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FINANCING GOVERNMENT

FINANCING GOVERNMENT

BY

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REVISED EDITION

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Dedication

TO MY STUDENTS
WHOSE ASSISTANCE AND COMPANIONSHIP
HAVE MADE THIS UNDERTAKING BOTH
POSSIBLE AND ENJOYABLE

Preface

When one undertakes the preparation of a book covering the principles, practices, and problems of public finance and at the same time attempts to write something significant for scholars, college students, and the lay public, he is likely to combine so many objectives that he may miss all of them. But this is the well-established role of the textbook writer in public finance in the United States, and it is a risk which the author has ventured to assume. In order to reduce this risk, however, he thought it advisable to keep one of these objectives uppermost. The objective selected was that of meeting the needs of students; and thus the primary aim of this book is to give a clear and comprehensive exposition of the subject. Presentation and defense of a point of view are secondary. It would be difficult, if not impossible, to write a book on public finance without a point of view, and no attempt to do so has here been made. However, there has been an effort to designate controversial issues.

The organization of subject matter is somewhat unorthodox. Sources of revenue are treated in advance of public expediture. The main reason for the more conventional order as opposed to the one used here is that governments, unlike individuals, spend their money first and raise it afterwards. This is only partly and superficially true, if at all, and unimportant if true. On the other hand, the most challenging problems of public finance are in the field of taxation. After these problems have been mastered, the reader may explore the more descriptive field of public expenditure as time permits. The chapter on shifting and incidence, sandwiched between the property and income tax chapters, may appear out of proper order. Logically it should precede the treatment of the revenue system. The purpose of the present arrangement is to give the student some exposure to the practical problems of taxation before he becomes too heavily absorbed in their theoretical aspects.

A reasonably thorough exposition of the principles, problems, and practices of public finance affords more material than can be covered effectively in a one-semester college course. By far the best solution of this problem, in the author's opinion, is to give two semesters of work in the subject, the first semester to be labeled "Taxation" and to extend perhaps through Chapter XIV of this book; the second semester course to be called "Fiscal Policy" or "Taxes, Expenditures, and Debts" and to cover the remainder of the book.

Certain collateral readings concerning tax practices in the state where the subject is taught might well supplement the first course. Also, written topical work featuring, among other subjects, the tax problems of the student's home community would strengthen the first course, while the second course might well include some supplementary readings or special topical work on fiscal practices and policies in the different countries.

If resources permit only one semester of work in public finance, of the first nineteen chapters the following may be omitted or studied extensively rather than intensively: Chapters I, IV (except the first ten pages), V, XII, XV, XVI, XVII, XVIII, and XIX; beyond Chapter XIX all chapters may be omitted or assigned for extensive reading, except Chapters XXII, XXV, and XVIII.

It is to be regretted that in order to meet the needs of American students, a heavy reliance had to be placed on illustrative material especially applicable to the United States. In Europe treatises seem to satisfy the needs of a student by confining their scope to principles and general experience. This is not true in the United States.

. . . . . .

It is with pleasure that I take this opportunity to acknowledge my debt for much valuable aid in the preparation of this text.

My thanks are due to my assistant, Joseph Rosa, and my graduate students who undertook the task as more or less of a cooperative enterprise. Deserving of particular mention among the latter are Bristol Goodman, Jesse Burkhead, Raymond Brown, Stefan H. Robock, Vernon Israelsen, George Thatcher, Nancy Hart, Byron Johnson, Joseph McClintic, and Walter Heller. Each of them has rendered valuable service in gathering material on subjects of his special interest.

Grateful acknowledgments are due to Dr. Roy Blough of the Research Division of the United States Treasury for reading, to their great improvement, the chapters on principles, fiscal policy, and on property, income, inheritance, and social security taxes; to Professor William Haber of the University of Michigan and to my colleagues, Professor Edwin E. Witte and Dr. Elizabeth Brandeis for reading the chapter on the social security taxes; to my colleagues, Professor George Wehrwein, Dr. Carl Wehrwein, and James Earley for reading the chapter on incidence; and to Lawrence Brokate for reading the chapter on incidence. Each of them has made many constructive suggestions.

But more than to any others, I am indebted to Joseph Rosa and Bristol Goodman. Mr. Rosa has made extremely helpful contributions by way of criticism and has devoted full time to research and the preparation of the manuscript. He has also contributed the survey on public finance literature appearing in the Appendix. Mr. Goodman has given me a great deal of assistance by his suggestions and has devoted extensive time to gathering

material, reading proof, and the arduous task of ensuring the proper form and accuracy of the references.

My thanks are also due to Mrs. Bristol Goodman and Mrs. Frank Welch for their diligence and care in typing the manuscript.

Great appreciation is due Helen Hoopes Groves, who contributed much both directly and indirectly to this project.

H. M. G.

April 10, 1939
Madison, Wisconsin

Preface to Revised Edition

In the revision all chapters have been substantially reworked and modernized in accordance with the many changes of the war years and the proposals for the postwar period. The three income tax chapters have been rewritten almost completely to take account of withholding, the war excess profits tax, and the recent dispute as to the postwar corporate income tax. New quantitative material has been introduced concerning breadth of the income tax base at various levels of exemption. The chapter on the estate tax has been enlarged and revised to include the results of new research on death tax loopholes. The chapter on tax limitation has been combined with those on the property tax, and the chapters on specific public expenditures have been consolidated into one chapter. The chapter on intergovernmental fiscal relations has been rewritten and enlarged to take advantage of the Treasury study and other research in this field. An account of the history of the movement for a "coordinated revenue system" has been included. The chapters on the public credit have been substantially redone in the light of our postwar prospects and some attention has been given to the problems of managing the postwar public debt. The chapter on fiscal policy has also been rewritten for our new setting, and a discussion of fiscal policy appropriate for "total war" has been added.

The author acknowledges valuable assistance in the revision of the property tax chapters from Bristol Goodman and in the revision of all the chapters from his research assistant, William H. Anderson. Mrs. Marion Goetz contributed much editorial assistance.

H. M. G.

May 1, 1945
Madison, Wisconsin

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FINANCING GOVERNMENT

CHAPTER I

Introduction and Historical Development of Public Finance

INTRODUCTION

Importance of the Subject

The Supreme Court of the United States paid high tribute to the importance of public finance when in 1899 it declared: "The power to tax is the one great power upon which the whole national fabric is based. It is as necessary to the existence and prosperity of a nation as is the air he breathes to the natural man. It is not only the power to destroy but also the power to keep alive." [1] These words were uttered many years ago. Since then the functions and expenditures of government have expanded substantially, especially during and since the First World War. Before the Second World War, approximately one-fifth of the national income of the United States passed through its various governments. For the one out of every ten gainfully employed who "worked for the state," public revenue was a direct source of livelihood. For many others—millions during the depression of the thirties—who looked to the government for relief, business assistance, or for some other aid, it was of no less importance. In preserving and raising the cultural level of the nation, the state is playing an increasingly important part. In recent years many have looked to the government for a financial program to balance the economic system and make the latter function in the public interest. This is a new and large order which greatly enhances the scope and importance of public finance. During the Second World War, taxation was used not only to raise unprecedented amounts of revenue for war purposes but also as a principal antidote for inflation. It is evident that the fiscal problems of the postwar era will be of critical importance. How much more true now than when they were uttered are Justice Peckham's words that "Taxation is an eminently practical" matter "and is in fact brought to every man's door. . . ." [2]

[1] Nicol v. Ames, 173 U. S. 509, 515 (1899).
[2] *Ibid.*, p. 516.

Boundaries of the Subject

Public finance is the science which treats of the income and outgo of government. In modern times this includes four major subdivisions: public revenue, public expenditure, public debt, and certain problems of the fiscal system as a whole, such as financial administration. On the other hand, it is usually thought to be exclusive of the public control of private credit, banking, and corporation finance. In a broader sense, of course, all finance is public finance. Banks may be owned by governments or public corporations, but even under private ownership their operations are so extensively controlled in the public interest that it would indeed be difficult, if at all possible, to draw definite bounds around either of the two fields of private and public finance. Nevertheless, this book will be confined to public finance as traditionally defined. It is in itself a field wide enough to survey so that adjoining fields will be avoided except where they will aid in the clarification of certain points of public finance.

Public finance is also on the border line between economics and political science. Obviously many of its problems are economic in character, involving very intimately the processes of "getting a living" and seeking command over economic goods, whereas others, in the domain of political science, relate primarily to the effective functioning of government as such.

Furthermore, there are no very clear lines separating public finance from many seemingly unrelated fields. Particularly is this true of the phase of public finance dealing with public expenditure. It is surely within the field of the science which treats of the income and outgo of government to consider for what purposes the public dollar is spent and to examine critically the comparative uses and the effectiveness with which the funds are applied to accomplish the avowed purposes. Once embarked upon this venture, however, there is no definite stopping place short of all public administration and all governmental science. And even this would not exhaust the field. Is it proper that we devote as much revenue to relief as heretofore? Would it be better to expand unemployment insurance or public works? Would it be desirable for the government to cultivate further the field of low-cost housing? Will greatly enlarged outlays for national defense be needed? These are questions which take us into the domains of sociology and military science. Confronted with such an enormous task, the writer on public finance is obliged to limit himself to the broad outlines of a field not only as large as government, but almost as large as life itself.

DEVELOPMENT OF PUBLIC FINANCE

Importance in General History

Taxation in Ancient Times. One needs to recall only a bit of general history to appreciate what a central place "the public purse" has had in the development of human affairs. Citations of a few of the more dramatic episodes may illustrate this. Going back to ancient history and the Bible, we find that the secession of the ten tribes of Israel, and thus the disruption of the Jewish monarchy, was in large part a tax phenomenon. The revolt is said to have been due to the refusal of Rehoboam to reduce the heavy taxes of his predecessor, King Solomon, who had embarked on an ambitious program of public works. The new king greeted a petition for tax relief with the ugly threat: "My little finger shall be thicker than my father's loins. And now whereas my father did lade you with a heavy yoke, I will add to your yoke; my father hath chastised you with whips, but I will chastise you with scorpions." As a prelude to the revolt which followed, the insurgent tribes answered the king by stoning his revenue agents to death.[3]

Taxation and Constitutional Development of Great Britain. Anyone with even superficial knowledge of English history can appreciate the role that taxation played in the political and constitutional history of that nation. A considerable portion of this history is the story of the struggle between the king and parliament for control of the government purse strings. In describing the significance of this struggle to constitutional development, one authority writes that "no constitutional change has been more important in securing popular control over the executive government, than the voting of supplies by the House of Commons: nor has any expedient been better calculated to restrain the undue influence of the crown, than a strict settlement of its revenues by Parliament." [4]

The Magna Carta (1215). The resentment which has been voiced against arbitrary taxation in England goes back almost to the days of the Norman conquest. It began with only a few powerful nobles and clerics who protested that they would not pay a tax to which they had not consented.[5] These were the protests of individuals. But in 1215 they joined forces and compelled King John to grant them a "charter of liberties," known in history as the *Magna Carta.* This celebrated document, among other things, promised that "no scutage or aid shall be imposed in the kingdom unless by the common counsel of the realm, except for the purpose of ransoming the king's person, making his first-born son a knight, and marrying his eldest

[3] I Kings, 12: 10-11.

[4] Sir Thomas Erskine May, *Constitutional History of England,* Longmans, Green and Co., London, 1882, Vol. I, p. 231.

[5] *Ibid.,* p. 67.

daughter once: and the aids for these purposes shall be reasonable in amount." [6]

Notwithstanding its promises to lighten the public burden, the Great Charter is significant in taxation history not because of its actual provisions but, rather, because of what succeeding generations of Englishmen were pleased to read into it. The *scutage* and the aids it refers to were not taxes in the modern sense; they were feudal dues which the tenants of the king were expected to pay him as overlord. And even these restrictions were left out of the later versions of the charter. But the idea of representation, that the sovereign agreed to treat with the representatives of the nation on revenue measures, persisted from that time on. It was this principle of national consent to taxation upon which Englishmen always relied in their long fight with their sovereigns on the question of public levies.[7]

Parliament and Charles I. One of the major issues in the great struggle between the British Parliament and the Stuart kings was the right of the king to levy taxes without the consent of parliament. This conflict came to a head under Charles the First. He quarreled with parliament and sought to raise revenue independently of its sanctions. One of the many expedients he resorted to was the forced loan. This was a mere subterfuge, for there was no pretense that the loans would ever be repaid. Five gentlemen who refused to comply with Charles' requests were imprisoned. Shortly after this incident, parliament submitted to the king the Petition of Rights, which in 1628 he reluctantly accepted. Among other requests agreed to was that none need thereafter "make or yield any gift, loan, benevolence, tax or such like charge" without the consent of parliament.[8] Nevertheless, the conflict continued, and for more than a decade following, Charles attempted to govern the country without parliament. He again resorted to various devices to secure money. One of these was the "Ship Money" which was based on an old tradition that each port must provide the monarch with a ship. Charles' version of it, however, called for payment in money rather than in kind, and payment by inland taxpayers as well as by those located in seaports.[9] But the king's financial embarrassment was not at an end, and in 1640 he resorted to the desperate expedient of buying on credit a large

[6] Stephen Dowell, *A History of Taxation and Taxes in England*, Longmans, Green and Co., London, 1888, Vol. I, pp. 42-43.

Further, it promised to "Let all merchants have safety and security to go out of England, to come into England, and to remain in and go about through England, as well by land as by water, for the purpose of buying and selling, without payment of any evil or unjust tolls, on payment of the ancient and just customs" (*Ibid.*, p. 76).

[7] S. A. Morgan, *The History of Parliamentary Taxation in England*, Williams College, 1911, pp. 68-70; F. W. Maitland, *The Constitutional History of England*, Cambridge University Press, London, 1931, pp. 94-96, 306-311.

[8] Stephen Dowell, *History of Taxation and Taxes in England*, Vol. I, p. 203.

[9] Opposition to this extortion was very strong, and at least one taxpayer, John Hampden, a courageous country squire from Buckinghamshire, refused to pay the 20 shillings which were demanded of him. He was tried by the king's judges, who, by a bare majority, sustained the tax.

cargo of pepper, which had just arrived in the ships of the British East India Company, and selling it cheap for cash.[10] The culmination of this strife was a civil war in which Charles was defeated, imprisoned, and beheaded.

Bill of Rights (1689). Forty years after this fateful blow to the Stuarts, James II, the last of that dynasty on the English throne, incurred the displeasure of his subjects and was deposed by parliament. He was followed by his nephew, William of Orange, who accepted the *Bill of Rights* (1689). This important document included among its provisions that the "levying of money for or to the use of the crown by pretense of prerogative, without grant of Parliament for longer time or in other manner than the same is or shall be granted, is illegal." [11] Having reasserted this principle and given it the effect of a law, the Bill closed a turbulent chapter in English constitutional history. This principle was never again seriously challenged except in connection with the colonies, and then not only the king but also his parliament were opposed to extending its application to their outlying possessions.

Taxation and the American Revolution. After the close of the Seven Years' War (known in American history as the French and Indian War), England was in great need of additional revenue to meet the resulting expenses. George the Third and his parliament attempted to levy certain taxes for this purpose upon the colonists and their trade. It was argued by proponents of this policy that it was but natural to expect the colonists to make some contribution for their own protection, including the debt which had grown out of the recent war. Accordingly, parliament passed the Stamp Act, which required the colonists to purchase stamps from the British Government and apply them to leases, deeds, and other documents as a condition of their legal standing. The colonists resented these levies on the grounds that the colonists were not represented in the British parliament and thus had not consented to such taxation. An assembly of colonial representatives in New York in 1765 protested that the Stamp Act indicated a tendency to subvert their rights and liberties.[12]

The protest of the colonists had a familiar sound in England and won the support of a considerable following in parliament. The Stamp Act was repealed despite the opposition of King George and the British "tories." The issue again arose, however, when the British Government imposed certain tariff duties on American trade, including the importation of tea. With the exception of the latter, these duties were repealed within three years. The retention of the levy on tea was more for the purpose of soothing the feelings of the king than for raising revenue. Had it been for this duty alone, colonial dissatisfaction with taxation might have entirely subsided. But tea was destined to play a notable role in American history in yet another way.

[10] Samuel R. Gardiner, *History of England* (1603-1642), Longmans, Green and Co., London, 1904, Vol. IX, p. 190.

[11] S. A. Morgan, *The History of Parliamentary Taxation in England*, p. 307.

[12] Charles A. Beard and Mary R. Beard, *The Rise of American Civilization*, The Macmillan Co., New York, 1930, Vol. I, p. 213.

The tea trade was made a monopoly and given to the East India Company This threatened to ruin a profitable business for both smugglers and legiti mate tea merchants of the colonies. With the tariff legislation of parliamen still fresh in mind, it took but little to arouse the ire of the colonists. Op position to this new measure soon came to a head in the famous "Bostor Tea Party," which contributed much toward bringing on the Americar Revolution.[13]

Taxation and the French Revolution. The American Revolution had a profound effect upon the French, who were discontented with the condition imposed upon them by the ruling class. The economic status of the masse during the Ancient Regime, partly because of the burdensome exactions tc which they were subjected, was extremely poor. If the discontent of the colonists was justified, that of the French people was even more so, for un doubtedly theirs was one of the most oppressive tax systems of all times The French had developed no constitutional rights of taxation by consent In England the fight against royal arbitrariness was carried to victory not sc much by the common people as by the nobles. But in France the noble had less cause to follow suit, for both they and the clergy were exempted from many taxes, the former on the ground that their obligation consisted in fighting for the king, and the latter on the ground that the state could not encroach upon what had been dedicated to God.

The Tax System Before the Revolution. Hastily surveying some of the most important levies which the French people had to pay before the Rev olution, one may observe first, that they had two "sovereigns" to support the king and the church, both costly. The church collected the *tithe*, orig inally a free offering of a tenth of one's produce but becoming at a very early age of French history a compulsory contribution not only in France but throughout Europe.[14]

Far more important than the tithe were the taxes which were levied by the king. Perhaps the best known of these was the *taille*, one of the many levies originating in the feudal period. Like the English *tallage*, it was pri marily a tax on the cultivators of the soil, based upon their supposed profits which were estimated by the value of their farms. But while the *tallage* as such came to an end in the fourteenth century, the taille was made a perma nent annual tax in 1439.[15] It was supposed to have been a general tax; actually, however, the nobles and the clergy, and even the wealthy bourgeois, were exempted.[16] "This tax besides," writes Adam Smith, "is supposed to

[13] F. A. Shannon, *Economic History of the People of the United States*, The Macmillan Co., New York, 1934, Chap. VI; Harold Underwood Faulkner, *American Economic History*, Harper and Brothers, New York, 1931, Chap. VII.

[14] *Palgrave's Dictionary of Political Economy*, The Macmillan Co., London, 1926, Vol. III, pp. 543-546.

[15] Stephen Dowell, *History of Taxation and Taxes in England*, Vol. I, pp. 39-58; E. R. A. Seligman, *Essays in Taxation* (10th ed.), The Macmillan Co., New York, 1925, pp. 43-44.

[16] *Ibid.*, pp. 50-51.

dishonour whoever is subject to it, and to degrade him below, not only the rank of a gentleman, but that of a burgher, and whoever rents the lands of another becomes subject to it. No gentlemen, nor even any burgher who has stock, will submit to this degradation." [17]

The administration of this tax was its most objectionable feature. The collectors, both because they were ignorant and because of compulsion, applied arbitrary methods of assessment. Appearances were their chief basis for evaluating income. Resistance, therefore, often took the form of simulated poverty. Thus Rousseau, the eminent French philosopher, relates his visit at the house of a peasant where he had stopped to ask for dinner. At first, his host put before him only barley bread and skimmed milk and said that this was all he had. Convinced at last that his visitor was not a government spy, the peasant opened the larder and produced some ham, good wheat bread, an omelet, and a bottle of wine. The peasant concealed his stock, so he told his guest, because of the taille, for he feared that he would be ruined by taxation if the officials had any idea that he was not dying of hunger.[18]

On top of this system of direct taxes in pre-revolutionary France was another and equally objectionable group of indirect taxes. During the Ancient Regime, France was cursed with an elaborate system of tariffs, effective not merely at the boundary of the country but also at the boundary lines of the provinces and even those of the cities. Their administration was not an easy task and was characterized by large-scale smuggling, with severe penalties for those who "got caught." There were also excise taxes on tobacco (through a state monopoly), wines, and ciders. The most dreaded of the indirect taxes was the *gabelle* or salt tax. The rate was higher in some districts than in others. Smuggling from low-taxed to high-taxed provinces was common. As if the physiological requirement were not sufficient, a law required every man, woman, and child over the age of seven to consume seven pounds of salt each year.[19]

[17] Adam Smith, *The Wealth of Nations* (Cannan, ed.), The Modern Library, New York, 1937, pp. 370, 805-806.

[18] Edward I. Lowell, *The Eve of the French Revolution*, Houghton, Mifflin and Co., Boston, 1892, p. 216. Also H. A. Taine, *The Ancient Regime*, pp. 354-357.

This system of direct taxation was supplemented from time to time with an income tax, which in 1749 became a permanent levy until the Revolution. It was called the *vingtieme*, or twentieth, because it was supposed to claim one-twentieth of the taxpayer's income. However, it was badly administered; it developed into an unreasonable levy, usually falling upon those who were least able to pay. The capitation or poll tax, graduated according to 22 classes of taxes, was subject to the same criticism (E. R. A. Seligman, *The Income Tax* (2nd ed.), The Macmillan Co., New York, 1914, pp. 50-53).

The corvee called for forced labor on the highways. As a service to the state, it was based on no general law but was imposed at will by the civil and military officials of the king. This imposition was confined largely to the peasants and was one of the most disliked taxes before the Revolution. It came to an end with the monarchy in 1793 (Edward I Lowell, *The Eve of the French Revolution*, pp. 226-227).

[19] *Ibid.*, pp. 222-225.

