191-193.

The same supplement contains the only discussions of the Carter report (of which I am aware) in which some allowance is made for the substitution-effect response of savings to the recommended changes. (See Grant L. Reuber and Ronald G. Bodkin "On Estimating the Effect of the Carter Commission's Recommendations on Domestic Savings," *ibid.*, pp. 206-232, and John Hellwell, "Stimulating the Macroeconomic Effects of the Carter Proposals," *ibid.*, pp. 233-254.) Reuber and Bodkin follow a procedure similar to that employed here. Their estimates of the change in savings induced by Carter through the substitution effect are smaller than mine, largely because of two consciously conservative assumptions which they employ: i) the assumption that the interest rate elasticity of saving was .15 rather than the .2 or more suggested by Wright's results, and ii) the exclusion of corporate savings attributable to Canadian investors from the base to which the elasticity is applied. Hellwell does not isolate a specific measure of the substitution effect upon savings, but since his basic model incorporates negative elasticities of consumption with respect to several rate-of-return variables, a substitution effect of undetermined size is implicit in the final results yielded by his simulation procedures.

assumptions are that the "typical shareholder" has a 50 per cent marginal personal tax rate under the present system,

but would have a 40 per cent marginal rate under Carter, that the dividend payout ratio is 40 per cent, and that the "typical company's shares exhibit normal 'goodwill gains' of 0.5 per cent per year, above and beyond capital gains reflecting retained earnings. Equilibrium between equity and bond markets (taking the latter to include all fixed-interest claims) is assumed to be established where the net-of-tax yield on equities is equal to the net-of-tax yield on bonds times a given multiplicative risk premium (equal to that estimated to produce equilibrium in the market at the time [1967] the study was made), or alternatively, that these two net-of-tax yields differ by an additive risk premium (also derived on the basis of the 1967 market situation). The current bond rate was taken to be 6 per cent, and the implications of the Carter proposals were worked out under two alternative assumptions: a) that the market interest rate remains unchanged, and b) that the new system will bring with it a rise in the equilibrium market interest rate to 7 per cent. The following table presents after-tax yields to the "typical share-

holder" under alternative assumptions regarding market interest rates and the nature of the risk premium.

When a multiplicative risk premium is assumed, the after-tax yield on both bonds and shares goes up by 20 per cent if the market interest rate remains unchanged, and by 40 per cent if the market interest rate rises to 7 per cent. Assuming that the saving done by Canadian individuals themselves plus that done by Canadian companies on their behalf is around \$3 billion a year, the increment to savings through the substitution effect implied by an interest rate elasticity of 0.2 would be between \$120 million and \$240 million for post-Carter market interest rates between 6 and 7 per cent.

When an additive risk premium is assumed, the after-tax yield on bonds again goes up by 20 to 40 per cent, but that on stocks rises from 10 to 20 per cent depending on where market interest rates settle in the range from 6 to 7 per cent. A plausible guess would be that, with an additive risk premium and an interest-rate elasticity of 0.2, the incremental savings induced through the substitution effect under Carter would lie between, say, \$90 million and \$180 million.

I must emphasize that the above estimates are too crude to be more than illustrative of what a compensated interest-rate elasticity of 0.2 might imply. My main purpose here has been to alert readers to the facts a) that most existing estimates of the effects of the Carter proposals on savings have neglected the substitution effect, and b) that this effect is potentially of sufficient importance that some allowance probably ought to be made for it when overall judgments are made concerning this aspect of Carter.

In contrast to Sifton, who is concerned among other things with the impact of the Carter proposals on the overall magnitude of national savings, Lynch and

Witherell are concerned with how much saving will be done at the corporate level. Their problem is thus a comparatively minor one so long as the overall level of savings is not adversely affected, although it must be noted that their concluding paragraph appears to reflect doubt as to whether corporations would be able to make up by new issues, in a Carter world, for the loss of retained earnings that they fear the Carter proposals would imply.

I have already indicated that the principles of rational behavior suggest that the ultimate decisions concerning the rate of national private-sector savings are made by individuals, who can achieve their personal savings objectives by adding to or subtracting from what corporations save on their behalf. This, together with making some allowance for the substitution effect of the Carter proposals on saving, as suggested above, leaves small room for fears of a serious drop in the rate of private saving out of disposable income.

