

Section 301 as an alternative method of enforcing rights under collective agreements or should employees resort to state court actions with greater frequency, the necessity of preserving a degree of coherence between arbitration practice and rules of judicial decision would be heightened. The successful reconciliation of the functions of the judiciary, NLRB, and private arbitrators requires not only further definition of their respective jurisdictions but also the mutual understanding and respect which can be achieved only through evolution of basic principles commanding common acceptance.

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EFFECTS OF TAXATION: INVESTMENTS BY INDIVIDUALS. By J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger. Boston: Harvard Graduate School of Business Administration, Division of Research, 1953. Pp. xxxiv, 533. \$6.25.

This work by Professor Butters and his Harvard associates, the seventh and final volume in their series of studies of the effects of taxation on business, deals with questions which are at the very heart of the battle raging in Congress at this writing in connection with the pending tax revision bill. The bill, as passed by the House of Representatives,<sup>1</sup> would reduce taxes on dividend income by an estimated \$240 million in the fiscal year 1955 and by \$814 million in each year thereafter.<sup>2</sup> This reduction is supported in part by the argument that a reduction in taxes on dividend income will encourage investment in equity capital and thereby contribute to the expansion of our economy. The Democratic opposition, on the other hand, is urging, in lieu of a reduction in taxes on dividends, increases in personal exemptions in order to offset the current business recession.

In the great debate now going on, glib assumptions and facile rationalizations are being widely substituted for facts, partly because of the political character of the debate but also because of the lack of empirical data as to many of the basic issues involved. The work by Butters and his associates seeks to substitute factual data for conjecture as to the impact of taxation on investment by individuals. And a striking feature of the work is the extent to which the study negates postulates accepted as gospel in many financial and investment circles.

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1. H.R. 8300, 83d Cong., 2d Sess. (1954).

2. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954).

Before turning to the authors' findings, the methods employed in the study should be noted. In seeking to make an empirical investigation of the influences of federal taxation on individual investments, a list of 746 investors who did business with 53 investment banking houses or securities dealers over the country was selected, with a view to obtaining a representative sampling of varying income, wealth, and investment policies. Personal interviews, based on an exhaustive questionnaire, were had with the investors by staff members. Because a very large part of the potential investment capacity is known to be concentrated in the higher income levels, the authors used in their sampling 535 persons with incomes above \$7,500, an income group which represented in 1949 5 percent of the population, of whom 353 had incomes of \$12,500 or more. They also utilized as their source-data questions included in surveys of investors made by the Survey Research Center of the University of Michigan.<sup>3</sup>

The authors have provided us with the most detailed study which has been made of the impact of taxes on investment decisions—particularly in the higher income levels. The sampling was, of course, a small one, and the interviewing technique is open to some question as to how truthfully individuals report their actual motivations; this problem is intensified by the antipathy of most high bracket taxpayers for tax collectors. Nevertheless, the elaborate and carefully prepared questionnaire, coupled with the critical sifting and analysis of the data by the authors, tends to offset these weaknesses of the method. Moreover, when one is dealing with the elusive task of ascertaining the reasons for investments and the extent to which taxes affect the judgment as to the investment to be made, men's minds are being searched, and there appears to be no satisfactory alternative to the method used, which is widely employed in psychological and sociological studies.

The authors start with the proposition that business must look mainly to a very small proportion of the population,<sup>4</sup> the upper 10 percent income bracket, for individual investment in equity securities.<sup>5</sup> Indeed, the authors conclude that the top 3 percent of the population, with incomes

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3. While the study was based on interviews had in 1949, the data were analyzed in the light of developments taking place in 1950 and 1951. During that period, both individual and corporate taxes increased; but at the same time the high level at which the economy operated, the increased tempo of business, and the high level of individual savings (They increased from about \$6 billion in 1949, to nearly \$11 billion in 1950, and to over \$17 billion in 1951.) lead the authors to conclude that their results are substantially applicable to 1952.