Every age is most alive to its own problems. The taxpayer, whatever age he lives in, is usually convinced that his generation is saddled with far heavier exactions than those of any other. If ever he was justified in this assertion, it was certainly in pre-revolutionary France. There is no authentic information concerning the total tax burden which the French people had to carry. Taine, the French historian, estimated that the combined levy of all types of taxes and feudal dues took over 81 percent from the meager incomes of the peasants.[20] Some historians question this figure, although their only argument is that existence could not have been possible on one-fifth of a peasant's produce.[21] It is apparent, however, that taxes took the major share of the earnings of the poor, whose patience was about exhausted. The outbreak of the Revolution in 1789 was to a great extent an indication of the desperation to which they were driven by the tax system of the Ancient Regime.

Abolition of the Ancient Taxes. The immediate outbreak of the French Revolution was due to the insolence of the nobles and the clergy, but important among its underlying causes were taxes and the financial troubles of the king's household. In vain did Turgot, one of Louis XVI's ablest finance ministers, labor to improve the financial situation. The expenditures of the king upon his court continued to be highly extravagant. The national finances were further strained by the indebtedness created to finance the annually recurring deficits. The time finally came when the king could borrow no more money and, because of popular resentment, could eke out no more taxes. Nothing remained for him but to consent to the summoning of the ancient Estates General, which, when it met, declared itself a National Assembly and proceeded in a series of steps to take matters into its own hands. One of its first enactments established the proposition that no tax not receiving its consent was valid. Soon the internal customs and the privileges of the tax-exempt classes were eliminated. The salt tax was abolished. For a long time, however, great confusion, incompetent administration, and inadequate funds continued to characterize national finances. In fact, it was not until the able administration of Napoleon that anything like an adequate and rational financial system was inaugurated.[22]

Importance in the History of the United States

Taxation and the Federal Constitution. The American colonies were ill-prepared to finance the American Revolution. No national system of taxation had been developed and the Continental Congress was forced to rely upon a combination of fiat currency, levies on the states (with no adequate

[20] H. A. Taine, *The Ancient Regime*, pp. 412-413.

[21] J. M. Perkins, *France Under Louis XV*, Houghton, Mifflin and Co., Boston, 1897, Vol. I, p. 43. Also Edward I. Lowell, *The Eve of the French Revolution*, p. 228.

[22] Leo Gershoy, *The French Revolution and Napoleon*, F. S. Crofts and Co., New York, 1933, pp. 97-106, 153-160, 459-462.

machinery for enforcement), foreign subsidies, and domestic and foreign loans for its revenue.[23] In fact, had it not been for the last-named assistance, particularly from France, the war could hardly have been carried to a successful conclusion. When independence was finally established, the Union unsuccessfully attempted to operate as a centralized government under the Articles of Confederation. One of the major weaknesses of the new government was that it had no independent powers of taxation.[24]

The necessity for a new constitution, with somewhat more generous financial powers for the government of the Union, was painfully apparent. It was no small matter to induce the states to surrender sufficient power to allow the federal government its own tax system. Many saw in this the development of tyranny more terrible than that against which they had just rebelled. Nevertheless, necessity prevailed and a new constitution, ratified in 1789, gave the federal government ample powers to balance its budget, re-establish its credit, and pay off its war debt, including some of the debts of the states which the new government assumed.[25]

The Federal Revenue System Inaugurated. The new federal powers merit a more adequate treatment than can be given here and will be reserved for a later chapter. It may be observed, however, that the federal government was given the power to levy tariffs and excises, the former being an exclusive right. Congress speedily enacted a tariff law (1789) which at once began to bring in badly needed revenue.[26] The owners of the new industries which had lately sprung up on American soil clamored for the use of the tariff for the nonfiscal purpose of protecting their enterprises. These new industries had taken root in the northern and central states, and the support for the protective tariff came from these sections. Planters of the South and farmers of the West, however, saw nothing to gain and much to lose in protection.[27]

[23] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, Prentice Hall, Inc., New York, 1937, pp. 47-48.

[24] Its only source of revenue, outside of borrowing, was requisitions from the states in proportion to the value of their lands and improvements. No national tariff could be levied without an amendment to the Articles, which in turn required the unanimous consent of the states. Such consent, however, was not forthcoming. The requisitions attempted were regarded by the states as voluntary contributions and were only partially paid. The Confederation Government never succeeded in balancing its budgets, and interest and principal payments upon its very substantial debt were either defaulted or refunded (*Ibid.*, pp. 72-74: also D. R. Dewey, *Financial History of the United States*, Longmans, Green, and Co., New York, 1928, pp. 49-50).

[25] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, pp. 91-103.

[26] Congressional debate on Madison's bill in the House of Representatives—a very moderate measure based on a general 5 percent *ad valorem* duty and including special rates on liquors, molasses, wines, tea, pepper, sugar, cocoa, and coffee—foreshadowed the central place which the tariff would have in American public affairs.

[27] The Washington Administration had what was regarded as an ambitious program of public expenditures for that period. In addition to the assumption and retirement of the public debt, it sought to strengthen the national government by developing some military strength. To help finance the program several excises were provided, including a tax on

Sectional Battle over the Tariff. The first tariff law was only mildly protective, but with subsequent legislation protection gained ground. Sectional division and conflict concerning this issue grew sharper. The high protective tariff law of 1824 received only a few votes among the representatives from below the Mason and Dixon Line.[28] Four years later Congress passed the notorious "Tariff of Abominations," so-called because its opponents had made it appear, with some justice, as vicious as possible in the hope of defeating it, a stratagem which proved unsuccessful. When the Tariff of 1828 became fully effective, it carried average rates of about 44 percent on dutiable goods. The Tariff of 1832 reduced rates and eliminated some of the abomination, but still it remained a highly protective tariff and very distasteful to the South.[29] It was plain that the Southerners regarded the federal power to tax as a menace to their traditional liberty, for which they had fought and for which they were willing to fight again. A convention called by the legislature of South Carolina in 1832 declared the tariff acts of 1828 and 1832 null and void and any attempt to enforce the latter in that state as a cause for secession. Governor Hamilton called for ten thousand volunteers to defend this position. President Jackson wrote to the collector at Charlestown that the Acts must be enforced and threatened to send 40,000 troops into South Carolina. At this critical state of affairs Congress passed a compromise tariff plan sponsored by Henry Clay. The new tariff called for substantial reductions in rates over a nine-year period. It was accepted by South Carolina and, as a result, a situation which might have led to a civil war was averted.[30]

whiskey and what had some resemblance to a personal property tax on carriages. The excise met with substantial opposition. Its opponents argued that whiskey was not a luxury, but a poor man's necessity. Opposition to it finally took on the proportions of an open rebellion in Western Pennsylvania, and President Washington was obliged to send a small army to ensure compliance (W. J. Shultz and M. R. Caine, *Financial Development of the United States*, pp. 104-111).

[28] The South had become convinced that the tariff was a device to tax the South for the benefit of the North. By that time it was becoming apparent that the South was dedicating itself to the cultivation of cotton, rice, and tobacco, which made its prosperity depend upon export trade and the opportunity of buying low-priced manufactured goods. Tariffs meant to the South higher prices for manufactured goods which the people of that region needed to purchase.

[29] Calhoun of South Carolina contended that it was unconstitutional for Congress to levy taxes for other than revenue purposes. (See Chap. XIX, on the federal power to tax for nonfiscal purposes.) A bitter debate between Senators Hayne of South Carolina and Webster of Massachusetts reopened the entire question of federal versus state powers.

[30] F. A. Shannon, *The Economic History of the People of the United States*, pp. 223-236.

Following the Civil War a period of very high protective tariffs ensued, and the issue became critical again during the Cleveland administration. With a huge surplus in the U. S. Treasury—$94,000,000 for the fiscal year of 1886—Cleveland denounced the tariff levies as a "ruthless extortion." He devoted his entire message of 1887 to this subject, stating that the theoretical arguments for the tariff—such as the contention that it makes for high wages in domestic industry, keeps money at home, creates a home market, and makes the country independent of foreign nations—were irrelevant since "it is a condition that

These few historical references have been drawn to demonstrate the central place which public finance has occupied in the history of the United States and other countries.

Development of Public Finance Institutions

No very clear pattern of evolution can be traced in the history of taxation and public expenditures. Most of the taxes and public expenditures known to the modern world are of ancient origin. The changes have been not so much in the tax system or in public expenditures themselves as in the nature of the institutions and the environment to and in which they have been applied.

Public Expenditures. From the earliest time of organized society the prime function of government has been the protection of the people from foreign aggression. This includes, of course, the perpetration of such aggression upon others. A second time-honored function has been the preservation of internal peace, order, and security, and the administration of justice. A third function, now exercised by only a few states, has been the maintenance of a state religion. In some states, where the church has been separate from the state, the latter, nevertheless, usually has had its own financial system with high powers of compulsion. A fourth function was formerly the maintenance of the king and his household, an expenditure which reached its height with Louis XIV of France, whose court probably cost the French about $100,000,000 in addition to much forced labor. This function has its counterpart in the general national governmental expenditures of today. These four functions have been the most universal. A fifth, however, that of public works, including the building of pyramids, roads, canals, and a postal system, has also been common. Egypt incurred heavy burdens to build its pyramids. Ancient Athens had an even more extensive program of public works, which included fountains, markets, gymnasia, walls, and fortifications. In addition, both the Greeks and the Romans assumed some responsibility for the welfare of their poor; the distribution of free grain in Rome is renowned. Beginnings of public recreation appear in the Greek theater and religious festivals and in the Roman amphitheater. The Roman sewers constituted a rudimentary public health program. Of all the major

confronts us and not a theory." In the election of 1888, in which he was defeated, the tariff was an all-important issue. Upon his return to office in 1892, he again sought a reduction in the tariff. He was not very successful in this endeavor, and it was not until the Underwood Act of 1913 that Congress enacted a substantial reduction in tariff rates (*Ibid.*, pp. 577-585, 785-788).

Cleveland's second administration is significant in the financial history of the United States for still another reason. In 1894 Congress enacted the first peacetime federal income tax, only to have it declared unconstitutional by the Supreme Court.

modern public expenditures, only education appears to have been entirely neglected, and even under this heading the Greeks provided physical education in the gymnasia and wrestling schools.[31]

Early Forms of Taxation. A large portion of human history has passed under some form of feudal organization. Under this system, best adapted to an agricultural civilization, the king or ruler theoretically owned the country. He retained only a part of it under his personal dominion, however, and from this he received an income in produce. Since the king could not administer all of the land directly, he ordinarily gave a more or less limited tenure to some of his soldiers or favorites, who in turn had their own subtenants or vassals. The tenants, like our modern share croppers, shared their produce with their overlords, to whom they were also expected to render various sorts of free services. Under such organization, taxation closely resembled land rent. This system prevailed in ancient Egypt and in all Europe (with variations) during the Middle Ages.[32]

Direct Taxes. Along with these feudal contributions, many of the nations of the ancient world developed rather complex revenue systems. The gross produce tax (like our modern gross income tax) was very common both within and without the feudal system. It depended upon the harvest and was more like our income than our property tax. More often than not these taxes were paid in produce, such as cattle, grain, wine, oil, honey, and textiles.[33] The Greeks and the Romans objected to direct taxes in any form; they regarded them as "derogatory to the dignity of a free citizen." [34] The Greeks nevertheless resorted to such taxes in times of emergency, and the Romans exacted them from the conquered provinces.

The best known of the taxes which have been handed down to us from the ancients, however, is the inheritance tax. The origin of this tax has been attributed to Rome, although there have been traces of it in Egypt many centuries earlier. In Rome it was first a 20th of the estate (*visesima hereditatium*), but under Emperor Caracalla the rate was doubled. It applied to both inheritances and bequests, but close relatives and the very poor were exempt. An interesting feature of this tax was its nonfiscal aspects; it taxed the estates of unmarried people 100 percent and those of childless couples 50 percent.[35] Apparently, the similar features of the income and inheritance

[31] A. M. Andreades, *A History of Greek Public Finance*, Harvard University Press, Cambridge, 1933, Vol. I, pp. 8-14, 114-120; Jules Toutain, *The Economic Life of the Ancient World*, Alfred A. Knopf, New York, 1930, pp. 237-238, 246-247, 256.

[32] James Henry Breasted, *The Conquest of Civilization*, Harper and Brothers, New York, 1926, p. 85.

[33] *Ibid.*, pp. 66, 201, 672.

[34] Alfred Zimmern, *The Greek Commonwealth*, The Clarendon Press, Oxford, 1924, p. 289.

[35] Max West, *The Inheritance Tax*, Columbia University Press, 1908, pp. 11-15; A. D. Winspear and L. K. Geweke, *Augustus and the Reconstruction of Roman Government and Society*, University of Wisconsin Studies in Social Sciences and History, No. 24, Madison, 1935, p. 161.

taxes of prewar Germany and Italy are no innovation in revenue legislation.[36]

Of the other direct taxes known to us, the poll or capitation tax is of very ancient origin. It was known in Egypt where it was levied upon the male population from 14 to 62 years of age, but with numerous exceptions. In Rome it was levied upon all those engaged in business who were not citizens. Although it remained a poll tax in form, in time it actually developed into a kind of personal property tax.[37]

Indirect Taxes. The indirect taxes were also well developed in the ancient world. Probably the oldest of them was the customs, which first appeared in the form of gifts to the king as the price of the permission to trade. Merchants were frequently required to pay a tax upon both importing and exporting.[38] Strabo, the Greek historian and geographer, writes in his discussion of the Egyptian trade as follows: "The most valuable consignments" of India and Ethiopia come "to Egypt, and are sent on from there to the rest of the world, so that Egypt gets double duties from them, on coming in and on going out; and the duty is heavy in proportion to the value of the goods."[39]

The sales tax was also familiar to the ancients. "In Egypt . . . there was not a single stage on the way by which goods went . . . from a place of production to a place of consumption, where the exchequer did not step in and seize some proportion of the value of the goods."[40] It was also a very profitable source of revenue to the Greeks. They levied it on practically all buying and selling. To Athens especially the sales tax on slaves brought in huge sums, since that city was the chief mart for the slave trade during the fourth and fifth centuries B.C.[41]

[36] Early governments had little need for direct taxes since they levied tribute upon their conquered and weaker neighbors. The Greeks financed a goodly share of their public expenditures out of the generosity and patriotism of their wealthier citizens. "It was by free gifts," wrote Thucydides, the historian, "that the Athenians armed the fleets which were so long supreme on the seas, by free gifts that they formed the choirs which performed the dances and recited the songs 'taught' them by the poets" (Quoted from Alfred Zimmern, *The Greek Commonwealth*, p. 290).

Another rich source of public revenue enjoyed by many of the ancient nations was the public domain. Athens and a few other of the city-states derived a considerable profit from their mines. According to one historian, Carthage obtained nearly half of her revenues from the mines in Spain, which in later years also proved to be a good source of revenue for Rome (A. M. Andreades, *History of Greek Public Finance*, pp. 268-273).

[37] A. D. Winspear and L. K. Geweke, *Augustus and the Reconstruction of Roman Government and Society*, p. 158.

[38] A. M. Andreades, *History of Greek Public Finance*, pp. 138-143.

[39] Quotation from Jules Toutain, *The Economic Life of the Ancient World*, p. 161.

[40] *Ibid.*

[41] A. M. Andreades, *History of Greek Public Finance*, pp. 143-145, 281-285.

Other revenue sources known to the ancient world included licenses and special assessments. Both of these are of ancient origin. Many of the countries of the Greco-Roman world required a license fee (occupation tax) for certain callings of shady reputation, notably, oracle mongers, jugglers, and prostitutes. Egypt levied a special payment for irrigation projects similar in many respects to our special assessments (*Ibid.*, pp. 107, 127, 284).

The Financial System. It will be observed that most of our modern taxes were introduced before the Middle Ages. Only the net income tax, perhaps the most important of the present-day levies, appears to have been neglected. The gross produce tax had much in common with our modern property tax. It was based upon rentals or annual values, which is also true of European property taxes today. Apparently, actual yield was the base rather than an objective rating independent of management and fortune. In this respect the tax was more like the modern net income tax. Its closest resemblance is found in our gross income and severance taxes. Even the modern democratic tradition of no taxation without the consent of the taxed was not unknown to the ancient world. It was accepted in the Athenian democracy.[42]

Medieval Public Finance. During the Middle Ages public finance became closely identified with the feudal system, a system which was not unknown but less important in the ancient world. One writer has referred to this system as one of "patrimonial," as distinguished from "contributory," finance.[43] The king, dukes, counts, barons, bishops, and convents received their income partly from the land they held directly and partly from the feudal dues paid to them by their subordinates. Except during certain intervals and in certain emergencies, the king was expected to subsist mainly upon the income from the property he held directly. The exceptions included such occasions as ransoming him, knighting his eldest son, and marrying his eldest daughter. The additional revenues he sought on such occasions were designated (at least in England) as subsidies or grants. Such grants or subsidies were often made necessary by foreign wars. These revenues were "contributory" in the sense that both the expenditure and the grant itself depended upon the assent of a representative assembly. The "assent" principle, of course, was not always conceded, and it was the basis of that long constitutional struggle outlined above.[44]

Income from the Royal Demesne. In medieval England the king's demesne land was enormous, including at one time many towns and cities, among

[42] *Cambridge Ancient History*, The Macmillan Co., New York, 1927, Vol. V, p. 27.

[43] Antonio de Viti de Marco, *First Principles of Public Finance*, Harcourt, Brace and Co., New York, 1936, p. 56.

[44] The medieval feudal system was an ideal instrument for arbitrary power. The king and the barons were under no obligation to render a *quid pro quo* for their revenues since they received them as a matter of right. The budget of the state was merged with the personal budget of the monarch, including the outlays for servants and entertainment. As the system developed, public expenditures increased owing to the prodigality of the rulers and to the increasing scope of collective wants. Patrimonial revenues, on the other hand, shrank owing to the gradual contraction of the public domain. For this the king himself was responsible, partly because of the generosity with which he compensated his favorites out of his lands and partly because he was forced to yield a portion of it for immediate revenue. These were auspicious circumstances for his rebellious vassals and, as we have seen, they made the most of them. The results were limitations upon the absolute power of the king both in England and on the continent (Antonio de Viti de Marco, *First Principles of Public Finance*, pp. 62-65; also, Sir Thomas Erskine May, *Constitutional History of England*, Vol. I, Chap. IV, and James Westfall Thompson, *Feudal Germany*, University of Chicago Press, Chicago, 1928, Chap. X).

them the city of London. This domain yielded a patrimonial or rental income almost sufficient for his needs. His forests provided extensive hunting grounds for him and his friends, and a supply of venison for the royal table. In addition, they brought in revenue from fines upon those who hunted in them without permission. Gradually, however, much of royal domain became partially or entirely alienated through the process of grant and charter.[45]

Medieval Taxes on Land and Other Property. The first known taxes in England were land taxes levied by area, or, as we would say, at so much per acre. Only the unit was not the acre, but the *hide*. The *hidage*, as the tax is sometimes known, was based upon a farm sufficient in size to support a household. It was replaced under William the Conqueror by the *carucage*, the basis of which was the carucate or plow land—an area that could be plowed by one plow and a team of eight oxen. Shortly thereafter a new imposition appeared, but fell only upon the knights to take the place of the personal services they had to render to the king under feudal tenure. This was the *scutage*. Strictly speaking this was not a tax, but it played a leading role in the history of taxation; as previously mentioned, it was one of the grievances the *Magna Carta* was supposed to have righted.[46]

Gradually the annual value (rental value) of land became the basis of assessment. Movable or personal property was assessed either on its capital value or on a calculated annual value. During certain stages this tax, both on real and personal property, assumed a character much like our modern general property tax; at no time, however, was it as universal in its inclusions. As far as personal property was concerned, it raised much the same difficulties of administration as those confronting our modern tax. As Seligman puts it, "in actual practice virtually nothing was assessed except real estate, so that the tax soon became a land tax." [47] As a source of revenue, the land tax could not keep up with the growing expenditures of the national government in the eighteenth century. With the attempt to secure a more fertile source, it was relegated to a secondary position. In 1798 it was made permanent at prevailing rates and the landowners were allowed to pay it off in perpetuity with lump-sum payments. Many of these landowners took advantage of the opportunity, which accounts for its gradual disappearance as a source of British national revenue, although a property

[45] Stephen Dowell, *History of Taxation and Taxes in England*, Vol. I, pp. 13-15, 50-55; also Sir Thomas Erskine May, *Constitutional History of England*, Vol. I, pp. 225-229.

The revenues of the English kings were also supplemented by benevolences, gifts in token of loyalty to the king. In fact, all contributory payments to the crown were regarded as more or less "benevolent," as is indicated by the phrases "subsidies" and "grants" frequently applied to what we would now call taxes (Stephen Dowell, *History of Taxation and Taxes in England*, Vol. I, pp. 196-203).

[46] *Ibid.*, pp. 8, 34-48.

[47] E. R. A. Seligman, *The Income Tax* (2nd ed.), pp. 48-49.

To some extent, in the effort to make the tax all-embracing, a semblance to the modern income tax appeared with the inclusion of the stipends from public offices in the tax base. This feature was in effect also in the early tax systems of Massachusetts and Connecticut.

tax (called the rates) still remains the mainstay of local revenues in England.[48]

The Medieval Poll Tax. The poll tax was introduced in England in 1377. On its second imposition in 1379 it was graduated according to rank, for which an elaborate classification was provided. It included all males and females over the age of 15, except beggars. Curiously enough, it was argued that its harshness upon the poor would be mitigated because the rich were expected to aid the poor in paying it. Endless disputes arose over the age of taxpayers, and a rather insolent attempt to ascertain the age of a young girl was said to have been the immediate cause of the Kentish rebellion (in 1381) under the leadership of Wat Tyler.[49]

Medieval Indirect Taxes. Indirect taxes were also common in medieval England, particularly levies upon foreign trade. The taxes upon the latter were so well established at the time of the Great Charter that they were regarded as belonging to the king without the assent of the people and were sometimes referred to as the "ancient customs." This did not mean, however, that the king could levy customs as he saw fit. The heavy duty on wool, for instance, levied by royal prerogative during the reign of Edward the First (1297), was regarded as a violation of the Magna Carta and was subsequently released by the king.[50]

In the more modern era of Oliver Cromwell, inland revenues or excises were introduced into the tax system of England. In the course of English history almost every conceivable article of consumption has been taxed through either customs or excises, or both. To mention only a few, there have been taxes on salt, corn, meat, sugar, pepper, olive oil, vinegar, confectionery, tea, coffee, cocoa, glass, candles, leather, paper, newspapers, and, of course, liquor and tobacco. The tax on salt was resented in England as elsewhere, although its final repeal was not attained until 1825. The corn laws were a special object of criticism, but it was not until 1846 that agitation against them finally succeeded in forcing not a complete repeal, but a reduction at least to a nominal rate.[51]

Medieval Presumptive Taxes. A curious species of tax, not entirely extinct and savoring of both the property and income taxes, were a group of levies

[48] On occasions the British property taxes were apportioned rather than proportioned (to use Prof. Plehn's terminology); that is, a certain sum was allotted to territorial subdivisions and they were allowed to proceed more or less on their own in collecting the revenue (compare with the American system of state equalization under the general property tax, Chap. IV).