I therefore turn to the issue which occupies the bulk of the Lynch-Witherell paper, of whether there would in fact be a large drop in cash retentions if the Carter proposals were adopted. The paper by Break provides a convenient starting point for the treatment of this issue. In his Table VII, Break presents values for the payout ratios that would, under Carter, give individual shareholders the same cash flow as they now have out of a dollar of pre-tax corporate profits. He shows that for companies with current payout ratios of 60 per cent or less, the current cash flow could be matched or exceeded under Carter (with a maximum marginal rate of 50 per cent) by dividend payout ratios ranging from zero to 30 per cent. Thus if investors desired simply to have as much cash as now, out of each dollar of corporate pre-tax profits, the implementation of this desire would entail a sharp reduction in payout ratios. The reduc-

tions Break implies would be even sharper had he taken into account that marginal personal tax rates would be lower under Carter than they are today.

But it certainly is arguable that if investors care about the percentage that is distributed in dividends, their decisions in this regard would concern the fraction of available income that they would like to receive in cash, rather than the cash flow out of a dollar of pre-tax earnings. I shall here explore this hypothesis for the case of a "typical shareholder" who now has a 50 per cent marginal personal tax rate and who would, under Carter, have a 40 per cent marginal rate, on the assumption that corporate savings are reflected in capital gains, and for a current payout ratio of 30 per cent. The calculations under these assumptions are carried out in the following table. Note that the individual income tax payable on dividends under the present system is (.5 - .2) times the amount of the dividends, reflecting the 50 per cent marginal tax rate and the 20 per cent dividend credit. Available income is simply cash flow (defined as dividends minus the personal tax on them under the present system, and dividends plus the tax rebate on corporate withholding under the Carter System) plus corporate retentions.

The conclusion emerging from the table is that the current ratio of cash flow to available income, which equals .23 under the assumptions used, could be duplicated under Carter with a 7.6 per cent payout ratio. Corporate saving under Carter would be .462, whereas under the present system it is .35. If the same comparison is made using a current 40 per cent payout rate, the corresponding payout rate under Carter is 19.6 per cent. On this basis 30 of retained earnings under the present system is to be compared with 40.2 under Carter. Finally, in any case where the current payout ratio is 22 per cent or less, the ratio of cash flow to available income

AFTER-TAX YIELDS ON STOCKS AND BONDS TO THE "TYPICAL SHAREHOLDER" UNDER ALTERNATIVE ASSUMPTIONS

Type of Security and Nature of Risk Premium	Market Interest Rate	
	Current	Under Carter
Bonds	.06	.07
Shares (with multiplicative risk premium)	.03	.036 .042
Shares (with additive risk premium)	.06	.072 .084
Shares (with additive risk premium)	.06	.068 .072

*The concept of a "typical shareholder" is defined in *ibid.*, p. 162, footnote 2.

will be higher under Carter than it is now, even if no dividends are paid.

ILLUSTRATIVE CALCULATION OF PAYOUT RATIO UNDER CARTER WHICH IS REQUIRED IN ORDER TO MAINTAIN CONSTANT THE FRACTION OF AVAILABLE INCOME RECEIVED BY THE INVESTOR IN CASH

Current System	
Corporate Income Before Tax	100
Corporate Income Tax Available for Distribution	50
Dividends	15
Individual Income Tax [15(.5 - 2)]	4.5
Cash Flow [15 - 4.5]	10.5
Available Income [50 - 4.5]	45.5
Ratio of Cash Flow to Available Income [10.5/45.5]	.23
Carter System	
Corporate Income Before Tax	100
Corporate Income Tax Withheld Available for Distribution	50
Dividends	3.8
Personal Tax Rebate [100(.5 - .4)]	10
Cash Flow	13.8
Available Income [100 - 40]	60
Ratio of Cash Flow to Available Income	.23
Implied Corporate Payout Ratio (3.8/50)	7.6%

Thus the current ratio of cash flow to available income could be maintained under the Carter system with a much lower dividend payout ratio. This is not to deny that in all likelihood people would prefer, under Carter, a higher ratio of cash flow to available income than at present, because the current tax system clearly discriminates in favor of earnings retention. What I do contend is that there is an ample range over which the cash flow-available income ratio can be increased while simultaneously increasing corporate retentions, and that the cash flow-available income ratio is a much more rational object of investor preferences, as one tries to compare the current and the Carter systems, than is the dividend payout ratio.