4. The authors note that American business obtained the bulk of its equity capital for expansion and growth not from new stock issues but from retained earnings. P. 2. This matter is considered at length in an earlier study in this series. See SMITH, *EFFECTS OF TAXATION: CORPORATE FINANCIAL POLICY* (1952).

5. Pp. 16-29, 122-143.

of \$10,000 or over and holding about 75 percent of all marketable securities owned by private investors, provide the major reservoir of individual investment funds.<sup>6</sup>

The study does not substantiate the widely held belief in the business and financial community that severe increases in tax rates have for all practical purposes wiped out the capacity of individuals with large incomes to accumulate new investable funds. Instead, the writers find that while changes in the tax structure made in the past five or ten years have substantially reduced the capacity of the upper bracket taxpayers to accumulate new investable funds, their remaining capacity is still very large and, indeed, is much larger than is popularly supposed.

The fact that individuals in the high income brackets are still able to accumulate large amounts of investable funds under existing tax rates, makes it, in the authors' view, particularly important to determine the extent to which this potential equity capital reservoir has been absorbed as a result of federal tax policies. In approaching this problem, the authors divide investors into several categories. First, income and security minded investors in the higher income levels, who place major emphasis on an adequate income yield or on the preservation of their capital, tend to be driven by income taxes from high yield common stocks into low yield investments, such as government bonds. Such investors, particularly those in the top wealth classes, are influenced by income and death taxes to increase their holdings of cash, government bonds, and life insurance at the expense of corporate securities. When the authors turn, however, to the investors who are mainly interested in capital appreciation and are typically prepared to take risks of capital loss, they find that the effects of taxation are of an entirely different character. The single most important feature of the tax structure for these investors is, they find, the preferentially low capital gains tax rate, which has stimulated venturesome individuals to seek out investments offering prospects of capital gain. Significantly, because investors normally expect to make a profit and not suffer a loss, the authors found few instances in which individuals were deterred from making investments because of the limited deductibility of capital losses from ordinary income.

Turning from the types of investments into which investors put their money, the authors studied the influence of taxation on the timing of the buying and selling of securities. They sought to test the belief that the capital gains tax accentuates fluctuations in the securities market by discouraging the sale of securities on which there are large unrealized capital gains, thereby reducing the supply of securities offered for sale

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6. Pp. 25, 140; Ch. XVII.

and exaggerating market booms. The conclusion reached is that the timing of investment transactions was definitely influenced by the capital gains tax, but the authors were unable to find that these tax influences have in any sense been a dominant or major explanation of the swings in securities markets. Moreover, the data conspicuously fail to provide support for the charge that the capital gains tax impairs the transfer of capital from existing securities to new ventures on any significant scale.

The combined estate, gift, and income tax structure creates, the authors report, strong incentives for inter vivos and testamentary family gifts in trust. The setting up of a trust creates a new income tax entity beginning at the lowest tax bracket, removes wealth from the highest estate tax bracket, and substitutes the lower gift tax rates (again starting at the lowest rate bracket). These have been powerful incentives to the wide use of gifts in trust, in which management and control of wealth largely remain in the settlor. Moreover, with a life estate given to the prime beneficiary and remainders over to the secondary beneficiaries, ordinarily one generation of estate taxes is skipped.

Over-all, the authors find that the wide use of gifts in trust tends to create a greater conservatism in investments than if the property were held by the donor.<sup>7</sup> Corporate trustees in particular are traditionally and openly conservative in their investments.<sup>8</sup> The magnitude of the effect of trusts on investment policy may be indicated by the fact that in 1949 corporate trustees managed \$50 billion in assets for the benefit of private individuals—a sum approximately equal to the total policy reserves of all life insurance companies in that year. Hence, the effects of trusteeships in preventing the flow of funds into the stocks of less well-established companies and new ventures is not inconsiderable. Curiously, therefore, a major impeding tax effect on the venture capital market found by the authors is one for which the government itself is only indirectly responsible; but the conservatism of the one branch of the financial community itself, the corporate trustee, bears the primary responsibility.