This system was also used in France, including apportionment to certain orders such as the clergy. Ordinarily no special treatment was accorded to the British clergy and nobles. Once the shares of particular units were established, they remained fixed over long periods in spite of changes in wealth and population (Stephen Dowell, *History of Taxation and Taxes in England*, Vol. I, pp. 95-98).

[49] *Ibid.*, pp. 91-103.

[50] *Ibid.*, pp. 76-78.

[51] Stephen Dowell, *History of Taxation and Taxes in England*, Vol. II, pp. 8-14, 63, 74-81, 171, 174, 269, 330.

based upon some circumstances of living which were thought to indicate one's ability to pay, as well as one's economic and social status. Such were the hearth tax, the window tax, the carriage tax, and a few other similar taxes. The hearth tax was based upon the number of stoves and chimneys, and the window tax upon the number of windows in the houses. Both encountered serious difficulties. The hearth tax had been imported from France (1662), where it had been a part of the revenue system for many years. The British resented taxes imported from France and objected to the hearth tax on the additional ground that it involved an invasion of their homes by the assessors. The window tax (1696) raised the problem of defining a window and was objected to as a tax on light and ventilation.[52]

Net Income and Inheritance Taxes in Modern Times. The net income tax was first introduced into England in 1798[53] and was in effect there sporadically until 1842, when it became a permanent part of the British revenue system. Like many new revenue measures, or the rediscovery of old ones, it grew out of a financial distress occasioned by war. At the outset the tax was proportional rather than progressive, but an exemption was allowed for necessary living expenses. The progressive feature was not introduced until 1907.[54] At present this tax is the mainstay of the financial system of Great Britain. The death duties were first introduced as stamp duties. Because of evasions they were not very productive and, in 1796, were replaced by a new law which levied the tax on the transfer of property itself. Owing to the strong opposition of the landowners, this tax applied only to personal property (of collateral heirs), but finally, in 1853, it was also extended to real property. It was not until 1894, however, that it assumed something like its modern form.[55]

In this brief and rapid survey, the development of tax institutions in other countries of Europe can be largely ignored, except for the reference already made to the taxes in effect in France prior to the French Revolution. In modern times the development, on the whole, took the same course as in England, although there were many variations. The Prussian income tax with a graduated feature was introduced in Prussia in 1851. The French were slow to develop a general income tax, but after the Revolution they

[52] A curious tax, sometimes classed in the group under consideration, was the British tax on powdering of hair, a tax which contributed to a change of fashion (*Ibid.*, Vol. III, pp. 163-177, 255-259).

The tax on inhabited houses (1778), exclusive of land, based on annual value appears to have been a cross between the type previously described and a special property tax. In levying this and some other taxes, Lord North, hard pressed for funds to carry on the war against the American colonies, went to the *Wealth of Nations* for inspiration. Adam Smith, the author of that famous treatise, advocated a house tax based upon annual rental value rather than upon the number of windows in a house—the type of house tax that was in effect in England in his time.

[53] Enacted into law only in 1799.

[54] E. R. A. Seligman, *The Income Tax* (2nd ed.), pp. 72-80, 128-136, 202-207.

[55] *Ibid.*, pp. 452-456. Stephen Dowell, *History of Taxation and Taxes in England*, Vol. III, pp. 124-140.

developed a business tax, which was a curious and complicated compound of a classified occupation or license tax, and a special income tax containing a few traces of the progressive principle.[56]

Early American Public Expenditures. The American colonies founded their tax institutions upon British experience, but some variations appeared in these institutions as they developed on American soil. Public expenditures in the colonial era were exceedingly modest. Many public officials served gratuitously or were compensated with fees. There were no social welfare appropriations, and public works were unimportant. It was not until the close of the eighteenth century, and especially the third decade of the next century, that large outlays were made for turnpikes, canals, and railroads. Public schooling was still in its infancy, although New England early became interested in public elementary education. The church, on the other hand, was supported by taxes in some of the colonies until after the Revolution. In Connecticut, for instance, "The inhabitants met in town meetings to appoint their minister as they did their selectmen and taxes were paid to support the minister as well as the teacher." For a time, Episcopalians and other dissenters were taxed for the benefit of the official church (Congregational). By 1729 they were relieved of this obligation, but it was not until much later that the Congregationalists themselves came to support their church through voluntary contributions instead of taxation.[57]

Colonial Direct Taxes. The direct taxes employed by the colonies (payable in tobacco in some states) were the poll tax, the so-called faculty tax,[58] and the property tax, the latter more like the English "rates" than our present general property tax. These taxes were not in effect in all colonies to the same extent. The New England colonies employed all three of them, but the property tax predominated there. In the southern colonies the poll tax played the more important role, although the chief sources of revenue were indirect taxes. This also held true for the middle colonies until the latter part of the eighteenth century, when greater reliance upon the property tax brought them closer to the New England system.[59]

Development of the General Property Tax. The American *general* property tax seems not to have developed until the nineteenth century. According to Professor Jensen there was only one case, that of the Constitution of Tennessee (1796), where a semblance of uniformity and universality appeared in the property tax during the early days of the Republic. This constitutional provision stated that, "All lands liable to taxation . . . shall be taxed equal

[56] C. C. Plehn, *Introduction to Public Finance* (5th ed.), The Macmillan Co., New York, 1926, pp. 119, 125-127.

[57] Arthur F. Potter, "Taxation System of Connecticut in 1776," *Bulletin of the National Tax Association*, Vol. XXIII, No. 7, Apr. 1938, p. 196. D. R. Dewey, *Financial History of the United States*, pp. 8-9.

[58] The faculty tax was a substitute for the property tax and applied to the earning capacity of artisans and professional people.

[59] D. R. Dewey, *Financial History of the United States*, pp. 9-14.

and uniform, in such manner that no one hundred acres shall be taxed higher than another except town lots which shall not be taxed higher than 200 acres of land each." [60] It was uniformity by area rather than by value that this provision referred to—hardly an equitable measure of uniformity judging by our present standards. The Connecticut statute listed the items to be covered and included in the statute valuations at which they were to be listed. The assessors had little discretion and were (properly) called listers. Lacking property, the artisans and professional people were also included on the list—according to their "faculties."

The new constitutions of the 1820's and 1830's (Illinois, 1818; Maine, 1819; Missouri, 1830) called for the assessment of all property (with provisions for exceptions either in the constitution or by statute) including personal property, and all in proportion to value. The Illinois constitution of 1818 contained a uniformity rule which has prevailed substantially down to the present time. This constitutional provision, however, was ignored by the legislature until 1839.[61] At this time there was a strong movement toward uniformity, the principle of which was incorporated in most of the state constitutions written later. Curiously enough, in recent years there has been a reversal in this policy. The movement now is toward the classification and special treatment of different kinds of property.[62]

Colonial Indirect Taxes. All of the colonial governments employed indirect taxes, especially duties on commerce, including in many cases the commerce with the other states.[63] As we have seen, the Federal Constitution of 1789 appropriated the exclusive use of the customs to the federal government, in whose hands it became the major source of federal revenue for many years.

[60] Quotation from Jens P. Jensen, *Property Taxation in the United States*, University of Chicago Press, Chicago, 1931, p. 37.

[61] Just six years preceding this constitution, the territorial legislature set up a classification of lands—such as bottom lands, other located lands, claims to lands not yet located—and levied specific taxes against such lands at a certain sum per acre (resembling the earliest taxes of England). The best or first-class land was expected to pay one dollar per acre. Although the newly adopted constitution called for a tax in proportion to the value of one's property, the tax law of the following year merely modified the classification in effect by attaching a value per acre to each of the three different classes. The present uniform tax on all property (within the same district and with specified exceptions) did not develop until after the statute of 1839.

The present provision reads: "The general assembly shall provide such revenue as may be needed by levying a tax, by valuation, so that every person and corporation shall pay a tax in proportion to the value of his, her or its property" (Constitution of 1870, Article IX).

[62] Jens P. Jensen, *Property Taxation in the United States*, pp. 38-41, 45-47.

With the development of the general property tax came complicated problems of administration and the necessity for extensive machinery for equalization and review. This machinery began to appear as soon as the tax became universal. The difficulties with which it has been beset and the refinements which, as a consequence, have been made on it are the subjects of later chapters.

[63] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, pp. 40-41.

Special excises, such as those on liquor and tobacco, have been employed by the federal government for many years, particularly since the Civil War, and more recently by the states. The latest addition to the taxes of the states is the retail sales tax, having developed mainly during the depression of the 1930's.[64]

Other Taxes. The inheritance tax was first introduced into the tax systems of the states in 1825, although its modern and effective use waited until the twentieth century. The same is true of the net income tax. Both were used by the federal government during short intervals, but neither of them became a permanent feature of the federal revenue system until the First World War. Corporation and business taxes developed in the states mainly after the Civil War.

As will be seen later, considerable problems have arisen through the current use of many similar taxes by both the federal government and the states.

Conclusion. This rapid survey of the development of tax institutions should convince the reader that little which is entirely new in taxes or public expenditures has been invented in the modern era. The net income tax is a relatively modern innovation, and public expenditure for education is relatively new. The changes that have taken place have not been so much in the types of taxes and expenditures as in their degree and in the environment in which they operate—the economic institutions.

Changes in Economic Institutions

Development of the Modern Corporation. The growth of the large modern corporation to a dominant position in industry and trade has revolutionized the problems of taxation. Recent studies have disclosed that in 1930 the combined assets of the 200 largest nonbanking corporations in the United States amounted to nearly half of all the corporate wealth in the country, excluding banks.[65] Such large corporations are difficult to tax equitably because they cannot easily be subdivided for local taxes, because their identity is not easily merged with or distinguished from that of their stockholders, and finally, because the corporations may have intangible assets distinct from their physical value.

The Industrial Revolution. With the development of the corporation and the development of urban and industrial life, there has been an increase in

[64] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, pp. 306-307, 518-521.

[65] A. A. Berle and G. C. Means, *The Modern Corporation and Private Property*, The Macmillan Co., New York, 1935, p. 19.

In 1929, corporations accounted for about 86 percent of the transportation and other public utility business, about 92 percent of manufacturing, about 63 percent of trade, and 57 percent of all business, excluding government but including agriculture (Twentieth Century Fund, Inc., *Big Business*, New York, 1937, p. 17). It is said that the American Telephone and Telegraph Company alone controlled more wealth in 1932 than the combined wealth of 21 states.

personal property, both tangible and intangible, and a high degree of differentiation of such property. The property tax, which may have served well in an agricultural era, is likely to be found unequal to this new environment. Unquestionably, the industrial revolution and its aftermath had as profound effects on the tax problem as upon other political and economic problems.

Territorial Interdependence. The development of territorial interdependence, with the growth of internal trade, travel, migration, and communication, has had a decided influence on public finance. The problem of which state or subdivision has the legal and moral right to tax cosmopolitan business is a highly vexatious one. In the case of a great mail-order house doing business throughout the country, the question presents itself as to how much of its property, income, and sales are properly included in the tax base of the city in which the business is located, and how much, if any, belongs to the hinterland trade area. In modern times it is necessary to inquire not only *who* should be taxed and *how*, but also *where*. In public expenditures, interdependence obscures the responsibilities of government. If all the graduates of a village high school remained in the home community, it could be plausibly argued that educational costs were properly confined to local taxpayers. But what shall we say when only a minority of the graduates remain at home and the others go forth into other communities and states?

Expanding Public Expenditures. Mention should also be made of the changed attitude toward government which expects the latter to perform a positive role in providing for the welfare and security of the citizen. This, together with the industrial revolution, has brought about a relative volume of public expenditure seldom known in the past and certainly a wider range and more complicated pattern of expenditures than has ever heretofore existed. The increased utilization of public credit on an enormous scale has been one of the direct outcomes of these changes.

Use of Taxation to Control and Stimulate Production. Since the days of Adam Smith, it has been recognized that taxes should be levied with as little hindrance to production as possible. This aspect of taxation took on new significance, however, in the depression of the thirties. And it is certain to have much attention in the postwar era, when all economic policies will be judged, in part at least, by their effects on employment.

The Universal Franchise. For many years there has been an intimate relationship between the right to vote and the obligation to pay taxes. In the early years of American history, a property qualification for voting was the rule. This is no longer true, but in some states the payment of poll taxes is still linked with the right to vote. Many looked with much foreboding on what they regarded as the highly explosive combination of the universal franchise and progressive taxation. Present income and estate taxes with steeply graduated rates are sometimes regarded as the vindication of these fears.

Class Conflict in Taxation. Taxation, like many other aspects of our economic world, has played and continues to play a role in the conflicts of the classes. Organized industry, organized labor, organized farmers, and other organized economic groups each has its "tax program," designed either to favor its own interest or to promote its view of what constitutes the public interest. Thus, organized labor is likely to oppose indirect taxes and to favor income and estate taxes that are steeply graduated and offer high exemptions. It is likely to meet the opposition of the National Association of Manufacturers on some or all of these objectives. Tax legislation is often more largely a result of a balance of power between conflicting interest groups than of the application of taxation principles.

Importance of the Economic Institutions. It is apparent that the institutional background is a large factor to be considered in determining fiscal policy. Thus, when wealth consisted mainly of land and the instruments of tilling it, the property tax was a fair measure of ability to pay. This was particularly true where the quantitative distribution of wealth was fairly equal. In a state like North Dakota today the property tax is far more equitable as a main source of revenue than in New York. The tax would be more equitable in the former state, however, if all the farm land were owned free of debt by those who farm it. The advent of a completely socialistic or communistic state would change the significance of tax institutions even more. For example, the sales tax, now the principal levy in Soviet Russia, differs considerably from what it would be in the United States. The income tax in China, where the population consists largely of relatively poor farmers, is quite a different institution from that in industrialized Great Britain.

SUMMARY

The subject of public finance, as distinguished from that of private finance such as banking, corporate, and personal, deals primarily with the financing of government. The field has become of increasing importance in recent years, although to be sure it has played a central role throughout history as may be evinced from only a cursory glance into the past, particularly such phases of the past as the constitutional development of Great Britain, the American Revolution, the French Revolution, and the early years of the history of the United States. In fact, most public finance institutions, of which only those relating to public revenue and public expenditure have in this chapter been considered, are of ancient origin. In various forms and degrees, most of them were employed even in ancient times. As we know them at present, many have been handed down directly from medieval England, whence the colonists carried them to America. The general property tax is probably one of the few peculiarly American products. At all times, how-

ever, public finance institutions have been conditioned by the prevailing economic institutions. In the course of history the latter have undergone great changes, of which the industrial revolution, the growth of territorial interdependence, the development of the modern corporation, the universal franchise, class conflicts, and a changed attitude toward government, may be cited as illustrations.

SELECTED READINGS

No attempt is made here to give an exhaustive list of references or even all those referred to in the preceding pages. Rather, with the view of being helpful to the laymen and students in an introductory course in public finance, the following references consist mainly of generalized treatments of the various subjects covered in the chapter.

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CHAPTER II

Distribution of Governmental Burdens

INTRODUCTION

Nearly all human activity is for the purpose of satisfying human wants of one sort or another, and in this respect governmental activity is no exception. Some wants are well satisfied by individual action, but most of them require cooperation for best results. Very often cooperation takes the form of an organization dedicated to the collective satisfaction of individual or collective wants. To mention only a few, recreational wants are satisfied through country clubs, social wants through fraternal organizations, political wants through political parties and clubs, professional and vocational wants through professional associations and trade unions, religious wants through churches, economic wants through private corporations and cooperatives, and so on. Most of these organizations have a constitution and by-laws, as well as a budget of some sort, a treasury, and a financial problem. Most of them have, in addition, the problem of distributing the burden of support among their members. The government is one of these organizations, differing from the others in that both membership and contributions to the treasury are always compulsory, though the latter with some qualifications. The problem considered in Part Two of this book is the division of the burden of these contributions among the membership of government.

It has been observed in the preceding chapter that modern governments require a great deal of revenue and that a bewildering variety of taxes and other sources of income have been evolved to meet this need. In the following chapters these different sources will be considered in detail. An attempt will be made, among other things, to explain their nature, the arguments with which they are defended and attacked, the special problems involved, and finally, their role in the revenue system. No analysis of taxation can proceed far without encountering the important allegation that many who pay taxes pass on the burden to others; this problem will receive special attention in Chapter VI. Moreover, since these sources of revenue are alternative sources, in order better to judge the place, if any, which should be given to each, it will be helpful to consider in general some of the qualifica-

tions of a good revenue source, certain general standards or principles of distributing government burdens, and certain alternative ways of setting up tax rates. These general aspects of apportionment will be considered in the present chapter.

FACTORS TO BE WEIGHED IN CHOOSING REVENUE SOURCES

Justice

Reasonable Classification. What principles should guide the government in distributing the burden of its needs among its membership? First of all, most people will answer, the government must be guided by considerations of fairness. Each member must assume his share. Taxes and other sources or revenue must be just and equitable. Here, however, the agreement ceases. Philosophers have debated the meaning of justice in the abstract since the ancient Greeks, and students of public finance have wrestled almost as long with its application to their field. Short of a precise definition of justice, however, there is a more or less common agreement on some of its attributes. One is that it cannot be achieved by treating everyone alike. If identity of treatment were contemplated for all, then whatever burdens and immunities were allotted to *A* must also be allotted to *B*. On first thought this seems to give no reason for complaint, but on further reflection it becomes evident that this might be reason enough for either *A* or *B* to complain. To be sure, if we were all in precisely the same circumstances, justice would require the same treatment for all. But circumstances differ widely. Suppose the issue is who shall be chosen to bear arms during a war. Identity of treatment would require that selection be made on the sole basis of drawing names out of a hat, so to speak. Actually conscription during both the First and Second World Wars followed a very different procedure. People were divided into several classifications according to certain relevant circumstances, such as sex, age, dependents, physical condition, ability to produce at home, and so on. This classification met with wide approval and few, if any, thought it unjust. It was an application of *reasonable classification*, under which people in different circumstances are treated differently.

The principle of reasonable classification is applied to many fields. In the field of labor legislation, it is used to sustain laws protecting women and children but not applicable to men. Its use in taxation is extensive and important. Without classification, revenue would have to be raised by a single universal poll tax, with no exemption for babies, old men, lunatics, or others. This would be a very simple tax system, but few people today would proclaim it just.

If it is apparent that it is unjust to treat *A* and *B* alike when their circumstances are different, it is likewise unjust to treat them differently when their

circumstances are the same. That is why almost everyone will agree that the French tax system before the French Revolution was very inequitable. Taxpayers in like economic circumstances were treated unequally if they belonged to different orders or carried different titles, or, for that matter, because they did not reside in the same district. For similar reasons the American income tax is criticized because it exempts certain people who derive their income from "tax-exempt securities" and because certain taxpayers are allowed to escape their taxes by accumulating their wealth in corporations beyond the reach of the personal income tax. It is generally agreed that there is something wrong with a tax which imposes a 50 percent burden upon one person with a million dollars of wealth or income and only half as much upon another whose economic status is exactly the same.

In other words, justice requires not identity, but impartiality of treatment. This is another way of saying that classification must be reasonable and not arbitrary. To exclude babies, or even youth, from a poll tax appears just, but the exemption of red-haired people would be an entirely different matter. The principle of reasonable classification may seem an obvious principle of equity in taxation. But reference to the preceding chapter will suffice to convince one that people have not always enjoyed this blessing; and they do not enjoy it in full by any means today.

Along with the idea of reasonable classification goes that of rough approximation. Both legal and economic students of taxation recognize that it is no simple technical task to raise the revenue of a modern government. Thus we frequently hear it said that "rough justice" is the best that can be expected.

The Subjective Aspect of Justice. Beyond the fact that there should be equal treatment for those in like circumstances, the requirement of justice in the distribution of governmental burdens is largely a subjective matter. It is a question not of fact but of opinion. What seems just to one critic may seem otherwise to another.

The difficulties in the search for any objective standard of justice in taxation can be clearly observed in the analysis of the similar and related problem: what constitutes or would constitute a fair distribution of wealth? On what grounds is A entitled to more in the way of economic rewards than B? Because A needs more? Many people would object to the "needs test," contending in the name of justice that there should be "equal pay for equal work." Should it be on the ground that A has greater ability? Someone would answer that ability is its own reward and that one who can do creative work for a living (the sort that he might choose for recreation) is fortunate enough, even if his share in the distribution of wealth or income is very meager. Is A entitled to more because he has a disagreeable job involving a high pain cost or disutility? Some people would object that this would leave much talent unrewarded and that talent is entitled to its reward. These and similar questions always pose themselves when one attempts to find an "equitable" basis for raising governmental revenues.

Justice and Social Expediency. Obviously there are many matters besides justice that must be taken into account in making practical financial decisions. There are some who would make the concept more inclusive and define justice in pragmatic terms as that which works to the best advantage of all. However, most people use the word in a somewhat narrower sense. Sometimes they speak of sacrificing justice for the sake of social expediency. Social expediency in the distribution of governmental burdens consists of choosing those sources which produce the best or least undesirable results. It includes justice and much more. Thus, it appears that justice in the tax system, beyond impartiality of treatment, consists of what seems fair and equitable to the particular critic. It is a highly intangible and subjective factor, but a very important one.

Administration

Some of the other elements of social expediency, in addition to justice, may now be considered. It will be observed that these elements are often in conflict and that not all of them can be had in any one particular revenue source. Social expediency consists in weighing them all and so choosing that the maximum advantage will be achieved.