IV

The papers by Mieszkowski and Tiltinghast are concerned with the international aspects of the Carter integration proposal. Both concede that the proposal

to retain the corporation income tax vis-a-vis foreign investors, while in effect eliminating it vis-a-vis domestic investors, entails a substantial deviation from accepted principles of international neutrality. But in the end Mieszkowski is more ready than Tiltinghast to concede Canada's "right" to take such a step. Tiltinghast says:

One can sympathize with Canada's reluctance to cede needed revenues to a richer neighbor; and it is difficult to see, as a practical matter, how Canada could afford to extend integration benefits to the American-controlled giants. If internal political and economic policies dictate the adoption of integration, the question which Canada and its free-world partners must decide is whether pressures or principles militating against national-investor preference in the end are strong enough to force the abandonment or dilution of the integration proposal (p. 86).

Mieszkowski, on the other hand, says:

This is a distributive matter that affects the treasures of Canada and capital exporting countries. The argument that this policy "discriminates" against foreign investors is not convincing. Most foreign investors would end up paying the same tax regardless of whether the tax is eliminated for all investors or is eliminated only for Canadian residents. If countries which export capital to Canada are unhappy about the distribution of tax revenues they should press their case independently of this particular Carter recommendation (p. 108).

I do not propose to enter the debate on the question of neutrality as such or on the legitimacy, in some sense or other, of the proposed treatment. Rather, I would like to assess the wisdom of the Carter proposal in terms of its likely effects on the Canadian capital market.

The issue is that Mieszkowski is only partly right when he says that "most foreign investors will end up paying the same tax" regardless of whether the benefits of integration are extended to them or not. This need not even be true

for direct investments, and is clearly far from true for portfolio investments.

The simplest way to envisage the extension of the integration proposals to foreign investors is to assume that Canada repays its corporation income tax. Under such a change, subsidiaries of foreign companies would be subject to their home countries' corporation income tax. If that tax applied to the Canadian subsidiaries' income as it accrued, and if the rate of tax in the home country was the same as the current Canadian rate, the situation of the companies would be essentially the same as at present; their tax would simply be paid to their own rather than to Canada's treasury. If, on the other hand, the home-country tax on subsidiaries' income were tied to the repatriation rather than accrual of earnings, the effective tax burden on the subsidiaries would be significantly less than at present, even if the home-country tax rate were set at the current Canadian level. A company consistently repatriating, say, half of the earnings of its Canadian subsidiary could, for example, be liable for only half the United States tax that would apply if the foreign subsidiary's earnings were drawn into the U.S. tax base as they accrued. Although the Revenue Act of 1962 somewhat modified the earlier provisions under which the repatriation principle was essentially uniformly applied to all, it remains true today that the great bulk of the income from foreign subsidiaries is taxed on a repatriation rather than an accrual basis. Hence more is involved in extending full integration to foreign corporations than merely a transfer of revenues; in fact, a considerable overall loss of revenue would be involved, and U.S. firms would have a greater incentive than now to invest in Canadian subsidiaries rather than at home, for given gross-of-tax rates of return.

The case of portfolio investment by individuals is even more striking. If full integration were achieved simply by

abolishing the Canadian corporation income tax, it would be difficult for the Canadian tax authorities to capture the full income tax on corporate savings and on goodwill gains. On this variant the U.S. investor would be benefited not only by his not having to "pay" the Canadian corporate tax, but also by the more favorable U.S. personal tax treatment of capital gains. In this the U.S. holder of Canadian shares would have more favorable treatment than the Canadian holder.

Under these circumstances there would surely be a flood of new U.S. portfolio investment in Canada, which would grossly disrupt the Canadian capital market. To see this, let p_c and p_u be the equilibrium levels of the before-tax rates of return to corporate equity in Canada and the U.S., respectively, and let t_c be the U.S. corporation tax rate and t_u be the marginal personal tax rate of the "typical" U.S. shareholder of Canadian securities.⁴ For simplicity assume that the dividend payout ratio, δ , is the same in both countries, and that corporate savings are fully reflected in capital gains. Then the after-tax rate of return on investment in U.S. shares would be $r_u = p_u(1-t_u)[\delta(1-t_u) + (1-\delta)(1-25\lambda)]$. Here λ is a discount factor reflecting the postponement of the tax on capital gains, and the .25 factor builds in a 25 per cent nominal rate on capital gains. By contrast, the U.S. investor's after-tax return on his Canadian shareholdings would be $r_c = p_c[\delta(1-t_c) + (1-\delta)(1-25\lambda)]$. If U.S. investors operated so as to equalize the net expected rates of return on the two classes of investments, it is clear that equilibrium would be reached where $p_c = p_u(1-t_u)$. If p_u were 12 per cent, p_c would be around 6 per cent. For $t_c = t_u = .5$ and $\delta = \lambda = .4$, $r_c = r_u$ works out to be .0444.