What impact do these findings, the principal factual conclusions of the authors, have on the current revenue revision? Perhaps the most striking conclusion suggested is that the continued favorable treatment of gains on sales of securities—*i.e.*, taxation of net capital gains at the special 25 percent rate as contrasted with treatment as ordinary income—is a significant factor in inducing investments in equity securities and that the substantial disallowance of capital losses as deductions from ordinary income is not a serious deterring factor. However, as the

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7. Pp. 370-371.

8. *Ibid.*

authors carefully point out, granting of preferential tax treatment of capital gains poses a serious problem in tax equity in view of the taxation at ordinary income rates of wages and salaries, authors' royalties, doctors' and lawyers' fees, and the individual merchant's profits.<sup>9</sup> In weighing the impact of the existing capital gains tax on the investment market alongside considerations of equality in taxation, two of the authors favor "heavier taxation of capital gains," while the third believes that "both on equity and on economic grounds" the capital gains tax should be reduced.<sup>10</sup>

The study sheds light on several facets of the current dividend tax reduction controversy. One may fairly infer from the authors' findings that a cut in the effective tax rate applicable to dividends will tend to influence the more conservative and the income-minded investor to turn more readily to equity securities than he now does—although such incentives are not required to provide the equity capital needed by established businesses during periods of over-all prosperity and optimism (which are the only types of businesses in which this class investor will put his money in any event). In times of depression, the authors point out that the investment risks—not those concerning taxes but the risks of loss of capital—would constitute the major factor which would deter the ready flow of funds into equity securities. Moreover, as they point out, the existence of tax-free havens for investments, such as tax exempt state and local governmental securities and life insurance, appears to be a major factor in diverting the funds of income and security-minded investors away from corporate securities. The conclusion implicit in their study is that the closing-up of those avenues of investor income tax escape could exercise a highly important influence on the flow of funds into the corporate securities market. And finally, one may infer from the study that elimination of the tax advantage to the settlor of the family trust would go far towards freeing large amounts of potential investment capital for the equity securities market.

These are controversial conclusions not drawn by the authors but, in this reviewer's judgment, implicit in the study. It does not follow that a

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9. The justification for special treatment of capital gains provided by earlier statutes under which the broad objective of the capital gains tax was to approximate the liability which would have been incurred had the profit been realized ratably over the holding period no longer exists under the current law. Thus, under the Revenue Act of 1934, 100 percent of the profit was taxed at ordinary income rates if the security or other capital asset had been held for one year or less, 80 percent if the asset had been held for more than one but not more than two years, 60 percent if the asset had been held for more than two but not more than five years, 40 percent if the asset had been held for more than five but not more than ten years, and 30 percent if the asset had been held for more than ten years. INT. REV. CODE §117. Obviously, the rationale supporting the earlier statute has no application to the present law under which there is a maximum 25 percent tax for all capital assets held for more than six months. INT. REV. CODE §117(c).

10. P. 68.

wise over-all tax policy would embody these conclusions in a taxing statute. There may be strong countervailing considerations such as the effects of taxation of income from state and local governmental securities on the ability of hard pressed state and local governmental units to raise money and the consequent impacts on the entire local governmental tax and fiscal structure, which might make taxation of the income from such securities unwise. Likewise, taxation to the settlor of the income of family trusts would produce a whole host of other problems. In order to prevent tax avoidance and to produce equity among taxpayers, such a step might require taxation to the donor of all family income or at least of income from property which has been the subject of gift whether or not in trust. In short, the effects of a change in tax policy on the flow of capital into the equity investment market is only one of many considerations which must be weighed in shaping tax reform.

Facts have a way of being troublesome and disturbing to accepted notions. The tax investment facts produced by this valuable study, which constitutes an important contribution to the literature of the field, not only serve to undermine a good deal of wishful assuming but in addition suggest fresh and provocative lines of re-examination of tax policies affecting individual investments.

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