It will be generally agreed that consideration must be given, in weighing alternative revenue sources, to the administrative difficulties which they may entail. Administrative difficulties are of two kinds: cost of administration, and inequity resulting from evasion or the unequal application of the tax to taxpayers in similar circumstances. An example of a tax involving excessive cost of collection is the poll tax. In theory the poll tax is defended on the ground that it makes everybody pay a direct tax to government. In practice, the poll tax, as applied to those who pay no other direct taxes, can be collected only with difficulty and at heavy expense. The excess profits tax is an example of a tax which may produce unfair results because of administrative difficulties. The rate of this tax is based upon the ratio of profits to capital, and if the latter cannot be ascertained with some precision, erratic results are sure to follow.

The efficiency of a tax (in terms of the proportionate net return to the government over outlays for administration) cannot be reckoned without giving due weight to the "cost of compliance"; that is, the outlay the taxpayer must make in order to calculate and meet his responsibilities to the government.

Effect upon Production

Other things being equal, that revenue source is best which interferes least with the private production of wealth. It is commonly observed that taxation should be so devised as "not to kill the goose that lays the golden

egg." There is agreement on this objective, but not on how to accomplish it. It is obvious that a tax system designed to impede production as little as possible should conserve the resources of the country, particularly the human resources. A sensible nation does not skimp the food rations of its army. And both during war and peace, the country's civil personnel as well as its regiments are "in the army" in the broad sense. A heavy tax on food would be open to the criticism that it threatens adequate nutrition. Many hold that the principal check to production in a highly developed economy is a tendency toward oversaving and an inadequate market. Very probably the cure for this tendency, if it is real, would be the development of income and inheritance taxes with steeply graduated rates. But oversaving might also be remedied by more investment and the expanding demand that would be engendered by it. This brings us to the incentive approach to the problem of fostering production: to the contention that economic activity and initiative can be developed mainly by properly designed rewards (or penalties) applied at strategic points in the economic system. The term "incentive taxation" has been used to describe certain tax proposals such as one that would decrease the tax on a business if the latter would expand its payroll. But without going so far, a judicious selection and application of taxes can be very important in supporting production. For instance, death taxes may be less inhibitive to the economic incentives than income taxes. In husbanding production potential, the form of taxation may be quite as important as the degree. Thus, a high tax on capital gains with provision for the full deductibility of losses may be less repressive than a lower tax without such provision.

Yield

Other things being equal, that revenue source is best which yields the most revenue. It is highly important that public revenues be sufficient to maintain essential governmental functions. Beyond that, occasion may arise where public opinion is far more interested in a generous program of public expenditures than in the alternative means of financing it. At least it can be said that a tax which is perfect except that it brings in no money has no financial usefulness. The first question that any practical critic will ask about a new tax is: "How much will it yield?" Thus *adequacy* of revenue produced is a major consideration in selecting revenue sources. Besides the quantity of revenue which a tax or a tax system brings in, the *steadiness* of its yield is significant. Since most expenditures are made regularly, it causes considerable embarrassment to the government if revenues fluctuate widely from year to year. This is particularly true of state and municipal governments, which are often in no position to borrow when deficits occur. Some have contended that, in the case of federal taxes, instability of yield is a

positive advantage. Taxes that are "cycle-sensitive" (yielding much less in depression than in prosperity) will deprive the private economy of less purchasing power when the latter is needed to maintain trade. Thus unstable taxes, like the income tax, are automatically inflationary and deflationary at the proper times. In addition, it is desirable that a revenue source possess some degree of *elasticity* in its productivity (a tax is said to be elastic when it can be easily manipulated to produce more or less revenue as required). Such a source can be relied upon to meet the needs of government in times of emergency.

Other Fiscal Considerations

There are many other less important matters to weigh in selecting revenue sources. Other things being equal, a tax which is *simple* and readily understood by the taxpayer is preferred. Unfortunately, our economic system and institutions are so complicated that often tax laws cannot be simplified and clarified without sacrificing other important virtues.[1] However, some simplification is possible without sacrificing desirable objectives.

Taxes should be *widely shared* because it is wholesome for all to participate in democratic government (both financially and in the determination of policy). Where the masses vote themselves benefits that are paid for exclusively by a few rich taxpayers, both the contributors and the beneficiaries are likely to be demoralized.

As a practical matter, legislators and administrators must always keep one eye on the reactions of the taxpayers and on the political consequences of possible fiscal policies. Economists are likely to prefer direct to indirect taxes; but from a political viewpoint the latter have an advantage in that they are less likely to make the taxpayer resentful. There are some who go so far as to say that in practice the only principle of taxation is the art of getting "the most feathers with the least squawking." Without going so far, it is clearly reasonable to accept *convenience of payment,* a time-honored canon, as a factor worth considering.

Moderation has sometimes been selected as an element of major importance in a revenue source. Of course, it would simplify the tax problem if all taxes could be moderate in degree. Whether or not moderation is an end in itself, there can be no question about its bearing upon administrative difficulties. Beyond a certain point, difficulties in assessment and collection usually increase geometrically as tax rates advance.

[1] "The cry for equality and justice is louder and more unanswerable than the demand for certainty and convenience. . . . Replace the complexities of the income tax with the simplicities of the sales tax tomorrow, and within ten years the income tax would be back. In the light of financial history 'simplicity' is a lesser god." (T. S. Adams, "Fundamental Problems of Federal Income Taxation," *Quarterly Journal of Economics,* Vol. XXXV, Aug. 1921, pp. 554-555.)

Effect upon the Distribution of Wealth and Income

Justice as a factor in choosing revenue sources has already been considered. Many people regard inequalities in income as a clear case of the tyranny of the strong and fortunate over the weak and poorly endowed. Quite aside from this, however, many would sanction the proposition that (other things being equal) those revenue measures are to be preferred which reduce rather than widen inequalities in wealth and income. This is on the ground of social expediency as well as that of justice. Recently a writer expressed this philosophy as follows: "Since the time of Aristotle it has been recognized by the wise that extremes of riches and poverty, that spectacular differentials of income, are dangerous and pernicious in any society. The enlargement of the middle class as against the poor and the rich must, therefore, be sought by anyone who wishes a society to live soundly and endure long." [2] There are others who put the stress on equality of opportunity, a factor which will be considered at length in connection with the inheritance tax. However, the use of taxation to reduce inequalities of wealth has not been without forceful opponents. They regard the reduction of inequalities as "putting a ceiling on achievement." Among these was John McCulloch, the British economist, who inaugurated the "leave-them-as-you-find-them" theory, that is, that the tax system should leave the taxpayers in the same relative economic position as they were before taxation.[3]

Other Social and Economic Consequences

In addition to the factors listed above, there is a wide variety of social and economic effects which are important in the consideration of particular taxes. The effect of the British and French window tax on ventilation, mentioned in the previous chapter, is a case in point. Taxes may discourage certain consumption deemed wasteful or harmful, an element which has played a large part in the history of taxes on liquor and tobacco. Exemptions from taxation may be supported on the ground that they encourage useful activities such as philanthropy, education, and housing. Tariffs are usually selected with at least one eye on their effects upon domestic industry. Poll taxes may be levied to prevent the poor from voting. Taxes may also affect the business structure, size of business units, methods of corporate financing, and so on.

These and a great many other consequences of a similar nature are sometimes referred to as the nonfiscal aspects of taxation. Some deny the propriety of using taxes for nonfiscal ends. However, there are also nonfiscal effects from a tax levied primarily for revenue. They are quite as much entitled to consideration as any other effects of a tax. Even a tax predominantly moti-

[2] Walter Lippmann, *The Good Society*, Little, Brown and Co., Boston, 1937, p. 232.
[3] J. R. McCulloch, *A Treatise on the Principles and Practical Influence of Taxation and the Funding System* (3rd ed.), Adam and Charles Black, Edinburgh, 1863, p. 143.

vated by the desire to control must be judged by the sum total of its consequences and cannot be condemned *a priori* because of its motive.

Author's Selection of Important Objectives for Postwar Taxation

The following are submitted as major objectives in postwar taxation:

1. Taxes should be fair; distinctions in tax burden should be based on reasonable principles and not be arbitrary. This is important both for its own sake and for the morale of the taxpayer.
2. Taxes should reduce inequalities in wealth, income, power, and opportunity. Wide inequalities are abhorrent to democracy.
3. Taxes should conserve the human resources that "man the works."
4. Taxes should preserve a wide market and not aggravate oversaving.
5. Taxes should preserve incentives and avoid penalties upon those who innovate, take risks, and assume responsibilities.
6. Taxes should be as direct as feasible; generally, taxpayers react most sensibly to what they see and understand.
7. Direct taxes should be widely shared. Wide participation in government is desirable both on the voting and the financial sides.
8. Taxes should be adequate.
9. Tax reductions and tax increases serve as stimulants and narcotics to business, and these drugs should be administered so as to mitigate rather than aggravate business instability. Tax reductions should be reserved for depressions and tax increases should be applied, as far as possible, during prosperity.

So much for the many factors that must be weighed in sizing up the social expediency of a revenue source. As a means of achieving justice and social expediency in the apportionment of governmental burdens, certain standards or general principles of distribution have been advanced. Consideration will now be given to these general principles.

PRINCIPLES OF APPORTIONING GOVERNMENTAL BURDENS

The Principle of Benefits Received

In the commercial world it is a rule that every commodity or service carries a single price for all buyers regardless of class or circumstances. When *A* and *B* go to the grocery store to buy a sack of flour, they are not subjected to an inquiry concerning their fortunes. On the contrary, to the grocery clerk, a purchaser is a purchaser; he is quite happy to sell to anyone willing to pay the market price.[4] It has been contended by many that this simple rule of

[4] There are exceptions, of course, particularly in the professions where the charge for services is likely to be gauged somewhat by the individual's capacity to pay.

paying for what one gets should be applied to the goods and services supplied by the government as well as to those supplied by the grocer. If those who received benefits always had to pay for them, there would be less clamor for government help.

No Definite Measurement of Benefits Possible. The benefit theory appears plausible, but it is open to fundamental difficulties and criticisms. The first is that, for many governmental services, no very clear accounting of benefits can be made. One of the characteristics of government is that its services in the main are rendered for the benefit of all, and the particular interest of any one taxpayer is not determinable. Unfortunately, one is equipped with no mechanism to measure the benefits he receives from government as he is, for instance, with a meter to gauge his services from the gas company. How is the benefit of a new battleship to be divided among the people of the United States—people with varying wealth and income and in all parts of the country? Similarly, by what process of accounting could the benefits of the national capitol be prorated?

When *A* attends the public school for a year, who gets the benefit and how much? First of all, the benefit may be greater or less than the cost to the government. Waiving this complication, what about the division of benefits? Presumably *A* and his family have some direct interest in this education; both stand to gain, at least if the result is increased earning power for A. It would not be easy to calculate in quantitative terms how much this direct interest amounts to. Certainly many others are interested in *A*'s education besides himself and his family. Employers of labor are interested because some of them may wish to employ A. At least a certain amount of education will make him a more efficient employee. To make matters more complicated, A may be educated in Bangor, Maine, and end up as an employee in Sacramento, California. The publishers of a national magazine in Philadelphia are interested in *A*'s education, for he may become a potential subscriber. The voters, both of the country at large and of *A*'s state, are also interested. *A* will soon have the powers and responsibilities of a voter, and it is dangerous to leave the complicated problem of government in ignorant hands. And so on.

Who Receive Greater Benefits—the Rich or the Poor? There is no clear consensus as to whether the rich receive more benefit from the government than the poor, or vice versa. On the one hand, it is contended that the rich are clearly the greatest beneficiaries of government, that in fact government exists mainly to protect property rights and to prevent those who have not from encroaching upon those who have. Rousseau, for example, in his *Discourses on the Causes of Inequality*, held that government was a device of the rich and the strong to protect their property against the poor.[5] But it

[5] A. T. Williams, *The Concept of Equality in the Writings of Rousseau, Bentham, and Kant*, Columbia University, New York, 1907, p. 14.

also can be argued that the poor have a greater stake in government than the rich. The poor must rely upon the police force to protect them, whereas the rich can buy protection in the form of private guards, barbwire fences, bulldogs, and other protective equipment. The medieval castle was an example of such privately provided protection. Further, the rich man can either send his son or daughter to a private school to be educated or employ a special tutor for this purpose, but the poor man is entirely dependent upon the public schools. It is not necessary to arbitrate between these two contending points of view. The argument illustrates well the difficulty of measuring benefits from the government.

Benefit Principle Incompatible with Wide Consumption. The second main difficulty with the benefit theory is that public opinion supports the wide use of many public services which would be impossible under our existing system of distribution of wealth and income were beneficiaries to pay an equivalent for the benefits. What would become of the poorhouse, for instance, were the inmates to pay for their publicly furnished board and lodging? The answer is that the poorhouse would become a hotel and would, of course, lose the function for which it was intended. We are not content to confine education to those who can afford and have the inclination to seek it. On the contrary, we pass compulsory education laws requiring all children below a certain age to attend school whether or not they wish to and whether or not their parents can afford to send them. "It is felt that, when . . . government compels a man to accept . . . that service at its hands, whether he wishes to or not, it would be unfair to ask him to pay for it." [6] It has been reported that, in a number of school districts during the depression of the thirties, the public school was abandoned and reorganized as a private institution with each parent paying for the education of his child. In one city of 15,000, it is alleged, over two hundred children were excluded from school because, under the new arrangement, their parents could not afford the tuition.[7] Most people, when presented with such facts, feel that the latter are very abnormal and that something ought to be done about them.

Governments have expanded partly by adding to their free list, that is, to those goods and services furnished without direct compensation from the immediate beneficiaries. A strong case is now being made for the addition of housing, medical service, and even electricity to this free or partially free list. As a matter of fact, the government is urged to provide these services or aid in their provision mainly because of the view that it would be in the social interest for all to have them and that private incomes in many cases are inadequate to purchase them in suitable quantity or quality.

[6] A. C. Pigou, *A Study in Public Finance*, Macmillan and Co., Ltd., London, 1928, p. 47.

[7] Maxine Davis, "The Little Red School House," reprinted from *McCall's Magazine*, 1934.

Payment for Special Benefits. Although the benefit theory is thus open to some valid criticism, it does find much reasonable application in the revenue system. Where governments engage in more or less commercial activities (e.g., operation of public utilities), they usually collect for their services in full from the beneficiaries. Charges are made according to the cost of the service—which differs little from the benefit principle. "*Prima facie* it is fair that the users of ordinary services should pay for them in proportion to their use, and should not receive a subsidy at the expense of other people." [8] The term "public prices" rather than "taxes" is ordinarily used to designate these payments. The stamp system of paying postage is an illustration, though the cost-of-the-service principle in this case is tempered by other considerations. The Detroit publicly owned street railway charges its patrons like any other street railway. Similarly, certain special services of government are paid for by fees. To mention one example only, when a public officer performs a marriage ceremony he makes a regular and standard charge for this special service. Many public improvements are also paid for in full or in part by special assessment; that is, by a special levy upon the abutting or near-by property which is supposed to derive special benefits and probably an increment in value because of the improvement.[9]

The above applications of the benefit principle for the distribution of governmental burdens are mainly outside the field of taxation. They are supported, and in most cases plausibly, on the ground that the government has performed a special and clearly discernible benefit for private beneficiaries. It is proper that the government should collect from these beneficiaries accordingly.

Payment for More General and Partly Discernible Benefits. Within the broader field where the services of government are paid for by taxes and the benefits are only partly discernible, the benefit principle still has wide application—much of which is entirely defensible. The benefit principle is nowhere near so antiquated and obsolete as many recent critics would have us believe. Perhaps the best known case of its application in taxation is the gasoline tax. Gasoline consumption is regarded as a fairly good measure of the service one obtains from a publicly constructed and maintained system of highways. It is generally thought that those who enjoy this service should pay for it. Social security taxes, perhaps more properly called contributions, are also assessed on the benefit and cost principles. One of the soundest arguments in behalf of unemployment insurance is that unemployment should in part be regarded as one item in the overhead cost of doing business and should be paid for by business or its customers. Business and property taxes rest most plausibly upon the principles of benefits and costs. They are defended on the ground that "almost all general public services take on the

[8] A. C. Pigou, *A Study in Public Finance*, p. 46.

[9] Some account of these sources of public revenue other than taxes is presented in Chap. XVIII.

character of goods which are instrumental in the production and necessary for the consumption of the goods produced by private persons." [10] Government is an important "factor of production" and an overhead cost of doing business and owning property. It is true that, at best, these benefits and costs are but very roughly measured. And it is at least debatable whether business and property taxes are not based more on opportunism and rationalization than on equitable principles. Nevertheless, it would be difficult to conceive a tax system with no such taxes.

Lastly, the benefit theory has wide application in determining which unit of government should pay for a given public service. It would be regarded as unjust to require that the taxpayers of Albany pay for an ornamental street-lighting system installed by local ordinance in Syracuse. The United States Supreme Court has stated the importance of benefits in a case in which it ruled that a governmental unit may not tax those who are beyond its jurisdiction: "The power of taxation, indispensable to the existence of every civilized government, is exercised upon the assumption of an equivalent rendered to the taxpayer in the protection of his person and property, in adding to the value of such property, or in the creation and maintenance of public conveniences in which he shares. . . . If the taxing power be in no position to render these services, or otherwise to benefit the person or property taxed . . . the taxation of such property within the domicil of the owner partakes rather of the nature of an extortion than a tax. . . ." [11]

The Ability-to-Pay Principle

Another principle, one which is more often urged as the proper one to use in distributing taxes, is the ability-to-pay principle. Within the family it is customary for each to contribute toward common ends according to his ability. The church solicits funds among the parishioners with the thought that each should give as God has prospered him. To hundreds of common enterprises (community chests, Red Cross, etc.) people are expected to contribute according to their means. Governments are one of these common enterprises fostered to serve the citizens as a group, to protect them, enhance their prestige, and add to their general welfare. What is more natural and appropriate than to distribute governmental burdens according to ability to pay?

Measurement of Ability to Pay. Ability to pay, like benefits received, does not easily lend itself to measurement. There is not even a general agreement as to what should be the measuring rod. Some advocate property or wealth as the proper criterion; others prefer net income; still others support expenditure; and some advocate a combination of two or all three of these. If net income, perhaps the most popular of the many standards, were to be selected

[10] Antonio de Viti de Marco, *First Principles of Taxation*, p. 115.
[11] Union Refrigerator Transit Co. v. Kentucky, 199 U. S. 194, 202 (1905).

as the proper "yardstick," there would still be the problem of defining net income—by no means an easy task. In addition, many would like to qualify net income with allowance for dependents. Some would also differentiate between the various sources of income and ascribe more ability to "unearned" (property) than to "earned" (service) income.[12] This problem bristles with complications and difficulties and no attempt can be made to discuss it fully at this point. Suffice it here to express the opinion that the difficulties are by no means insurmountable if ability to pay is accepted on other grounds as a desirable principle to apply.

Minimum Sacrifice. Several strong arguments in support of the ability-to-pay principle readily suggest themselves. It is contended that the application of this theory involves a minimum of sacrifice on the part of the taxpayer. Minimum sacrifice is but a corollary of the utilitarian principle that governments should seek the greatest good to the greatest number, or the maximum aggregate welfare. As applied to taxation, this means that the inconvenience and loss to the people as a whole should be kept at the lowest possible total. Application of minimum sacrifice and ability to pay is based upon the marginal utility theory as applied to income, according to which the value of a dollar to the recipient decreases as his income increases. If the less important dollars are taken by the taxation of persons according to their means, the total sacrifice of these individuals collectively will be less.

The principal argument against the minimum sacrifice theory of taxation is that its logical application would lead beyond where its proponents care to go. As long as incomes are unequal, the minimum aggregate sacrifice could be attained by taxing only the larger incomes. A tax on a smaller income would hurt its owner more than if the amount were added to the tax bill of one whose income were greater, since the value of the dollar to the latter would be still less than to the former. It is obvious that if this principle were followed in practice, with the existing wide inequalities of fortune, there might not be "taxation enough to go round, so to speak," until "complete equality of fortunes" were attained.[13]

Some proponents of the sacrifice theory, unwilling to accept the quite extreme program which it seems to require, have largely accepted an alternative for practical application—the principle of equal sacrifice. Thus they would approve some levy on the smaller incomes, up to the point perhaps where the sacrifice would equal that involved in levies on the larger incomes. In other words, everyone would be required to make a contribution, but small

[12] The terms "earned" and "unearned" as applied to income are used in two quite different senses. Here the terms are used to distinguish between two sources of income but without any ethical connotation. Elsewhere the terms are used to distinguish between income for which a return is rendered to society and that for which no such return is rendered. The dual use of these terms is very confusing but well established.

[13] F. Y. Edgeworth, "The Pure Theory of Taxation," *Economic Journal*, Vol. VII, 1897, reprinted in his *Papers Relating to Political Economy*, Macmillan and Co., Ltd., London, 1925, Vol. II, p. 103.

contributions from the poor would be assumed to equal in sacrifice the large contributions from the rich.[14]

Others have conceded that an extreme application of the sacrifice theory would have unfortunate effects upon production and would be difficult to administer. They would give sacrifice some weight in choosing taxes but would temper its logical application so as to avoid these undesired results.

There is some support for a ceiling (and a floor) to personal income but few go so far as to say that the ability-to-pay principle should be carried to the point where all incomes would be leveled by taxation. Concern for economic incentives calls a halt to this extreme application of the ability principle.

Objective Aspects of Sacrifice. It has been contended that sacrifice is a subjective matter and that it differs from individual to individual, even among those in the same economic circumstances. This is true, but only partially, as there are objective as well as subjective aspects to sacrifice. Even though *A* may feel the loss of dental care less than *B* feels the loss of his second automobile, society feels it more in the sense that *A*'s teeth have more social importance than *B*'s automobile.

The social interest in minimum sacrifice is much broader than that of keeping pain and inconvenience as low as possible. There is a social interest in allowing individuals to retain enough means after taxation to maintain themselves in health, vigor, and informed citizenship. Thus, it would seem unwise in these days to tax people of little means to such an extent that they could not afford to take a newspaper—even admitting the imperfections of the newspaper as an instrument of adult education. Taxation according to ability to pay simply means that a nation viewed as a family satisfies its most urgent wants before it indulges in superfluities.[15]

[14] See T. N. Carver, "The Ethical Basis of Distribution and Its Application to Taxation," *The Annals of the American Academy of Political and Social Science*, July 1895, pp. 79-99; F. Y. Edgeworth, "The Pure Theory of Taxation," pp. 100-125.