But what of the typical Canadian investor in Canadian securities? He would receive a net-of-tax rate of return of $r'_c = p_c(1-t'_c)$ where t'_c is his marginal rate of tax. If p_c is 6 per cent, then a marginal

tax rate of .4 would imply $r'_0 = .036$. This would compare with after-tax rates of return on bonds equal to .036 if the market interest rate in Canada held at 6 per cent and to .042 if the market interest rate rose to 7 per cent. This compares with a current (based on 1967 data) after-tax rate of return on shares of something like 6 per cent (see table on after-tax yields, above). Far from giving Canadians a greater incentive to hold equities than at present, the outright abolition of their corporation income tax would result in a great disincentive to shareholding by Canadians, and would probably produce a massive influx of American equity capital into portfolio investments in Canada. Americans would bid up share prices to the point where, even more than now, they would dominate the equity scene in Canada, and Canadians, in all likelihood would be left holding the bonds!

By contrast with this stark picture, stemming from "full integration for all," the actual Carter proposals would barely cause a ripple in the capital market. The results of my earlier examination of the implications of Carter for the capital market were that interest rates would probably rise by less than one percentage point, relative to the U.S. level, and that the average of share prices would probably not change by much more than 10 per cent. The marginal yield on equity investments would remain, then, much the same as now, and neither direct corporate investors nor individual portfolio investors from abroad would face any substantial change in the market conditions facing them. The yields to U.S. investors, on both Canadian stocks and Canadian bonds, would remain close to where they are today (i.e. close to what those investors can obtain in the U.S. market). On the other hand, the net-of-tax yields to Canadian investors in both Canadian stocks and Canadian bonds would rise, and, assuming that the relationship between the two continues to be governed by risk premia reflected in

current market values, this relationship would itself be affected little if at all. In sum, I feel that Carter's restriction of integration essentially to Canadian shareholders is wisely designed to avoid massive shocks and disruptions in both national and international capital markets. In this sense it is, in terms of its effects, far more "neutral" than the alternative of outright abolition of the corporation income tax, the probable consequences of which I find frightening to contemplate.

V.

I turn now to Breton's very thoughtful paper. Breton faults the Royal Commission for having failed to take into account the expenditure side of the government ledger in reaching its judgments about both equity and efficiency. As far as the basic point with regard to equity is concerned, he is clearly on the side of the angels, at least in theory. One can imagine an allocation of government expenditure in Canada which was so heavily weighted in favor of the wealthy that the net impact of government activities on the welfare of the various income groups would be regressive. One can also imagine an allocation so heavily concentrated in the lower income groups that many people would judge the total degree of progression involved in this expenditure distribution plus the Carter tax proposals to be excessive. But I would judge that the Carter Commission was operating in the context of an expenditure distribution similar to that currently prevailing in Canada, and that within that context the degree of progressivity of the net contribution of the various income groups (the differences between the taxes that would be paid under the Carter proposals and the benefits received under the present expenditure distribution) would be regarded as reasonably equitable by most Canadians.

While, as already indicated, I cannot deny Breton's assertion that the benefit

distribution should in principle enter alongside the tax distribution in our general judgments of equity, I part company with him when he enters into further detail. The starting point of his analysis of neutrality is that many public expenditures are for public (and also non-private) goods. His second step is to demonstrate that "tax neutrality in this context would require that tax rates should be equal to the marginal value placed on [any public good] by each [individual]" (p. 160). From this he concludes that "except by accident, a poll tax cannot be a neutral tax In measuring the welfare cost of taxation the benchmark has to be a benefit tax, not a poll tax [Only] if the income elasticity of demand for public goods is greater than one is it possible for a basically neutral tax system like the one recommended by Carter to approximate a system of benefit taxes in such a way that in fact the over-all budget would be approximately neutral" (p. 161). "In the same fashion, if the income elasticity of demand for public goods is . . . less than one, benefit neutrality would require . . . a regressive income tax (p. 161).