[15] Individual differences, moreover, can be ignored on the ground that, on the average, the loss of economic goods becomes less important as people acquire more of them. Theories must be made to suit the general rule rather than the exceptions. To argue that the wealthy have acquired tastes and habits which must be weighed in a calculation of sacrifice seems to beg the question. The distribution which determines these tastes and habits is the issue in question.

It may also be said that subjective sacrifice is influenced by the taxpayer's pain cost of producing income; that is, *B* may have put more effort and worry into earning his automobile than *A* put into earning his fillings. It seems highly probable, however, that the costs follow somewhat the same curve as utilities, only that they diminish more rapidly as income advances. Earning a thousand dollars a year at ditch digging possibly requires at least as much cost of acquisition as any income of any size, even one running up into the millions. If this is true, it makes the acquisition cost of the latter income very small on each thousand. Of course, one can reckon costs in terms of current pleasures which might have been enjoyed and which were foregone. It will be argued that this is the proper way to reckon the cost of saving. But for people whose every important want has been satisfied, the cost of saving is negligible.

Faculty or Power of Earning. The case for the ability-to-pay theory may be approached from another angle, namely, the power of the individual rather than his sacrifice. Thus viewed, the emphasis is laid on one's capacity to bear responsibilities. Accordingly, one is expected to shoulder as much of the public burden as his capacity permits. In this connection the parable of the talents in the New Testament may be recalled. The servant who demonstrated his skill in managing the talents entrusted to him was given the additional responsibility and burden of managing other talents formerly entrusted to a less capable servant. Sir. Josiah Stamp has described this principle as it would be applied in a non-monetary economy which, he says, would call for direct service to the common good and which would expect more from the powerful man than from the decrepit; in some tasks, more from the taller or swifter members of the community than from the slower; and in teaching the young, more from the educated than from the ignorant.[16] In terms of our actual world, the possession of wealth or the receipt of income is itself an evidence of faculty or power not only to pay taxes out of one's income but also to earn additional income. Money earns money. The first thousand dollars "comes the hardest." He who has a bank account has three hands: his right hand, his left hand, and his bank account.

Privilege. Ability to pay may also include elements of privilege. The term "special privilege" is frequently used to describe favors received from government by legislation partial to some as compared with others. It is used generally in disapproval of monopolies, tariffs, and the like. Many also enjoy privileges by virtue of their social environment; society plays a heavy part in the production of every income. Society is every entrepreneur's partner, and a very important partner at that. "The organizer of industry who thinks that he has 'made' himself and his business has found a whole social system ready to his hand in skilled workers, machinery, a market, peace and order—a vast apparatus and a pervasive atmosphere, the joint creation of millions of men and scores of generations. Take away the whole social factor and we have not Robinson Crusoe, with his salvage from the wreck and his acquired knowledge, but the naked savage living on roots, berries, and vermin." [17] For many years philosophers, criminologists, and others have debated the question of how much credit or blame can justifiably be attributed to individuals in their success or failure. No definite answer has as yet been found, but few people would deny the important part played by circumstances (environment, etc.) in the course of one's life.

If it were possible to distinguish the rewards that are due to effort from those that are due to fortune, the former would have strong claim to preference in taxation. Perhaps people should be paid not according to their

[16] Sir Josiah Stamp, *The Fundamental Principles of Taxation*, Macmillan and Co., Ltd., London, 1921, pp. 7-8.

[17] L. T. Hobhouse, *The Elements of Social Justice*, pp. 162-163; quoted by H. W Peck in *Taxation and Welfare*, The Macmillan Co., New York, 1925, p. 179.

talents but according to their efforts. Some school teachers recognize this distinction in the competition for school grades. However, even effort in some degree depends upon inherited characteristics.

The Conservation of Purchasing Power. There is still another argument that has been urged in support of the ability-to-pay principle, an argument which will be considered in more detail later. It is now contended by many that production is ordinarily limited by consumption rather than the reverse, which has hitherto been widely accepted as true. Thus it is held that much unemployment of men, resources, and equipment is due to the inadequacy of the existing market. Those who have the most ability to pay save a relatively large part of their incomes and thus add little to the existing market for consumers' goods. Taxing their marginal dollars would result in a relatively small curtailment of consumption. This theory is vigorously criticized by many economists who claim that the saved dollar provides employment when it is used to produce new equipment; these economists deny that there is any tendency for saving and investment to outrun consumption. On the contrary, they are quite concerned lest taxation, and particularly taxation according to ability to pay, unduly undermine the supply of capital.

Penalizes Industry and Thrift. Perhaps the strongest argument against the ability-to-pay principle is the penalty which it is alleged to place upon industry and thrift. The man who increases his inheritance and along with it his ability to serve the community, it is said, ought not to be penalized by the government for his good qualities and efforts while his brother, the prodigal son who wastes his inheritance in riotous living and indolence, is rewarded for his unsocial conduct by exemption from tax contribution. Society cannot afford to encourage the indolent while it dulls the incentives which make for productivity and progress.

". . . it is easy to see what would happen to morale in the field of sports if a football team that won its game by seven touchdowns to three were to be told at the end of the second half that three touchdowns were to be taken from its score because of its greater ability to make touchdowns. Substitute dollars for touchdowns and the illustration applies to the effect of progressive taxation upon the effort and initiative of individuals in business." [18]

Not All Income Is the Result of Industry and Thrift. Cogent as is the above argument, there are important rejoinders which can be made. The first is that much income and wealth in our day are not the rewards of industry and thrift or of any other virtue. On the contrary, they may be the rewards of vices and unsocial conduct. Or they may simply be due to fortune —good luck.

If one were to make a list of all the ways through which people become wealthy without industry and thrift, the list would include inheritance, gift, marriage, racketeering (in multitudinous forms), gambling (not including

[18] Harley L. Lutz, "Progressive Taxation in Postwar Tax Plans," *The Tax Review*, Tax Foundation, New York, Dec. 1944, p. 53.

speculation), monopoly, exploitation, and discovery. Someone has said that the national income consists of earnings, findings, and stealings, and the greatest of these three is not earnings. Whether this is true or not, it will be admitted by many that if the national income were reduced by any amount equal to what at present circulates as "blood money," "luck money," and "graft money," the amount remaining as compensation for the industrious and thrifty would be considerably less than the whole.

Difficulty in Securing Revenue from Unproductive Qualities and Activities. If instead of taxing industry and thrift we were to reverse this policy and impose heavy taxes on indolence and prodigality, we might encounter serious difficulties. It is impossible to secure money where money is not. The unproductive spots in the social pattern are likely to prove "poor picking" for the tax collector. The individual who is unproductive, either because of misfortune or because of his vices, is in a strategic position as far as taxation is concerned. It is true that he can be taxed, if he has any income at all, through indirect taxes, which add to his cost of living. However, it is probably impractical to reach him through direct taxation, which alone would "make him conscious of his vices."

Importance of Incentives. Somewhere along the road the ability-to-pay principle must come to terms with the interest in adequate incentives. Even the Russians, with their great interest in creating a classless society, have found it expedient to allow substantial differentials of income. One of the incentives which requires attention in a mixed (public and private) economy is that offered the risktaker. Those who innovate, assume responsibility, take chances, and employ their capital and talents in an active role need somehow to be encouraged. The application of the ability principle, even to a high degree, may not be incompatible with the social interest in enterprise, but some skill and strategy are required to avoid repression. For instance, the generous treatment of losses certainly can temper the repressiveness of a highly progressive tax. Where losses are deductible against current or future gains, a high rate of tax might even whet the appetite for risktaking. The case of Marshall Field and his newspaper ventures is often cited as an example of how, through the tax system, the government shares the risks of an enterpriser. Were there no losses to offset against Mr. Field's other income, the government might claim a very large portion of it. However, it seems reasonable to hold that few would care to risk their resources if speculative ventures (because of taxes) *could* not yield more than safe investments. We know far less about business and investment incentives than we should. But elemental common sense is sufficient to support the judgment that, when a tax system takes from a fifth to a third of the national income and ability to pay is accepted as the principle for tax distribution, some concern is necessary lest the tax system unduly impede the initiative which provides the tax base.

Considerations of administration, adequacy of revenue, and political expediency may also conflict with the ability theory and restrict its application.

Taxing "Undeserved" Income

According to a third theory, taxes should consider not only the size but also what Hugh Dalton has called the "undeservedness" of the income. The proponents of this theory hold that ability to pay among taxpayers differs, not only quantitatively but qualitatively as well. It matters not only that *A* and *B* are rich and getting richer, but also *how*. Professor John R. Commons phrased his canon of taxation with this idea in mind when he said that taxes should be apportioned "*directly* to ability to pay and *inversely* to ability to render a public benefit." [19] This is, of course, the essence of the "Georgian" [20] approach to taxation, which makes a sharp distinction between income from capital and that from land on the ground that the former is the result of human effort and adds to wealth whereas the latter is the product of scarcity. This theory recommends taxes upon the "findings" and "stealings" in the national income. Just and wise as it may be to tax unearned income with special severity, it must be observed that in practice such income, with the exception of inheritances and the rent of urban land, is very difficult to isolate.

The Social-Expediency Principle

Finally, a fourth principle of distribution is one which either abandons or includes all the others. The proponents of this theory take the pragmatic view that those revenue sources and that tax system are best which work best. In order to determine what sources such a theory would support, the specific sources must be examined and their operation observed. Much of this book will be occupied with such examination and observation. Some of the factors to look for and to weigh have been suggested at the beginning of this chapter. Such a revenue system will make some distribution of the tax burden, at least in the case of special benefits, according to benefits received. It will take a generous portion of that burden and distribute it according to ability to pay, recognizing, however, that consideration of administration, productivity of the economic system, yield of the tax system, and resistance of taxpayers must temper the use of that principle. It will also include some application of the principle that unearned incomes warrant special treatment.

In practice it must be admitted that none of the above principles of distribution is always applied. The sales tax, for example, can be justified by

[19] John R. Commons, *Institutional Economics*, The Macmillan Co., New York, 1934, p. 821.

[20] So called because of the influence of Henry George, whose book *Progress and Poverty* advocated a "single tax" upon the economic rent of land.

none of them (unless under special circumstances it might be justified under the social-expediency theory). It is an inverse application of the ability-to-pay theory. It does produce revenue, however, sometimes with a minimum of complaint. Much of the tax system in fact is undoubtedly the result of political bargaining and the pressure of conflicting interests. Logical theories frequently give way to practical requirements, including the requirements of practical politics.

THE RATE STRUCTURE

Definition of Terms

Students of taxation speak of tax rates as regressive, proportional, progressive, and degressive. Before examining what kind of rate structure is in accord with the requirements of equity, it will be necessary to give some attention to the meaning of these terms. A tax base is the object upon which a tax is laid, and a tax rate is the amount of tax (usually expressed as a percentage) which is levied per unit of base. The total amount of the tax is equal to the base times the rate. This may be conveniently expressed by the formulas, $B \times R = T$ and $R = T/B$, where R represents the rate, B the base, and T the amount of tax.

Rate structures have to do with the behavior of R, the rate, when B, the base, increases or decreases. Thus, if the rate (R) decreases as the base (B) increases, the rate structure is said to be *regressive*; if the rate (R) remains constant as the base (B) increases, the structure is said to be *proportional*; and if the rate (R) increases as the base (B) increases, the structure is called *progressive*. Progressive rates may advance regularly or irregularly, at a slow rate of increase or at a rapid rate, with a constant or a changing acceleration. If the increase is at a decreasing rate, that is, if the acceleration becomes constantly less as the base increases, the rate structure is said to be *degressive*.

Illustrations. To choose some illustrations from the tax system, the property tax usually operates with proportional rates. The base is the value of property owned by an individual. If the value is $1,000 and the rate 1 percent, the tax will be $10. If the value is $10,000, the rate will still be 1 percent, although the amount of tax in this case will be $100. A frequent complaint against the property tax is that in practice it is regressive. The regressivity arises from an administrative failure which takes the form of underassessment of the more valuable properties. The rate remains constant on the nominal base, but it falls as the actual or proper base increases.

Income taxes usually follow a progressive schedule of rates. If a $1,000 income base is taxed at a 1 percent rate, a $10,000 income may be taxed at 3 percent, a $20,000 income at 6 percent, and so on. Rate structures in many income tax laws are complicated by the use of the bracket system, under

which, rather than one rate applying to the total, different rates are applied to the different parts of the income. Under the bracket system, that portion of a net income which falls between $1,000 and $1,999 may be taxed at 1 percent, while that part falling between $2,000 and $2,999 is taxed at 2 percent. To determine what the true or effective rate is on any one income, it is necessary to compute the tax and divide it by the base. Thus, with the rate schedule given above, if the individual has an income of $2,500, the first $1,000 of which is exempt, he would have to calculate his taxes first as follows:

Tax Base	*Tax Rate*	*Amount*
1st $1,000	exempt	none
2nd 1,000	1%	$10.00
3rd 1,000/2 = $500	2	10.00
Total $2,500	.8%	$20.00

Then, to calculate the effective rate from these total figures, he would have to divide the tax (T = $20) by the base ($B$ = $2,500), which in this case would make his true or effective rate equal to 20/2,500 (T/B) = .8 percent (R). The bracket system is used in order to obtain a smooth progression. Without it, the amount of tax one would pay on an income of $2,001 might be so much greater than the amount he would pay on an income of $1,999 that actually he would be better off with the smaller income.

For many years the British income tax applied a degressive rate structure. This was made possible by a nominally proportional rate and a constant personal exemption, the effect of which is to make for a degressive schedule. This may be seen in the following hypothetical illustration:

Income	*Personal Exemption*	*Nominal Rate*	*Amount of Tax*	*Effective Rate*	*Increase per $1,000*
$1,000.....	$1,000	1%	—	—	—
2,000.....	1,000	1	$10	.50%	.50%
3,000.....	1,000	1	20	.66	.16
4,000.....	1,000	1	30	.75	.09
5,000.....	1,000	1	40	.80	.05

Consumption or sales taxes are usually regressive. Nominally, of course, they are proportional. The federal cigarette tax, for example, is based upon the number of cigarettes sold. If it is paid by the consumer in higher prices for cigarettes, it is paid by him according to the number of cigarettes he purchases and consumes. As the rate remains the same regardless of the number of cigarettes consumed, the tax is proportional on a strict application of the above definitions. However, a tax is ordinarily compared with the net income or wealth of the taxpayer. The amount of cigarettes consumed, and consequently the cigarette tax paid, does not increase with the wealth and income of the individual. The rate with respect to wealth and

income actually decreases as wealth and income increase. In this sense many consumption taxes, including this cigarette tax, are said to be regressive.

Arguments Concerning the Propriety of Progressive Rates

Arguments in Support of Progression. The question of what kind of rate structure is most desirable has yet to be considered. The advocates of the ability-to-pay principle have usually "gone to bat" for progressive rates. They hold that not only should the $10,000 income pay ten times as much taxes as the $1,000 income, but it should pay more than ten times as much. In other words, the $10,000 individual should contribute at a higher rate. As previously suggested, this proposal is supported on the theory of minimum sacrifice. The view that $10 to the $1,000 income recipient is worth more than $100 to the $10,000 one is said to be in accord with this theory. This proposition is not self-evident, however, and does not follow as a necessary corollary of the marginal-utility-of-income theory. Moreover, there is no conclusive objective evidence to establish its truth or falsehood. Sir Josiah Stamp has a choice analogy to describe the predicament in which advocates of the above proposition are likely to find themselves. "It is very difficult," he says, "for a man to say quantitatively that one boot pinches three times as much as the other, even where both are his own, and how much more difficult is it for one man to say that his boot pinches twice as much as another's!" [21] Nevertheless, it is quite widely accepted that ability to pay does increase more rapidly than income or wealth. All the other arguments used to support the ability-to-pay theory are also mustered to defend the progressive-rate feature. Some approach the problem from the angle of social control rather than ability to pay and quite frankly advocate progressive rates to bring about what they regard as a more equitable distribution of wealth.

Uncertainty of Proper Acceleration. All of the arguments against the ability principle and the use of taxation for social control can be used against progressive rates. Mention may be made of several additional arguments which seem to apply particularly to the progressive application of the ability-to-pay doctrine. John McCulloch, in a classic statement in opposition to progressive rates, argued that when you abandon proportionality in taxation "you are at sea without rudder or compass, and there is no amount of injustice and folly you may not commit." [22] Being at sea, he went on to explain, is due to the fact that there is no scientific and objective information to indicate how fast rates should advance as the base increases. Perhaps the $10,000 person should be required to pay more than $100 if the $1,000 person is charged $10. But how much more? There is no calculus by which the utility of the dollars on the margin of the $10,000 income can be measured and quantitatively compared with the utility of the marginal dollars sim-

[21] Sir Josiah Stamp, *The Fundamental Principles of Taxation*, pp. 53-54.
[22] J. R. McCulloch, *Taxation and the Funding System*, 1845, p. 143.

ilarly measured for the poorer individual. Thus, said McCulloch, if a progressive scale is to be used, the degree of progression will be a matter of guesswork—a "shot in the dark." John Stuart Mill, though favorably disposed toward an exemption of "the necessaries of life" and progressive rates "as applied to legacy and inheritance duties," accepted this argument against the graduated principle in general as conclusive. The difference of ability to pay in income, he said, is not "capable of being decided with the degree of certainty on which a legislator or a financier ought to act." [23]

A rejoinder to this criticism of progressive rates has been made by Professor Seligman. His argument is that, although the degrees of progression warranted by considerations of equity cannot be determined with mathematical exactness, it is better to approximate justice than to be clearly unjust. If it is clearly unjust to ask the $1,000 income to contribute to the state at the same rate as the $10,000 income, should we not apply a higher rate to the $10,000 income even though we cannot be altogether certain just how much higher the rate should be? [24]

Evasion and Failure to Yield. Another objection to the progressive principle was presented by Bastable, who argued that its application would result in widespread evasion of taxes and a disappointing yield of revenue. There is some validity in both contentions. The very high tax rates of modern income and inheritance taxes do add incentives to evasion. A high rate on the relatively few incomes in the highest brackets would probably not bring in enough to support the state. The income structure is like a pyramid or a spindle in shape; small increases in taxes at the base of the pyramid or the broad part of the spindle often will produce as much revenue as very much larger increases at the peak of the pyramid or at the end of the spindle.[25]

These arguments, sound as they are and worthy of weight in practical decisions concerning particular taxes and tax systems, nevertheless do not invalidate the progressive principle entirely. Administrative difficulties are not excessive while the application of the progressive principle remains moderate. Moreover, administrative considerations may be outweighed by considerations of equity and other social and economic interests. It does not follow that particular incomes should be exempt from a just portion of tax because their taxation will not by itself solve the revenue problem. It cannot be denied that use of the progressive principle, particularly in the middle brackets, has added much to the productivity of the income and inheritance taxes. And there is still considerable mass at the top of the pyramid. It has been estimated that in a year of good income the federal government might

[23] J. S. Mill, *Principles of Political Economy* (Ashley ed.), Longmans, Green and Co., Ltd., London, 1936, p. 807.

[24] E. R. A. Seligman, *Progressive Taxation in Theory and Practice*, Publication of the American Economic Association, Vol. IX, No. 1 and 2, 1894, pp. 193-194.

[25] Illustration borrowed from Antonio de Viti de Marco, *First Principles of Public Finance*, pp. 196-203.

get enough revenue to satisfy its peacetime needs from a 100 percent tax on net income in excess of $4,000.

Restriction of Taxation Sources. It is also argued against progression that it tends to destroy its own productivity by drying up the sources from which future revenues must come. It dries up the sources, it is alleged, in two ways: first, by undermining production, and second, by making it impossible for great fortunes to grow and perpetuate themselves. The relation of the distribution of wealth to productivity will be given fuller consideration in a later chapter. Suffice it to say here that it is by no means verified that wide inequalities in wealth and income are necessary for maximum productivity. The opposite proposition is argued with some plausibility. It cannot be doubted, of course, that large fortunes would grow faster if they were not molested by taxation. At what point they tend to decrease under fire from the tax system is not clearly established. Furthermore, there is also the question whether large fortunes are worth nursing along as prospective milch cows for the future tax system. To say the least, great issues of public policy are involved in these arguments.

In spite of a severe system of direct taxation in Great Britain for many years, large inequalities in that country seem to persist (or did at least up to the time of the Second World War). Professor Pigou cites the study of property distribution in England and Wales for the period of 1924-1930 (by Professor Daniels and Mr. Campion), which found that 1 percent of the population 25 years of age and over owned 60 percent of the total privately owned capital. A study of the distribution of income by Mr. Colin Clark found that 12 percent of the recipients took 42 percent of the national income.[26] On the other hand, it is probably true that high death taxes have been in use too short a time to show their full effect; there is some evidence of a small decline in the proportion of large estates to total estates.[27] It is also too early to say what the effect of severe war taxation may have been.

Distinction Between Progressive Tax and Progressive Tax System. It should be pointed out that a progressive tax and a progressive tax system are two quite different institutions. Alfred Marshall described the difference as follows: "Onerous taxes, imperial and local, must be treated as a whole. Almost every onerous tax taken by itself presses with undue weight upon some class or other; but this is of no moment if the inequalities of each are compensated by those of others, and variations in the several parts synchronize. If that difficult condition is satisfied, the system may be equitable, though any one part of it regarded alone would be inequitable." [28] A tax system is likely to consist of many taxes, some of which are regressive, some proportional,

[26] A. C. Pigou, *Socialism versus Capitalism*, Macmillan and Co., Ltd., London, 1937, pp. 12-22.

[27] See L. H. Parker, "The Time Element in Estate Tax Valuation," *Proceedings of the National Tax Association Conference*, 1937, pp. 219-225.

[28] Alfred Marshall, *Memorandum on Imperial and Local Taxes* (C.-9528), p. 113; quoted from A. C. Pigou, *A Study in Public Finance*, p. 75.

and others progressive. The regressive taxes may offset the progressive taxes, with the result that the entire tax system may be proportional. Before the progressive income and inheritance taxes were added to the tax system of the United States, the latter was regressive, and it is probably still regressive within certain ranges of income.[29] It was clearly progressive in the ranges of income above $5,000 even before the war, and the more intensive application of the net income tax to a broader base has now undoubtedly reduced the range of regressivity.

It is true, as has been stated, that not all taxes lend themselves to the application of the progressive principle. In practice, as a rule, only the net income tax, the profits tax, and the death taxes have been graduated. Graduation fits the personal taxes best, and it is of doubtful propriety in the case of impersonal taxes. Some writers believe that one of the principal merits of the progressive rates is their limited applicability.[30] It would seem that if progression is accepted as a sound and just principle in its own right, and not merely as a device to offset regressive taxes, then the fact that it can be most easily and logically applied to personal taxes constitutes an argument for the extension of such taxes.

Resistance to the Development of Progression. The progressive rate structure is a high-powered weapon of social control. The present rather general acceptance of its propriety, at least as a feature of some taxes, was not achieved without resistance. William Gladstone, liberal as he was, once said of progression that when a stone of that character gets rolling no one can tell when or where it will stop. Conservative writers exhausted their invectives in abusing the principle. Thus wrote one of them before the adoption of the progressive principle in the British estate tax in 1894: "The very name, graduation, stinks in the nostrils of wealthy men . . . graduation is unjust . . . graduation is a filching from rich men a payment for that which they do not receive . . . it is a demand on rich men to pay a shilling for the loaf which men of moderate means are to get for ninepence." [31] William Newmarch, the eminent economist and statistician, said that it was not the task of taxation to correct "the vicissitudes of fortune," and further that graduation is "confiscation, punishing prudence and virtue, taxing a man for being good to himself and doing good to others." [32] As previously stated, the combination of progression and the universal franchise was regarded as particularly dangerous.

[29] Twentieth Century Fund, Inc., *Facing the Tax Problem*, New York, 1937, p. 237; Gerhard Colm and Helen Tarasov, "Who Pays the Taxes?" Monograph No. 3, Temporary National Economic Committee, 1940. It should be observed that the resultant is an average which obliterates the fact that particular individuals may enjoy privileges or suffer under inordinate burdens.

[30] H. L. Lutz, *Public Finance* (3rd ed.), p. 363.

[31] Wm. Lucas Sargant, "An Undiscriminating Income Tax Reconsidered," *Journal of the Statistical Society of London*, Vol. XXV, 1862, p. 352.

[32] Quoted by Sir Josiah Stamp, *The Fundamental Principles of Taxation*, pp. 39, 56.

The United States Supreme Court has accepted the principle of progressive taxation. Justice White, in an opinion sustaining the federal estate tax enacted during the Spanish-American War, stated that, "The grave consequences which it is asserted must arise in the future if the right to levy a progressive tax be recognized involves in its ultimate aspect the mere assertion that free and representative government is a failure, and that the grossest abuses of power are foreshadowed unless the courts usurp a purely legislative function." [33] However, Justice Brewer, in an earlier opinion on the subject, expressed a vigorous dissent: "Equality in right, in protection, and in burden is the thought which has run through the life of this Nation and its constitutional enactments from the Declaration of Independence to the present hour . . . when a tax law directly, necessarily, and intentionally creates an inequality of burden, it then becomes imperative to inquire whether this inequality thus intentionally created can find any constitutional justification." [34]

The approval of the progressive principle is partly to be accounted for by the combination of growing democratic sentiment, on the one hand, and by the wide and growing differences in the distribution of wealth, on the other. There has been increasing feeling that the inequalities of wealth and income are neither just nor socially desirable and that large elements in the national income are paid for no socially useful equivalent.

Professor Taussig's proposition that one cannot sanction the progressive principle and still accept the existing distribution of wealth seems hardly tenable; but it is true, nevertheless, that widespread disapproval of the present distribution of wealth has been a major factor in legislative support for progressive rates.

This, combined with the narrower fiscal arguments supporting progression—that people should contribute according to their faculty and that faculty increases more rapidly than income as the latter advances—accounts for the wide acceptance of the progressive principle in recent years. That the acceptance today is far from unanimous is indicated by recent state support for a constitutional amendment placing a ceiling on federal income and estate taxes.

In the last analysis, whether or not one believes that the progressive principle is desirable depends considerably upon his general philosophy of life. In this respect people are generally divisible into two groups. One group would prefer a world in which a free hand is given to the strong and the clever. This group holds that a free struggle makes for strong, vigorous character and that large inequalities are necessary to support the economic incentives. These people accept the progressive principle, if at all, with reluctance. They feel that progressive taxation, especially if the rates are steeply graduated, violates the moral law against one's "reaping where he has not

[33] Knowlton v. Moore, 178 U. S. 49, 109 (1900).
[34] Magoun v. Illinois Trust and Savings Bank, 170 U. S. 283, 301 (1898).

sown." They also contend that many who wish the tax system to reduce inequalities would confine its role in this respect to incomes above their own. The second group holds that the strong have a decided obligation to the weak and stresses the solidarity of human interests. It dislikes and doubts the wisdom of great inequalities. Those who belong to this latter group are very likely to approve the progressive principle with enthusiasm.

TAXATION FOR NONFISCAL PURPOSES

Much is said these days about the use of taxation for social control or for nonfiscal purposes. Taxation for nonfiscal purposes is usually defined as tax legislation motivated mainly by some purpose other than raising revenue. For example, the protective tariff has as its primary aim the elimination of foreign competition; taxes on oleomargarine in some states are designed mainly to reduce competition and improve the market for the products of the dairy farmer. It should be remembered, however, that taxation itself is social control, and no tax or fiscal policy can be judged apart from all of its consequences whether they are classed as fiscal or nonfiscal. Professor Commons states this idea in the following words: "Taxation, then, is the most pervasive and privileged exercise of the police power. . . . Even when not consciously intended to be regulative, taxes nevertheless regulate, for they, like the protective tariff, determine the directions in which people may become wealthy by determining directions in which they may not become wealthy. They say to the business man: Here is profit, there is loss. It is impossible to avoid these effects of taxes, therefore impossible to escape the police power of taxation, therefore impossible to look upon taxes of any kind whatever as merely a means of obtaining revenue according to any principle of equality, or ability to pay, or accumulation of wealth, or any standard that looks solely to the acquisitions of the past." [35]

Taxation for nonfiscal purposes or social control is objected to by some critics because, it is said, the revenue system is complicated enough without saddling upon it a load of regulation and, further, because regulation can be accomplished more effectively and economically by direct regulatory legislation than by tax laws.

The first answer to these arguments is that nonfiscal motivation behind legislation is a matter of degree; no clear line can be drawn between tax legislation which is nonfiscal and that which is fiscal in character. This point is very aptly expressed by Sir Josiah Stamp's excellent analogy, "that it is wrong to marry for money, but all right to marry where money is."

The second answer is that each proposal of tax legislation with nonfiscal ends must be weighed on its merits. If there are other better ways of accom-

[35] John R. Commons, *Institutional Economics*, p. 820.

plishing the ends sought, certainly the proposal should be turned down. However, this may not always be true, and no tax measure need be defeated because it seeks to accomplish some nonfiscal ends. For example, it is said that Peter the Great at one time levied a tax upon beards. He held that the beard was a superfluous and useless ornament. The tax is said to have been proportional according to the length of the beard and progressive according to the social position of its possessor. Every person paying the tax received a token which he had to wear so it could be seen. Inspectors were provided with scissors and were ordered to cut off ruthlessly beards of those who did not show badges.[36]

Peter's tax on beards seems objectionable, not on the ground that it constituted an abuse of the taxing power, but that possibly the object was not a proper one or that it might have been accomplished through a better means. It probably is true that social control through taxation has often been ill-advised and ineffective. But the most to be deduced is that this creates a presumption against such use and one that is not conclusive. Each proposed use of taxation for nonfiscal purposes must be judged on its own merits.[37]

SUMMARY

The principle of distributing the public burden among the people forms a very important part in the problem of public finance. Equitable distribu-

[36] M. D. Cobleigh, "Some Queer Provisions of Former Tax Statutes," *Bulletin of the National Tax Association*, Vol. XIV, No. 4, Jan. 1929, p. 107.

[37] The terms "direct taxes" and "indirect taxes" appear frequently in taxation literature. Sometimes the former term is used to describe taxes which are not shifted or are not intended to be shifted. Sometimes it is used to describe taxes levied on a regularly recurring base adapted to the use of a list or roll. The term "indirect tax" is used to describe taxes which are shifted or intended to be shifted and taxes levied on a nonrecurring base (such as transactions) not adapted to the use of a list or roll. The two definitions do not ordinarily conflict, but in the case of death taxes the first definition would classify the tax as direct, the second as indirect.

The classification of taxes as direct or indirect is of no great significance, except that in the United States it may have much influence in determining the constitutional validity of a tax. In general, it is the direct taxes to which the ability-to-pay principle is applied. However, some of the direct taxes, for example, the general property tax, are criticized vigorously on the ground that they are not in accord with the ability principle.

Taxes are also classed as "personal" and "impersonal." The former term describes those taxes which are thought to be levied on persons as such according to some circumstance of a personal character, such as the sum total of income or wealth. Impersonal taxes are thought to be levied on objects rather than persons or, at all events, to be based upon objective facts without regard to their relation to particular persons. The income tax is often mentioned as a personal tax, but it may also be impersonal. The corporate income tax is clearly impersonal, as are taxes upon incomes from specific sources, such as real estate or intangible property. These taxes are ordinarily assessed without regard to most of the relevant personal circumstances of the recipients. It is the personal taxes particularly which furnish the chief field of application for the ability-to-pay principle and progression.

tion requires the observance of certain factors, of which justice probably takes the first rank in position. By justice we understand impartiality of treatment, which in turn in taxation resolves itself into what is commonly known as reasonable classification among revenue bases. Exactly what constitutes fairness, of course, is in many cases a matter of opinion, but, nevertheless, considerations of equity should be a highly important factor in determining a revenue system. Similarly, there are many other factors which must also be taken into account; for instance, the ease or difficulty of administering the possible revenue sources, their effects upon production, their yield, their effect upon the distribution of wealth and income, as well as their many other likely fiscal and nonfiscal consequences.

There are certain principles which have long been advocated as proper guides in the problem of apportioning governmental burdens. One of these is the benefit principle, which, however, encounters the objections that benefits from government are often not measurable and that the principle limits the distribution of governmental services more than is thought to be in the social interest. Nevertheless, the benefit principle has much reasonable application in the revenue system. Of more recent development and much more popular is the ability-to-pay principle. This is championed on the grounds that it results in minimum sacrifice, is in accord with power or faculty, takes account of privilege, and conserves purchasing power. The validity of some of these assertions is disputed and, further, it is urged against the ability principle that it penalizes industry and thrift. Among the rejoinders to the latter, however, is the contention that much wealth and income is not the result of industry and thrift.

Other principles which have been urged as bases for the distribution of governmental burdens include one that would apportion the latter according to the "undeservedness" of one's income, and another in which social expediency would be the all-important criterion. The latter principle includes many considerations, among them all of the factors concerning revenue sources previously mentioned.

The rate structures which may be used to raise governmental revenues vary, and there are several types in application in the current revenue systems. The justice and wisdom of progressive rates have been for many years the subject of much argument. In general these arguments follow rather closely those for and against the ability-to-pay principle, but there are special approaches, such, for instance, as the one which denies the possibility of selecting with any precision the proper acceleration to apply in progression, and the one which answers that rough justice is better than none. Progressive rates have made headway in the face of bitter opposition, partly because of the general feeling that they are equitable and partly because of dissatisfaction with the distribution of wealth. The latter, of course, implies a nonfiscal objective. Taxation for nonfiscal objectives is a very common phenom-

enon, but it has incurred considerable criticism. However, fiscal proposals must be judged by all their effects, whether or not such measures are designed to raise revenue.

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CHAPTER III

The General Property Tax: Importance, Theory, and Criticism

The previous chapter was devoted to the discussion of certain theories of how governmental burdens should be distributed. The task of the coming chapters will be to examine, in the light of those theories, the various means now employed for that purpose. Of these, the general property tax will be considered first.

IMPORTANCE OF THE PROPERTY TAX

Property Taxes in General. The general property tax is the backbone of the "state and local" revenue system in the United States. In 1941 it produced approximately 31 percent of all tax revenues (exclusive of payroll taxes) in the country—federal, state and local combined.[1] It was even more important fifteen years earlier when the figure was over 50 percent.[2] No other major country in the world except Canada raises such a large percentage of its tax revenues from property taxes.[3]

State and Local Property Taxes. With three exceptions the property tax has not been used by the federal government.[4] This means that its importance in state and local tax systems is much greater than the above figures would indicate. In 1941 the property tax produced about $4,689,000,000 for

[1] Tax Institute, *Tax Yields: 1941*, Philadelphia, 1942, p. 28.

[2] Jens P. Jensen, *Property Taxation in the United States*, p. 17.

[3] Paul Studenski, "Modern Fiscal Systems," *The Annals of the American Academy of Political and Social Science*, Vol. 183, Jan. 1936, p. 29.

[4] Once, in 1798, a direct tax was apportioned among the states to be levied on dwellings at a rate of one-fifth to one percent of value, on slaves at a rate of fifty cents per head, and on land for the difference between the yield of these two taxes and the amount apportioned to the states. Again during the War of 1812 a direct tax was levied as above. It yielded approximately $4,000,000 in 1814 and 1815. The last use of this tax was during the Civil War when a $20,000,000 levy was apportioned among the states for collection (W. J. Shultz and M. R. Caine, *Financial Development of the United States*, pp. 110-111, 141-142).

state and local governments or about 56 percent of their total tax revenue. A sharp trend in the case of state governments (as distinguished from that of their subdivisions) is to rely less and less on this source of revenue. The property tax has yielded ground to motor vehicle taxes, state income taxes, and retail sales taxes. In 1902 about 51 percent of the state tax revenues came from the property tax; in 1922, 40.1 percent; and, at present, from 5 to 10 percent.[5] In 1941, fifteen state governments did not rely on the general property tax at all.[6]

Since the property tax plays only a minor part in the financing of state governments, it is apparent that it must play a major role in the financing of local governments. The latter are under the control of the state and as a rule are allowed only such discretion in taxation as the legislature may give them. They are generally permitted to levy such property taxes as seem suitable, but beyond this they have little tax discretion. This applies especially to the smaller subdivisions, as is revealed in Table 1 where it is shown that the smaller units of government depend almost entirely on the property tax.

TABLE 1

Fiscal Importance of Property Taxes for the States and Minor Civil Divisions, United States 1932

(Thousands of Dollars)

Governmental Units	*Property Taxes*	*All Other Taxes*	*Total Taxes*	*Ratio of Property Taxes to Total Taxes*
State governments	323,477	1,318,373	1,641,850	19.7%
Counties	877,142	143,693	1,020,835	85.2
Townships	195,431	12,227	207,658	94.4
Cities, towns, villages, boroughs	2,057,495	193,794	2,251,289	91.9
School districts	1,118,744	2,292	1,121,036	99.8
Other civil divisions	112,495	2,584	115,079	97.8
Grand total	4,684,784	1,672,963	6,357,747	73.7%

Source: *Financial Statistics of State and Local Governments, 1932*, p. 7, U. S. Department of Commerce, Bureau of the Census, Washington, 1932.

According to this table, school districts in 1932 obtained only 0.2 percent of their tax revenues from sources other than the property tax.[7] The other

[5] Tax Institute, *Tax Yields: 1941*, p. 28; Jens P. Jensen, *Property Taxation in the United States*, p. 4.

[6] U. S. Department of Commerce, *Property Taxation: 1941*, State and Local Government Special Study, No. 22, Sept. 1942, p. 18.

[7] However, tax revenue and total revenue are not the same. School districts might secure considerable aid from the state and still receive all their tax revenue from the property tax.

local units of government, such as the county and the township, were not quite so restricted in their revenue, but no one would contend that their menu offered much choice. Later estimates show the property tax still supplying 92.6 percent of local tax revenues.[8]

Total property tax burdens increased quite consistently until 1930, when they reached a peak estimated at over 5 billion dollars and about twice the figure of ten years earlier. During the thirties the amount decreased sharply until 1934 and has risen only moderately since.[9]

THE NATURE OF THE GENERAL PROPERTY TAX

The General Property Tax Defined. What is commonly called the general property tax is such an important part of the revenue systems in the United States that a knowledge of its definition and nature is essential. In its broadest meaning the general property tax is a tax upon all wealth, tangible and intangible, which possesses exchange value. It is levied according to exchange value, at least in theory, and at a common rate for all property in the same district. It is thus a universal and uniform tax based upon value of goods owned. Usually, but not always, it is levied upon property wherever located and the tax is paid by the owner. In actual practice, as we shall see, the general property tax is nowhere near so universal nor so uniform as the above statements would appear to indicate.

The reader will find in Chapter I a brief account of the evolution of the general property tax in the United States. Originally the property tax was specific rather than general. Only gradually did it acquire those features of uniformity and universality that are its present characteristics. Classification and special treatment were once the rule rather than the exception. Only selected types of property were taxed and they were listed at prescribed arbitrary values.[10] And the present trend, as we shall see, is toward its original status when less uniformity and universality prevailed. Today the general property tax is a greatly modified and restricted tax, the extent of coverage depending upon the constitution, laws, and administrative practices in each state. In fact there are practically as many property tax systems as there are states.

Nature of General Property. It goes without saying that the kinds of goods which are owned and which have value in a modern state are numerous and varied. If one were to list all of the property which he might observe on a

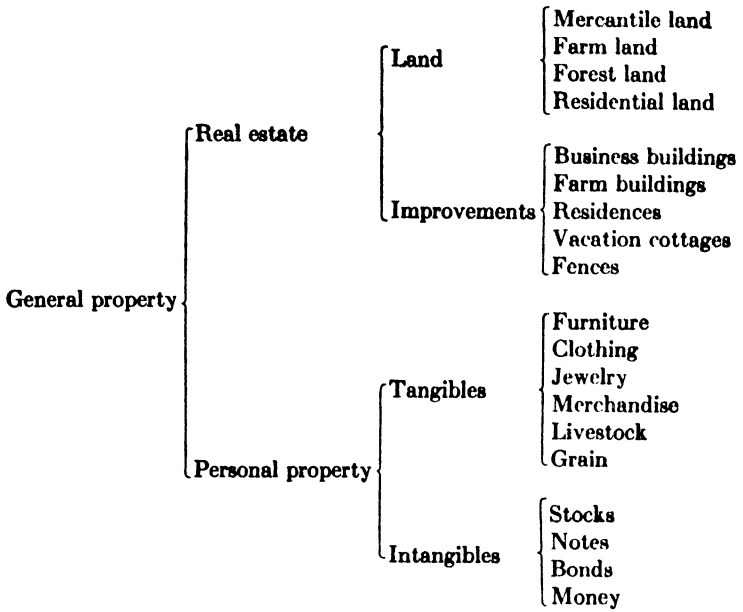
[8] Tax Institute, *Tax Yields: 1941*, Philadelphia, 1942, p. 28.

[9] Committee on Intergovernmental Fiscal Relations, U. S. Treasury Dept., *Federal, State and Local Government Fiscal Relations*, Senate Document No. 69, 78th Congress, 1st Session, 1943, p. 352.

[10] Jens P. Jensen, *Property Taxation in the United States*, p. 27.

mile walk through a city, he would have an impressive array of items. The two most important classes would be real estate and personal property.

Although not complete, perhaps the following simple diagram will illustrate the more common categories of property for tax purposes:



The line of decarcation between real estate and personal property is not too distinct but, in general, real estate consists of immovables and personal property of movables. Frequently this distinction is clearly a relative matter; many buildings are movable, and very little, if any, personal property is so fluid as to move without some difficulty. But these distinctions sometimes are quite important in property taxation.

Distinction Between Real Estate and Personal Property. Under the general property tax, the distinction between real and personal property is usually a matter of little significance since all property is taxed at the same rate regardless of designation. But with modifications in the scope of the tax, this distinction has taken on increasing importance. In some states, personal property is entirely exempt from taxation, and in an ever-increasing number of states more and more classes of personal property are being placed on the exemption list. In some cases the courts have been called upon to draw the line between these two classes of property. One court [11] set up the following considerations to facilitate the classification:

1. Degree of physical annexation of the property.
2. Adaptation of the property to the use to which it is devoted.

[11] Rinzel v. Stumpf, 116 Wis. 287 (1903).

3. Intention of the party supplying the property to make it a permanent accession to the freehold.

In one case (involving a personal property tax offset) the court was called upon to decide whether certain factory machinery was real estate or personal property.[12] The machines were of all sizes, were held in place by their own weight, were frequently moved about, and were connected to the premises only by belting and electric wiring. The machines were held to be real estate on the ground that they were adapted to the purpose for which the building was constructed and used. Had the building been one constructed for another purpose and rented for use by the manufacturing company, the decision would probably have been the reverse. In the absence of any statutory regulation the courts, as indicated above, will generally decide on the basis of the law of fixtures, according to which machinery and certain other equipment when attached to a building become an essential part of that building and therefore also of real property. Of course, for purposes of taxation the legislature may designate what shall and what shall not be treated as personal property.[13]

Classification of Real Property. Real property or real estate consists mainly of land and buildings (or what are called "improvements" on the land). It may further be classified according to the purpose for which the real estate is used; for example, residential, mercantile, manufacturing, agricultural, forest, and so on. In Wisconsin this classification is used for statistical purposes and as an aid to the local assessor in valuing each piece of property. Other states with "classified property tax systems" group real property into numerous classes so that each may be taxed differently. Minnesota thus makes a distinction between unplatted (rural) and platted (urban) real estate.

The distinction between land and improvements is not always made in our tax laws, but the differences between the two are very important in taxation. As we shall see in the chapter on incidence, the ultimate burden of the taxes on these two subjects may be quite different. Moreover, some jurisdictions apply different tax policies in the treatment of these two classes of real estate. Favorable treatment for improvements (either the temporary exemption of new improvements or the outright exemption of all of them) may be inaugurated to encourage building or on the ground that land, as a gift of nature, is an especially fit object for taxation. Land values and building values are subject to different conditions. Land may increase in value while the buildings on it are decreasing in value. Quite different methods are used in evaluating the two kinds of property. For instance, depreciation must be considered in the case of buildings and is not encountered in evaluating land.