There is one subtle and one not-so-subtle flaw in Breton's otherwise impeccable logic. To show this let me recapitulate his demonstration (Appendix, pp. 162-63) that the taxes that finance a public good should be proportional to the marginal utilities that the various individuals in the economy place upon it. Following Breton's notation, let S be the public good and P_1 and P_2 be the amounts consumed by individuals 1 and 2 of the single private good. Assume, too, that utility functions can be established for the two individuals, that the social preference function is such that these utilities are comparable and additive, and that the resource constraint of the economy is such that $P_1 + P_2 + S = R$, a constant. The constrained social utility function to be maximized is therefore the Lagrangian expression:

$$(1) U_1(P_1, S) + U_2(P_2, S) - \lambda(P_1 + P_2 + S - R).$$

The first-order conditions of a maximum are:

$$(2) \begin{aligned} a. U_{1P_1} - \lambda &= 0 \\ b. U_{2P_2} - \lambda &= 0 \\ c. U_{1S} + U_{2S} - \lambda &= 0 \end{aligned}$$

λ can here be identified as the "price" of the private good, and equation (2c) can be interpreted as saying that the sum of the marginal utilities which the two individuals attach to the public good will, at a social optimum, be equal to the price of the private good. Condition (2c) can also be written

$$(3) U_{1S} + U_{2S} - \alpha U_{1P_1} - (1-\alpha)U_{2P_2} = 0,$$

where α is an arbitrary positive fraction reflecting the fraction of the cost of the marginal unit of S which is borne by individual 1. If we require that no individual be worse off on this marginal move, (3) decomposes into the conditions of a Pareto optimum:

$$(4) \begin{aligned} a. U_{1P_1} &= \alpha U_{1P_2} = \alpha \lambda \\ b. U_{2P_2} &= (1-\alpha)U_{2P_1} = (1-\alpha)\lambda \end{aligned}$$

That is, individuals 1 and 2 will have to share the cost of the marginal unit of the public good in proportion to the marginal utilities they place upon it. This is Breton's result.

Two main points emerge from this analysis. The first is that the condition (3) for a social optimum (in which society as a whole is indifferent with respect to small marginal transfers of income among individuals) is consistent with any allocation of the cost of the marginal unit of S among individuals. The second is that even the condition for a Pareto optimum says nothing about the distribution of the costs of the inframarginal units of S among individuals. Breton therefore cannot infer that the regressivity or regressivity of the tax structure must reflect the regressivity or regressivity of the benefit structure. The most that one can say is that 1) whenever the society is indifferent to small

transfers, the optimum level of expenditure in a public good will be that for which the sum of the individual marginal utilities associated with the last unit of that good just barely covers its marginal cost, and 2) whenever society thinks that it already has the optimum distribution of net welfare, and insists on maintaining it constant, then regardless of the infra-marginal pattern of taxes and benefits associated with that distribution, marginal additions to the amounts of public goods being provided should be paid for by assessing the beneficiaries in accordance with the utilities that they attach to such marginal additions.

The major flaw in Breton's reasoning is his cavalier dismissal of the idea that a head tax is neutral. Any tax which falls on an item whose supply is zero-elastic by definition cannot by itself distort choices at the margin. To be sure, different patterns of head taxes will lead to different Pareto-optima, but that is because they change the distribution of income and wealth, not because they are allocationally non-neutral.

To conclude on a more positive note, let me suggest a schema that I feel is more realistic and useful than Breton's, and that is at the same time considerably more in accord with the philosophy underlying Carter. At the root of this schema is the distinction between taxes and user charges. Where we can identify the value of the benefits that a particular type of government outlay brings to particular individuals, and where it is administratively possible to collect a corresponding price at reasonable cost, and where it is judged appropriate on distributional grounds that the beneficiary should indeed be called upon to bear his share of the freight, let us by all means assess user charges. Where, as for the great bulk of government outlays, we cannot or do not choose to collect from beneficiaries, let us resort to taxes as distinct from user charges. In assessing the allocative effects of a tax or set

of taxes, let us compare it with a hypothetical neutral alternative (e.g. a head tax) with a similar distribution by income bracket and by other relevant categories. When analyzing the incidence (i.e. the distributive effects) of any tax on pattern of taxes, let us assume that the proceeds are exacted as tribute by an unknown outside power. These two key assumptions enable us to handle both allocative and distributive effects without opening the Pandora's box of having a different analyses of the effects of any given tax, associated with a way of spending the proceeds.