[12] State ex rel. Gisholt Machine Co. v. Norsman, 168 Wis. 442 (1919).

[13] People ex rel. General Chemical Co. v. Cantor et al. City Com'rs of Taxation, 172 N. Y. Supp. 582 (1918).

Personal Property: Tangible and Intangible. Personal property is classified into two main categories—tangible personal property and intangible personal property. Tangible personal property includes a great variety of goods such as the following: merchants' and manufacturers' stocks (inventories); business furniture, fixtures, and equipment; machinery, tools, and patterns; rolling stock of railways;[14] farm machinery; harvested crops; logs; household furniture, clothing, jewelry; and "other personal effects." When a student "goes off to college," what he takes with him is tangible personal property—his books, his clothes, his traveling bags, his study lamp. He looks forward to receiving intangible property from his parents on the first of each month.[15]

The second main category of personal property is intangible property. This class consists mainly of contractual rights which have been acquired by individuals or corporations in the tangible property of others and its earnings. The more familiar items are stocks, bonds, mortgages, deposits, money, and book credit. These are representative property; if the tangibles they represent were destroyed, the paper assets would lose all of their value. Copyrights and patents are intangibles of a somewhat different type, and good will, franchise value, and corporate excess are names given to the capitalized earning power of a business insofar as it exceeds the tangible assets of the business. Thus, in Illinois taxes are levied on the "corporate excess" of corporations in the same manner as property taxes are levied on all other property.

Often states distinguish between intangible and tangible property in arriving at a policy of tax exemption; intangibles have tended to disappear from the tax rolls as more and more states have adopted the income tax as a substitute for the general property tax on intangibles. Also, intangible property can more easily escape taxation either by migration or by hiding. It is indeed difficult to hide a barn from even the most perfunctory assessor, yet a bond can be safely hidden from the most diligent assessor. Many states classify intangibles separately and apply a low flat-rate tax to them as a sub-

[14] Public utility property in several states is included as personal property and assessed as a franchise; this is done to give the state more freedom in the taxation of such property (Jens P. Jensen, *Property Taxation in the United States*, p. 107).

[15] "All other personal property" is a class of tangible personal property sometimes used to include a variety of items too numerous and heterogeneous to enumerate or classify separately. Recently a supervisor of the Wisconsin Tax Commission described the work of a local assessor in listing this property as follows: "Mr. S—— in the city of Madison especially deserved credit for his efforts in reaching this property (all other personal property). . . . Such items as rooming house furniture, cash registers, typewriters, office furniture, adding machines, store fixtures, lawyers' libraries, dentists' and doctors' equipment and instruments, beauty and barber shop supplies and equipment and hundreds of other similar small groups of assessable property which so often are either entirely omitted or assessed at a nominal amount by assessors, will pay over $90,000 in taxes to the city of Madison. Mr. S——, through his efforts, reaches taxable properly which is often not found by city assessors to provide a revenue to the City sufficient to pay many times the expense of maintaining his office." (*Annual Report of Assessor of Incomes for Dane County*, Madison, Wisconsin, 1928, p. 17.)

stitute for the general property tax. As we shall see later, most intangible property, because it is representative of rights in the property of others, involves difficult problems of double taxation.

Exemption of Personal Property. The slow but steady spread in the exemption from taxation of personal property has tended to make the property tax more and more a real estate tax. Gradually the burden of taxation formerly borne by personal property is being shifted to real estate. But there is little uniformity in exemption policies among the states. By states, New York, Delaware, and Pennsylvania go the farthest by exempting all personal property entirely; Wisconsin ranks among the most liberal, exempting intangibles, household goods, motor vehicles, farm machinery, and horses, as well as other miscellaneous property. As to the treatment of intangibles, the states are divided among complete exemption, taxation under special low valuation or rate of tax, inclusion under the general property tax, and mixed treatment (including taxation under a special income tax).[16]

Many other kinds of personal property are exempt in certain states. As already inferred, household goods are entirely exempt in New York and Wisconsin, and many other states exempt them in amounts ranging from $50 in South Dakota to $1,000 in Michigan. A few also provide exemptions for personal property of whatever nature up to a certain minimum amount.[17]

Situs of Property. It is well settled that real estate must be assessed for property tax purposes where the property is located. The government under whose jurisdiction the owner resides has no legal right to tax his property if it lies in some other district.[18] This rule has not always prevailed. Thus in Texas, until 1840, real estate was taxed at the domicile of the owner.[19] A mortgage, on the other hand, is ordinarily regarded as personal property and follows the rules of situs applicable to personal property.

Tangible personal property, like real estate, is assessed at the location of the property, but there are some exceptions. For instance, a taxing district wherein the property is customarily kept ordinarily has the right to tax rather

[16] The exemption of the corporate stock of domestic corporations whose property or capital is otherwise taxed by the state is almost universal and generally this exemption extends to the stock of foreign corporations. Debts are deductible from credits in a few states (Tax Research Foundation, *Tax Systems* (9th ed.), Commerce Clearing House, Inc., Chicago, 1942, pp. 153-158).

[17] Oregon permits the assessor to exempt personal property of persons who, in his opinion, because of age, infirmity or poverty, are unable to contribute to the public treasury. Wearing apparel is specifically exempt in a large number of states. Industrial machinery, farm machinery, farm crops, growing or in storage on the farm, motor vehicles, and less frequently livestock, are exempt in some states. There are numerous other exemptions of personal property, usually unimportant, in specific states (*Ibid.*, pp. 167-168).

[18] Not infrequently the ownership of real estate is divided, so that one party has a life estate and another the remainder. Both interests are real estate, however, and while they may be separately assessed, both interests are expected to pay in the jurisdiction where the real estate is located (Jens P. Jensen, *Property Taxation in the United States*, p. 106).

[19] E. T. Miller, *A Financial History of Texas*, 1916, p. 38 (cited in Jens P. Jensen, *Property Taxation in the United States*, p. 110).

than the one in which the property happens to be on assessment day. Thus, the mere fact that an automobile is in a particular village or state on assessment day, even though it has been there for some time and will continue to be kept there for some time thereafter, will not justify the assessment of the automobile.

The rule is not so clear with regard to intangible personal property. It is well established that money and credits may be assessed at the domicile of the owner. An attempt to assess such property where it was kept at the time of assessment has been sustained in the past by the courts but is no longer allowed.[20] Ordinarily a credit may not be assessed in the jurisdiction of the debtor's domicile or in the jurisdiction where the security for the debt is located. An exception has been sustained in the case of a mortgage supported by real estate security where the taxing state allowed the mortgagor to deduct the debt from his assessment. In this case the mortgage was considered as an interest in the real estate and taxed in the state where the real estate was located. Moreover, intangible property may have a "business situs" and be taxed at the place where it is used by the taxpayer's agent as a "stock in trade." At present this does not invalidate assessment at the domicile of the owner.[21]

It is apparent from these practices that much territorial double taxation is possible under the general property tax as applied to intangible property. One will notice that, under our modern conditions of cosmopolitan living and investment, determination of the proper taxing jurisdiction is an exceedingly difficult and complex problem. This same problem will appear again and again in discussing net income and inheritance taxes.

Property Tax Impersonal in Character. As explained in the previous chapter, some taxes are said to be impersonal, and others, personal. Those levied upon things, business, and transactions are generally considered to be impersonal, whereas those levied upon individuals are regarded as personal. The property tax falls mainly in the first of these classifications. In the last analysis all taxes are paid by persons, but there is a difference nevertheless in the two types of taxes. The following characteristics of the property tax are evidence of its impersonal character: (1) for the most part it follows the location of the property, as far as jurisdiction is concerned; (2) security for collection is the property itself and sometimes is confined to that alone (though not universally); (3) property is listed by parcels and description rather than by name (except for personal property which may be listed according to alphabetical order by owners); (4) the tax is ordinarily upon the owner, but if he cannot be found, the occupier must pay or the tax can be placed on the property itself; (5) the taxpayer cannot offset his debts against

[20] Philip Nichols, *Taxation in Massachusetts*, Financial Publishing Co., Boston, 1938, pp. 97, 98.

[21] *Ibid.*, p. 98.

the value of his property (although he is sometimes allowed to offset debts against credits); (6) rates are proportional rather than progressive; and (7) no account is taken in one jurisdiction of what the taxpayer may own in other jurisdictions. If the tax were strictly personal, probably none of these characteristics would prevail. It will be observed that the tax as applied to real estate is highly impersonal, that it is less so in case of tangible personal property, and least of all in case of intangibles.

The property tax in Europe has often had a more personal character. A person's property was and is regarded as one indication of his ability to pay, and taxes were and are assessed against him personally with this index in mind. It is quite apparent from the above description of the American property tax that the latter has departed widely from this approach to property taxation.

The general property tax has sometimes been compared to an equity in property possessed by the government, an equity which commands a regular rental. As a landlord the government pays little attention to its "tenants" as long as they pay their taxes. When, however, they do not pay, they are evicted and someone is found who can and will pay.

GENERAL CRITICISM OF THE GENERAL PROPERTY TAX

Criticisms of general property taxes fall mainly into two classes—those applying to its theory or conception and those applying to its practical and administrative difficulties. It has been said that the general property tax has only two faults: first, it is wrong in theory, and second, it does not work in practice. Others have said that administrative defects of the tax somewhat compensate for its conceptual shortcomings. These people believe that if the tax worked the way it were supposed to, it would be quite unbearable. Consideration will now be given to some of these criticisms, first, from the viewpoint of equity and then from the viewpoint of practical application.

Theoretical Limitations

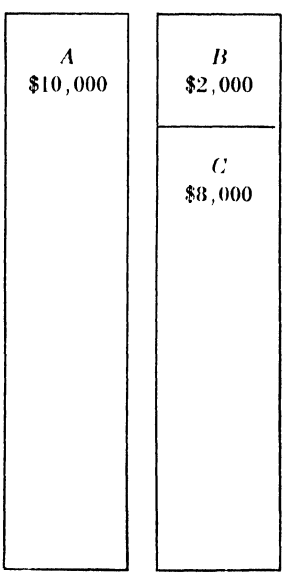
Property Is a Poor Measure of Benefits Received. It has been observed in the previous chapter that benefits received may not be a proper gauge with which to measure the amount of support that a government may require of its taxpayers. But even if benefits were a proper gauge, the possession of property would not be a very defensible measure of benefits.

For many governmental services supported wholly or partially by property taxation, no clear accounting of benefits can be made. Does a $1,000 lot receive the same fire and police protection as a $1,000 automobile? Does a

well-constructed building worth $10,000 receive ten times as much protection from the fire department as an old "fire-trap" building worth one-tenth as much? How can one determine how beneficial the city hall is to a particular taxpayer? Or the beautiful boulevard on the other side of the city where one takes his out-of-town guests to "show off" the community? Or the city jail? Or the "little red schoolhouse" to the childless farmer? Almost anyone will concede that property owners are benefited in some way by these expenditures of government, but to say that the property tax payment is the index of that benefit is another matter. Perhaps it would be more realistic to conclude that local units of government require revenue for public services; that the property tax is the only important source of local revenue available; and that therefore we have the property tax.

It is certainly true that some services of government are more properly considered "land services" than others. Thus garbage collection and sewage disposal represent services which property owners might re-establish on some basis of payment, not very different from the property tax, were the government to discontinue their provision. Education and health service are more personal in character and the benefits of these functions to property owners are indirect. The former might be regarded as more suitable for financing through the property tax than the latter. But in neither case is benefit accounting a very precise matter.[22]

The General Property Tax Results in Double Taxation. Let us suppose that there are two identical farms on opposite sides of the road, as shown in the diagram at the right. Let us assume that *A* and *B* are legal owners of these farms. The *A* farm is clear of debt, but the *B* farm is encumbered with an $8,000 mortgage which is owned by *C*. According to the theory of the general property tax, the assessments would be as follows:



A	$10,000
B	10,000
C	8,000
Total	$28,000

It should be apparent that an error has arisen in this procedure. The earning power and value of the two pieces of property are equal. Why should *A* on one side of the road be listed at $10,000 and the property on the other side at $18,000? Or to put it another way, how can there be listed $28,000

[22] Edwin H. Spengler, "Is the Real Estate Tax a Benefit Tax?" Memorandum No. 5, *Report of the New York State Commission for the Revision of the Tax Laws*, Albany, 1932.

of wealth when $20,000 is all that exists? Does a state get wealthy when some of its property owners borrow from others?

Alternative Procedures with Debts and Credits. Nor is this difficulty easily eliminated by modifications of the general property tax. If the proposal is to exempt *C* from the tax and assess *B* for the entire $10,000, the objection will be made that this compels *B* to pay taxes upon his liabilities as well as his assets. And why should *C*, who probably has more ability to pay than *B*, be exempt from all obligations under the general property tax? Two arguments may be made in answer to these objections. First, since *B* owns the farm and has control over its use, he should be responsible for the tax and the latter should really be considered a charge against the farm regardless of its ownership. In the end, however, all taxes are a burden upon people, and one can hardly ignore the personal status and interest of the debtor and creditor on the theory that the physical property pays the taxes. The second argument is that, regardless of the division of taxes between *B* and *C*, no injustice will result because an adjustment will be made between them through the interest rate. If *B* pays taxes on the physical property, *C* will loan for less; if *C* is required to pay some of the taxes, he will require more interest. This is a problem of shifting which will be discussed in Chapter VI. Suffice it here to say that no such precision in shifting has ever been proved as to warrant entirely ignoring the creditor under the property tax; and if there is doubt about such shifting, why not give the creditor the burden and let him shift it, if he can?

The imposition of taxes upon debtor and creditor each according to his equity would seem to be the most logical procedure, but it has seldom been attempted in the United States. Administratively it is simpler to assess the tax to the legal owner of the tangible property. Moreover, the theory of the property tax, that it falls on property rather than persons, has favored the creditor under the property tax. The theory is so thoroughly established that any attempt to graft personal elements to an impersonal tax might result only in confusion.

The truth is, of course, that property has two attributes; one, a physical existence, and the other, a bundle of ownership rights. If all the wealth of the country were double-listed accordingly, there might be no injustice in property taxation, but, where half is double-listed and the other half single-listed, grave injustice may result. Moreover, through the device of the intangibles instrumentality, a value may be multiplied to an almost infinite degree. For example, real estate may be mortgaged, bonds based on the mortgage may be issued, a corporation may be formed and issue capital stock with these bonds as its asset, and so on.

Examples. In Wisconsin intangible personal property is entirely exempt from taxation, except for the fact that the debtor and creditor are permitted to make their own arrangement concerning taxes by contract. Actually, by means of a standard contract form, the debtor almost invariably assumes

liability for the tax. The exemption of intangible property in Wisconsin occurred for the most part when the income tax was adopted; it was defended in large measure on the ground that the income tax would reach the creditor. However, the state income tax is a much lower-geared tax, particularly as applied to lower incomes, than is the property tax. Consequently, one finds anomalous situations, such as the following:

Mr. X, with securities valued at $50,000 and an income of $2,500 and if he has a wife and two children, may contribute directly to all state and local units of government the sum of $4.50 (his Wisconsin income tax; no property tax is required). Y, on the other hand, with a farm or a small business worth $10,000 from which he gets a net income of $500 a year, will be fortunate to escape with $150 to $200 of taxes. The situation may even be more inequitable if Y is in debt to X to the extent of most of the value of his property.[23]

In Illinois, credits are subjected to the property tax, as are other forms of property. The only concession made to the double taxation argument is that debts may be deducted against certain credits when the same taxpayer has both. Stocks of domestic corporations assessed under the Illinois property tax are exempt to the Illinois stockholder.

In Iowa, Oklahoma, Minnesota, and several other states, credits are taxed at a low flat rate—5 mills in Iowa, 2 mills in Oklahoma, and 3 mills in Minnesota. More will be said of this attempted solution of the problem later, but it may be observed at this point that the attempt is more of an administrative device than an attempt to eliminate theoretical defects.

California at one time attempted to tax the mortgagor and the mortgagee, each upon his equity. This appears to be the equitable solution of the problem, but Professor Plehn concluded from his observation of this system that the creditor regularly shifted all of his share of taxes to the debtor through higher interest and that he added an extra charge for good measure.[24] On the other hand, the circumstances of the California experiment were rather special ones; it would be rash to conclude that it is impossible (whether or not desirable) to tax creditors under the property tax.[25]

Property Taxation of Personal Abilities. Not only has the property tax failed to solve the theoretical (and as will later be observed, the administrative) problems of taxing creditors but, in addition, it ignores one important kind of intangible asset, personal in nature and not capable of exchange. This asset consists of skill and education. From 1928 to 1938, the percentage of the national income distributed as compensation for employee's services

[23] As previously stated, this situation can be defended only on the ground that Y is relieved through shifting and capitalization or because of these phenomena is doomed to bear the ultimate burden regardless of who takes it in the first instance. These problems will be discussed in Chap. VI.

[24] C. C. Plehn, *Introduction to Public Finance* (5th ed.), p. 130.

[25] See Chap. VI for a further discussion of this issue.

ranged from 60.4 to 67.8 percent.[26] The first American property taxes in the colonial period sought to tax personal "faculty" as part of the property tax. Thus, in Massachusetts a statute of the General Court provided that "in all rates and public charges the town shall have respect to levy every man according to his estate, and with consideration to all other his abilities whatsoever. . . ." An order explaining this added that "all men" were "to be rated in all rates according to their whole ability wheresoever it lyes." [27] Not infrequently, large salaries were listed along with the capital value of property to pay taxes at general (or special) property tax rates. In later years, this feature of the property tax was abandoned.

If education has the economic value claimed for it by its proponents or even a value equal to its cost to the state, it must be a considerable factor in the national wealth (using that term in its broadest application). In addition, of course, some have natural talent. Still others, perhaps, have valuable "connections." Of course, all of these forms of wealth have limitations. They cannot be exchanged, a point which is sometimes in their favor. More important, no doubt, is the fact that they are highly perishable, depreciating or disappearing with age, death, sickness and unemployment. Thus personal "faculty," if made taxable, would be very difficult to assess.

Inconvenience of the Property Tax. If it be conceded for the sake of argument that most property has value because it brings its owner an income and that the value has a more or less definite relationship to the amount of income, still it remains true that much property may go for long periods without bringing the owner an income. Thus, forest property may require 50 years in which to produce a crop. The property tax does not wait for the crop, but hammers away year after year while the property is yielding no revenue. It is partly for this reason that over half the states have placed forest land in a separate classification and given it special treatment. But forest land is not unique with respect to delayed yield. Idle lots held for sale may have the same characteristics. During a depression, property which retains value and prospects of future income may go for several years without any net return, if indeed it does not produce a deficit. Thus, the property tax is not at all discriminating; it strikes the taxpayers both when their ships are in and when they are out at sea.[28]

[26] Simon Kuznets, *National Income and Its Composition, 1919-1938*, National Bureau of Economic Research, New York, 1941, p. 218. This does not include the portion of entrepreneurial income which is attributable to services.

[27] C. J. Bullock, *The Finances of Massachusetts*, p. 2 (cited in Jens P. Jensen, *Property Taxation in the United States*, p. 27).

[28] See M. Slade Kendrick, *Taxation Issues*, Harper and Brothers, New York, 1933, pp. 75-78.

It is also contended that taxation in advance of income involves a species of double taxation. The tax is levied upon both the anticipation and the realization (A. C. Pigou, *A Study in Public Finance*, p. 155; also M. Slade Kendrick, *Taxation Issues*, p. 69). The latter source explains Professor Fred R. Fairchild's demonstration of this point as follows: Assume two properties, alike in value, one of which yields its owner a steady income of

It should be said that this feature of the property tax can be urged in its defense, as well as in its attack, for governments must continue even though some property taxpayers have no ready cash. It is precisely because the income tax waits upon the taxpayer's convenience that the income tax is likely to be a "poor producer" in times of depression. The landlord and the creditor do not wait for the property owner to realize upon his investment. Why should the government?

The property tax was designed mainly for a rural civilization and still retains its rural cast. Thus the assessment date is likely to be at a time when the assessor could formerly "get out with his buggy," and the payment date at the time when the farmer has sold his crops. These dates may be poorly adapted to an urban civilization. For instance, installment payment by the quarter or month is now required for the taxpayer's convenience and considerable tardy progress in this direction is being made. Assessment dates that differ from state to state afford considerable opportunity for cosmopolitan taxpayers, like chainstores, to manipulate inventories so as to have a minimum of stock on hand in a particular state on its assessment date.

The Property Tax Correlates Badly with Income from Property. The poor correlation between property taxes and the income from property may be partly a matter of timing, as discussed above, partly one of differences in management or fortune, and partly one of the legal interpretation of the property tax base. With three general bases for valuing property—(1) capitalization of current income; (2) appraisal of present value of anticipated future income; (3) market prices at which similar properties are being sold or can be sold—there is plenty of room for a discrepancy to occur between the time of income receipt and the tax payment.

In a static society these values might usually be the same, but in a dynamic society they are seldom equal. Legally, the property tax is generally levied on the market value of taxable property. Often there are very great differences between a value obtained by capitalizing current income and one obtained by using prospective income. To illustrate, Mr. Smith rents two city blocks of vacant land for $15 a year on which he pastures a cow. By capitalizing this current income at 5 percent, a value of $300 is obtained for this land. But the land is on the tax rolls for $20,000. Why? Simply because the present owner could obtain that sum for the property if he sold it for residential or business purposes. Yet the present property owner has to pay taxes on the $20,000 valuation irrespective of the fact that his current income from the land justifies an assessment of only $300.

The poor correlation between property taxes and the current income from property is most vividly portrayed on the fringe of cities where land is in the

$500 per year, the other nothing for fourteen years and $1,000 per year thereafter. According to Prof. Fairchild's calculation, a property tax of 1 percent would absorb 20 percent of the capital value of the first investment and 34 percent of the capital value of the second investment.

process of transfer from agricultural to urban uses. Before the influence of an expanding city is felt, a farmer may be operating his farm quite successfully and meeting his tax bills out of the income from the sale of his farm products. His land is valued and taxed according to its agricultural productivity. But, as the nearby city expands and new subdivisions are created, the value of his farm begins to increase. It is reflecting the added income that will be present when his farm ultimately becomes urban residential or industrial property. The assessor cannot long disregard this increase in value, for the law tells him that market value shall be the basis for assessing property for property tax purposes. As time goes by, the farmer is forced to meet higher and higher taxes out of his agricultural income. For a time he may be able to intensify his farming operations, but eventually a point is reached where he must succumb to the tax burden and either subdivide his property for much more intensive urban uses or sell to someone who will. Because the farmer's present agricultural income is insufficient to bear a tax on land valued not for agricultural purposes but for urban purposes, the property tax is instrumental in forcing a change in land use. Ultimately this may be to the existing owner's benefit, but much agricultural land has been taken out of production near cities that might well have remained in agricultural use until ripe for urban occupancy.