Similarly, when analyzing the allocative effects of any expenditure financed by taxes (i.e. not by user charges), let us assume that the financing comes from neutral taxes, distributed in a fashion similar to the benefits generated by the expenditure, and when treating the distributive effects of any such expenditure, let us assume that the funds are provided by some beneficent outside power.

Following these principles, we can decide on individual non-user-charge expenditures in terms of the net welfare benefits they produce, and on individual taxes in terms of the net welfare costs that they entail without constantly having to cope with both sides of the government ledger at the same time. In those relatively few cases where particular taxes might be allocated to specific purposes without being genuine user charges, it is obviously possible to make parallel studies of the allocative and distributional effects of a) the particular tax as a foreign tribute, b) the particular tax as against an allocatively neutral alternative of similar incidence, c) the particular expenditure as having been financed by an outside source, and d) the particular expenditure as having been financed by an allocatively neutral tax of similar distribution. Combining a) and c) we would then be able to estimate the distributional impact of the tied tax-expenditure package, and combining b) and d) we could do the same

as far as allocative effects are concerned.

Within this schema distributional effects can be treated in several ways, depending on the purpose at hand. In the first place one might want to inquire into the distributional effects of particular taxes or expenditures with regard to whether they seriously disturb accepted standards of horizontal and vertical equity. Thus a high milk tax might be adjudged deficient both on the ground that it discriminates against families with children and because, when added on top of a tax-expenditure system that is considered to be distributionally fair, it turns it into an unfairly regressive or insufficiently progressive system. In the second place, one's judgments of vertical equity must fundamentally be based, as Breton insists, on the overall pattern of taxes and expenditures, and not on the separate taxes and expenditures taken one by one. Here, however, we cannot follow a counsel of perfection; the facts of the "true" distribution of burdens and benefits of various alternative systems can never be more than very crudely determined, and even if they were known, one could never get full consensus regarding what was most desirable. Under those circumstances the best that can be hoped for is a general sense of whether the prevailing distribution is broadly acceptable or not. Even if it is broadly acceptable, there may still be some specific generally-recognized deficiencies which remain to be corrected, and these should have their place on the social agenda. In the third place, and as a corollary to what has just been said, once a distribution of burdens and benefits in the broadly-acceptable range is obtained, there should be essential neutrality with respect to modest shifts in the distribution as long as it does not cease to be broadly acceptable. This is essentially the underpinning of the Hicks-Kaldor principle of potential compensation, without which the rational analysis of real-world public policy decisions would be virtually impossible. It also

underlies the distinction between the case of the social optimum for a public good as reflected in equation (3) above (where the optimal distribution of the financing of the marginal unit is indeterminate) and the case of where no one is permitted to be worse off as a consequence of a social decision (i.e. compensation must be paid) which is reflected in equations (4) and in Breton's analysis.

I believe that the general schema just presented (which certainly has no claim to novelty) outlines the assumptions which, often unstated, have provided the theoretical basis for much of the established literature in the fields of taxation and public expenditure. In particular, I believe that it provides the underpinnings for the analysis given in the Carter Commission Report. The concept of horizontal equity pervades the entire report, and I find it inconceivable that what Carter considers to be serious horizontal inequities in the current system could even remotely be justified as appropriate user charges. If not, they should be eliminated, according to the schema presented above, and Carter is consistent with the schema in urging that they be. On the other hand, Carter's main concern with vertical equity is with the entire income-tax structure and not with the separate components of the proposed reform. Here, I read the Report as saying: "Many will find the proposed distribution of the income-tax burden preferable, many more will find it not perceptibly different, and few will find it inferior to the present one, in terms of its contribution to the overall welfare of society and given the way in which public expenditures and other taxes are and are likely to be distributed in Canada" (my quotation marks). If this is a fair representation of what the Carter Commission felt, then they base their recommendation on the judgment that at worst the distributional consequences of their proposals will result in distributional changes within the "broadly acceptable" range.