Indiscrimination of the Property Tax. Consumption goods, such as homes, furniture, and very often automobiles, are included in the property tax base along with farms, factories, and merchants' stocks. The former may save the taxpayer certain outlays which he would have to make if he were without these possessions.[29] In some cases, however, they may be a source of expense to the taxpayer rather than a source of revenue. It can be argued that the possession of an expensive automobile is an indirect indication of ability to pay—that only well-to-do people have or ought to have such luxuries. But it is at least doubtful if the possession of consumption goods is a very accurate gauge of ability to pay.

A tax on property in general suffers from the fact that it treats all property as a homogeneous class, whereas in reality property is made up of very different constituents. We have seen the trouble that arises from including equities and physical goods in the same tax base. Here it is argued that more confusion and injustice are added by including producers' and consumers' goods together. Finally, there are many who feel that land and improvements should be accorded different treatment because of their distinct economic characteristics.

The Property Tax a Burden upon Shelter. Particularly is this stressed at a time when adequate shelter is beyond the means of many and government subsidies are being proposed to make better shelter possible for more people. Directly and indirectly the property tax is a considerable factor in keeping the

[29] It may be contended that consumption goods are not nonincome-producing property; that is, that the services of consumption goods are income. See Chap. VII.

cost of shelter high. Where the retail sales tax is likely to add to the cost of the important necessities, food and clothing, the property tax, as far as it applies to residential property, is likely to do the same to the cost of an equally important necessity—namely, shelter.

Residential property bulks very large as a proportion of a typical property tax base. Wisconsin is among the few states that afford statistical evidence as to this point. In 1941 the assessed value of residential property (not including farm homes) in that state amounted to 45.1 percent of the assessed value of all property locally assessed.[30]

Residential property worth $10,000 may have a gross rental value of $1,000 per year. If the taxes on this property amount to $300, the tax will be equal to 30 percent of the owner's rental. If the occupier of the property has an annual income of $4,000, the tax will amount to 7.5 percent of his income.

The Property Tax Rate Proportional in Form and Regressive in Effect. Those who accept the view that ability to pay increases more rapidly than fortune usually support the progressive principle in rate-making. It can be argued, of course, that there is nothing in the nature of the property tax to prevent it from carrying a progressive rate. Why then have property taxes usually been proportional? Several answers may be given: (1) The property tax is an impersonal tax based on gross property. As has been shown previously, the tax is thought to rest on the acre or the property rather than the owner. A rich man's acre or lot, as such, has neither more nor less ability to pay than does that of a poor man. (2) The property tax, as a rule, is locally administered. Each town, village, and school district (or at the very least, each county) has a different rate. The local assessor pays heed only to the property which is situated in his district. No attempt is made (or could be made under the present system) to assemble scattered estates for the purpose of setting rates based upon total ability to pay.

Most, if not all, of the proposals for a graduated land tax have as their purpose not the spreading of taxes according to ability to pay, but rather the breaking up of large landed estates. The attempt, for example, in Oklahoma and the Great Plains states to enact such legislation has definitely had this nonfiscal purpose in mind. It is a familiar fact that assessors usually assess properties of small value at a higher ratio of assessed to true value than properties of great value. This may be due merely to the fact that the assessor is more likely to be familiar with properties of low value. Frequently he lives in a moderate-cost home himself and may have had other experience with similar properties. When it comes to assessing more expensive properties, he is less sure of himself and may give the taxpayer the benefit of the doubt. Or regressivity may appear because the owner of more valuable property is frequently more influential in the community and with the assessor than are the poorer neighbors. Taxes may be an item of such importance to this

[30] Calculated from data obtained from the Wisconsin Tax Department. Public utility property is centrally assessed.

property owner that he can well afford to invest some little time and effort in getting his assessment reduced or in seeing that the office is filled by one friendly to his interests.

Whatever the cause may be, regressivity is very general in property taxation. A recent survey reported its existence in twenty states where regressivity studies had been undertaken. In Maryland a sample of rural assessments showed properties worth less than $1,000 were assessed at 92.1 percent of true value; those worth from $1,000 to $5,000 at 76.4 percent; over $5,000 at 56.7 percent; urban property showed the same tendency with the percentages of assessment for the classes as stated running 76.2, 61.2 and 54.5, respectively. Not all studies in other states show as regular or as great a regression in assessment, but all show some regressivity.[31]

As previously stated, regressivity is sometimes reckoned in terms of the ratio of taxes to income. If this definition is used, an additional factor of regressivity in the general property tax as applied to residential property appears. Both the proportion of total consumption expenditure allotted to housing and the ratio of housing expenditures to income, particularly the latter, decreases quite substantially as incomes grow larger.[32] It has been argued by some that the property tax is more regressive than a general sales tax, but this is probably true, if at all, only on the assumption that the incidence of the tax is entirely on present occupants.[33]

Practical and Administrative Limitations of Property Tax

If the general property tax is subject to much valid criticism on the ground that it is theoretically inequitable, it is even more open to attack on the score that it does not work out in practice as planned.

The Property Tax Fosters Tax Colonization. It is sometimes argued that the property tax is especially adapted for local revenue, among other reasons because property is less migratory than other tax bases and cannot or will not leave high tax districts for those with lower rates. This is not true, of course, of intangible property, much of which is highly migratory. Where even a feeble effort is made to apply the property tax to bank deposits, they often are withdrawn from banks before assessment day. This not only defeats the purpose of the tax but is also very embarrassing to banks. It is true that real estate can be moved only with great difficulty, if at all, but taxes can be saved by judicious selection of the location where one buys. An interesting species of tax avoidance by selective location is the "tax colony," by which is meant a settlement of residents, usually suburban, where the prop-

[31] Joseph D. Silverherz, *The Assessment of Real Property in the United States*, p. 69.

[32] National Resources Planning Board, *Family Expenditures in the United States*, 1941, pp. 38, 45.

[33] Jesse Burkhead, "Property Tax as a Burden on Shelter," *Journal of Land and Public Utility Economics*, Vol. XX, pp. 255-263, Aug. 1944.

erty base is kept high in relation to public expenditures while tax rates and burdens are kept low.[34] Many cities complain bitterly that people who earn their incomes within the boundaries of these cities nevertheless reside in suburbs and pay property taxes outside the cities. Frequently the cities seek to recover what they regard as their own by urging consolidation of city and suburbs, but usually the suburbs strongly resist all such efforts.

Inequalities Among Various Taxing Districts. Sometimes assessors deliberately undervalue property in order to reduce their district's share of the county or state tax. This is referred to as competitive undervaluation and will be explained in more detail later. In a study of assessments in New York, 25 percent of the assessors stated that their reason for failure to assess at full value was their conviction that high assessments mean high taxes, and another 25 percent laid the failure to the fear of unfair county equalization resulting in excess state and county rates.[35] Sometimes different levels of assessments among districts are due to the fact that assessors of two adjoining districts may have different standards of assessment. At any rate, there is abundant evidence of variations in average assessment among the districts. A recent Kentucky study comparing assessments and sales among counties found a range in average ratios of assessed to sales value of real property from 45 to 105 percent.[36]

Several years ago in Texas, a state that requires 100 percent of true value assessment, a letter was sent to each of 252 county assessors asking at what percentage of true value their assessments were made. By their own admission, these assessment levels varied all the way from 20 percent to 100 percent of true value. With a rate of 7.7 mills, the state property tax on $1,000 of property could have varied all the way from $1.54 to $7.70, depending upon which county assessor had valued the property. In other words, the state tax was five times as high in some counties as in others. Such are the penalties of an honest and faithful assessor.

Inequalities in Assessments Within the Same Taxing District. Most any study of property tax administration will show a greater range in assessment rates among individual properties than among county averages. The mere fact that an assessor values property in his assessment district at an average of 50 percent of market value does not mean that each individual item of property is valued at this same ratio; he may have valued one piece of property at 30 percent of its market value whereas another was assessed at 100 percent. An examination of the 1923 assessment of the city of Chicago

[34] This situation is aggravated by the distribution of part or all of certain centrally collected taxes (such as income taxes) to the districts "of origin."

[35] C. B. Pond, *Full Value Real Estate Assessment as a Prerequisite to State Aid in New York*, Special Report No. 3, New York State Tax Commission, Albany, 1931, pp. 23-29.

[36] James W. Martin and Glenn D. Morrow, *Organization for Kentucky Local Tax Assessments*, Bureau of Business Research, University of Kentucky, Lexington, Vol. II, No. 4, Dec. 1941, p. 12.

showed a range in the assessment of individual properties from a fraction of one percent of true value to over 100 percent.[37] Although this is an extreme illustration, a range of very wide dimensions is the rule.

Minor inequalities among individual assessments within the same assessment district are to be expected as the normal result of even the best assessing practices. A variation of 10 percent around the norm is accepted by the experts as within the "zone of tolerance." Excessive inequalities are usually due to the selection of poorly qualified or incompetent assessors, to the financial undernourishment of the assessment process, to the outmoded system of assessment districts, or to the outright intentional favoritism of politically responsive assessors. A study of Chicago machine politics showed that approximately one-half of the leading party's precinct captains interviewed in 1936 were helping to "adjust" assessments and taxes.[38] This situation is by no means universal but it is not uncommon. The assessor's office is almost traditionally understaffed and many assessors work with little or no supervision or co-ordination of their work. More will be said of these problems in the next chapter, but it can be said here that property tax administration, developed mainly in the nineteenth century, has long been scored by the critics as very inadequate for the modern job of assessing.

Evasion of the Property Tax. One would suppose that this never occurred in the case of real estate. Due to confusion concerning legal description of property, it is not uncommon for large amounts of land to be omitted from the tax roll. Evasion, however, is especially important in the assessment of personal property. For many years evidence has abounded that the local assessor is either unwilling or unable (or both) to assess all, or anywhere near all, personal property.

To take another illustration from Texas, on September 30, 1932, total deposits in the banks of this state amounted to $783,140,000. According to the law, nearly all this money and credits should have been on the assessment rolls at face value. Actually there was $15,948,320 on the 1932 tax rolls, or 1.5 percent of the total deposits in the state.[39]

Although the above illustration relates to intangible property, there is also abundant evidence that much taxable tangible personal property escapes assessment. Household furnishings are usually very inadequately listed. Except where a personal property tax receipt is required as a condition for issuing a state license, motor vehicles in large numbers evade the assessor. It is reported that about half the automobiles and trucks registered in Ken-

[37] Herbert D. Simpson, *The Tax Situation in Illinois*, Institute for Research in Land Economics and Public Utilities, Northwestern University, Chicago, 1929, p. 7.

[38] Harold F. Gosnell, *Machine Politics: Chicago Model*, The University of Chicago Press, Chicago, 1937, p. 77.

[39] C. M. McFarland, *Texas Tax Tangles*, Railey Printing Co., Wichita Falls, Texas, 1936, p. 10.

tucky escape the general property tax entirely. The score in that state as to cattle, mules, and horses is little if any better.[40]

None too good at its best, the assessment of intangible property at its worst degenerates into a first-class racket. Undervaluation of property results in high property tax rates, and assessment of credits at par then may well be confiscatory. A bond yielding 4 percent interest ceases to have much value to its owner if it is subjected to a 5 percent property tax. Under these circumstances the assessor becomes a person of great power and can capitalize on this fact by "fixing" assessments for a secret consideration. Anyone who complains about the existing state of affairs can be heavily penalized with high assessments, particularly on intangible property.[41]

So much for the indictment of the general property tax. It is a strong indictment and to it might be added the judgment of innumerable commissions and students of public finance, the overwhelming majority of whom feel that the property tax has been tested in the crucible of experience and found badly wanting. As an example we may take the statement of Professor Seligman: "*Practically*, the general property tax as actually administered is beyond all doubt one of the worst taxes known in the civilized world." [42]

WHY THE GENERAL PROPERTY TAX IS TOLERATED

Why then do we continue to tolerate the general property tax? Several answers may be made. First, many states have sought to improve the tax by modifications; more will be said about this in a later chapter. Second, we are creatures of habit and do not easily surrender an old instrument even when it is proved to be a poor one. Moreover, the long tenure of the tax means that many people have bought and sold property on the expectation that the property tax would continue. They have paid a price for their property lower than what they might have paid had there been no property tax. To eliminate this tax now would simply amount to handing over the government's equity in it to private owners who may not have paid anything for its equity. Third, there are difficulties in all alternative ways of raising the necessary revenue. The sales tax, which is a principal alternative, is thought by many critics to rest on even less rational ground than the property tax and to be even more inequitable. It may be better to "bear those ills we have than fly to others we know not of."

Fourth, the property tax with all its faults has great fiscal virtues. It produces a large, dependable, and predictable revenue. It is elastic—an ideal

[40] James W. Martin and Glenn D. Morrow, *Organization for Kentucky Local Tax Assessments*, pp. 19, 22.

[41] A vivid account of such a racket in operation can be found in Herbert D. Simpson, *Tax Racket and Tax Reform in Chicago*, and *The Tax Situation in Illinois*.

[42] E. R. A. Seligman, *Essays in Taxation* (10th ed.), p. 62 (italics his).

source to squeeze at any time for a few extra dollars. Fifth, the property tax is well adapted to local use; so well adapted that it has suited the needs of a nation imbued with the spirit of home rule and opposed to a strong central government. And finally, property appeals to many as a justifiable basis for taxation. It seems right and proper that some responsibilities to government should be imposed as a condition of property ownership. The property owner must meet responsibilities or fixed charges of other sorts—such as interest and insurance—whether or not he is able to make the property yield a net income. If the government renders the property owner a service, why should not he pay for it, as a condition of retaining ownership?

When all this is said, however, it remains true, in the author's opinion, that the idea of taxing all property, tangible wealth, equities, consumer's goods, producers' goods, land, and improvements as one homogeneous mass is indefensible. The evidence is overwhelming that the unmodified property tax in practice was, and is, very unsatisfactory. Much, if not all, of personal property should be legally exempt from the property tax in conformity with what has already come about through the defects in its administration. The least that can be said is that substantial modifications in administration and some differentiation as to constituents is required, and with the exception of its application to urban land, the property tax has undoubtedly been overworked.

CHAPTER IV

The General Property Tax—Administration

UNITS OF GOVERNMENT

It has already been emphasized that the property tax in the United States is an important source of revenue for many units of government, and the smaller the unit the greater is its dependence on this source. It is true that some states now manage to get along without levying a property tax at all and that others are less dependent on it than formerly, but as a rule most units of government except the federal still rely, at least to some extent, upon this source. The same property tax often is divided to support several units of government. An understanding of property tax administration depends upon a clear conception of governmental structure. For this reason, before launching upon a more thorough analysis of the property tax, it will be necessary to consider the interrelationship, the multiplicity, and the functions of these political subdivisions.

The United States tops the list of nations both in the importance of the property tax in the revenue system (with the possible exception of Canada) and the number of governmental units. As to the former, the previous chapter pointed out that property taxes ran to 31 percent of total tax revenues in 1941; and as to the latter, one study found 175,369 units of government in the United States between 1930 and 1933.[1] Even when allowing for area

[1] William Anderson, *The Units of Government in the United States* (New Edition, Completely Revised), Public Administration Service, Chicago, 1942, Pub. No. 83, p. 2. Besides the national and state governments, this study gives the following distribution of governmental units in the United States:

	1930-33	1941
Counties	3,053	3,050
Incorporated towns, cities, boroughs and villages	16,366	16,262
Towns and townships	20,262	18,998
School districts	127,108	118,308
Other miscellaneous units	8,580	8,382
Total	175,369	165,000

and population, the latter is still an impressive figure compared with that of other countries.[2] Recent tabulations place the number at 165,000.

Counties. In 1941 there were 3,050 counties in the United States. With the exception of a few cities, the State of Rhode Island, and a few unorganized thinly populated areas in South Dakota,[3] these units covered the entire country, rural as well as urban. Like all local governments, counties are creatures of the state and are dependent for their powers and functions upon the state constitution and, more often, the state statutes. Powers and functions accorded them vary greatly from state to state.

Counties originally were assigned functions of general statewide interest. State legislatures desired uniform performance throughout the state, not by the state government, but by agencies acquainted with and responsive to the peculiar interests and needs of smaller units of territory. County governments are very important in property tax administration, and many students of public finance believe they should be still more important. Of the 26,304 primary local assessment districts in the United States in 1940, 1,956 were county districts; review or equalization of assessments was performed by an even larger number of counties, and collection of taxes was delegated to many of these units.[4] County governments are also responsible for a considerable part of total property levies. Of the 5 billion dollars of property taxes levied in the United States in 1932, counties levied 18.4 percent of the total, or nearly three times as much as levied by state governments in the same year.[5]

Towns and Townships. In almost half of the states the rural area of a county is subdivided into towns and townships.[6] In 1941 there were 18,998 of these units located mainly in the northeastern quarter of the United States.[7] In the New England states, the towns are very important and many are highly urbanized. In general they perform many functions which in other states are administered by the counties. Toward the west and south, the importance of the town tends to diminish and finally disappears altogether.

Wherever towns or townships exist, they usually have their own govern-

[2] Total number in England and Wales, 2,253; in Australia, 1,060; in France, 38,350 (Anderson, *The Units of Government in the United States*, 1934 edition, p. 37).

[3] The five county areas in the City of New York have been so denuded of functions and powers and so fully merged with the city government as to have lost their separate corporate character. County areas corresponding to the cities of Baltimore, Boston, Denver, Philadelphia, St. Louis, New Orleans, and San Francisco have merged with city government to disappear as separate units. There are also 24 independent cities in Virginia whose areas are not included within counties (*Ibid.*, 1942 edition, pp. 19-20).

[4] National Association of Assessing Officers, *Assessment Organization and Personnel*, Chicago, 1941, p. 38. An authoritative analysis of assessment organization in the United States is presented in this comprehensive analysis.

[5] *Financial Statistics of State and Local Governments*, 1932, p. 4.

[6] Although towns are predominantly rural municipalities, the New England town includes much urban territory.

[7] William Anderson, *The Units of Government in the United States*, 1942 edition, p. 2.

mental machinery, including executive officers, town halls, town meetings, and annual budgets. Their functions vary greatly from state to state but usually are fairly numerous and of both statewide and local interest. One of these functions, in most cases, is the assessment of property and the collection of property taxes. In 1940, there were 16,183 civil townships and 1,377 New England towns serving as primary assessment districts in the United States.[8] But, in amount of property tax levies, the fiscal importance of the township is not very great. In 1932 these units levied about 4.3 percent of total general property taxes or slightly more than half as much as state governments and less than one-fourth as much as the counties.[9] In the northwest quarter of the United States, their fiscal importance is much greater than the above average reveals.

Municipalities. Urban and partly urban incorporated areas are variously known as cities, villages, boroughs, and incorporated towns. In 1941, Professor Anderson enumerated 16,262 of these types of local governmental units.[10] These units, and sometimes their wards, frequently serve as primary assessment districts, and their property tax levies constitute a large part of all property tax levies—43.8 percent of the total levied in 1932.[11] The 1935 property tax income of the City of New York alone, which in the United States has a budget second only to that of the federal government, exceeded the combined incomes of the thirteen states of Wyoming, Vermont, Utah, Rhode Island, North Dakota, New Mexico, New Hampshire, Nevada, Montana, Maine, Idaho, Delaware, and Arizona; 55 percent of the city's normal budget, or 485 million dollars, was received from this source.[12]

School Districts. The most numerous unit of government is the school district, of which there were 118,308 in the United States in 1941.[13] School districts may or may not be coterminous with county, town, village, or city areas. In about one-fourth of the states these units are subdivisions of the towns or townships. Although school districts are not very important in property tax administration—there were only 439 of these units serving as primary assessment districts in 1940—they do account for a significant proportion of the total general property tax levy.[14] In 1932 almost one-fourth (23.8 percent) of the total property tax levies were imposed by these govern-

[8] National Association of Assessing Officers, *Assessment Organization and Personnel*, pp. 38, 364. A primary local assessment district is one of a group of similar or co-ordinate governmental units which are continuous and which together occupy the whole area of the state. Overlapping local assessment districts are governmental units which have established separate assessing agencies despite the fact that their property has been appraised and listed by the assessing agency of a primary district.

[9] *Financial Statistics of State and Local Governments*, 1932, p. 4.

[10] William Anderson, *The Units of Government in the United States*, 1942, p. 2.

[11] *Financial Statistics of State and Local Governments*, 1932, p. 4.

[12] Municipal Reference Library, *New York Advancing*, F. H. La Guardia, Mayor, New York, 1936, p. 27.

[13] William Anderson, *The Units of Government in the United States*, 1942 edition, p. 2.

[14] National Association of Assessing Officers, *Assessment Organization and Personnel*, p. 38.

mental subdivisions. Although more than eight times more numerous than municipalities, the property tax levies of school districts were just a little over one-half as large as similar collections of municipal governments.[15]

Special or Miscellaneous Units. Lastly, there were, in 1941, some 8,382 miscellaneous units of local government such as drainage districts, road districts, irrigation districts, and other miscellaneous units. Many of these districts administer their own property tax while some depend on other local agencies to perform this function. In 1932 these units of government levied 2.6 percent of the total property taxes levied in the United States.

THE PROPERTY TAX CALENDAR

"Tax calendar" is the name given to the successive steps involved in the process of assessment, levy, and collection of a particular tax. In practice the expression has been employed mainly in reference to property taxes. The reason for this is that the period involved in the process is quite long and the process is highly "ritualized." A brief description of the calendar will be given here, as some knowledge of it is essential to an understanding of property tax administration. The steps in administration presented below are not followed consistently in practice by all states, but they are followed in the main and may be offered as a general procedure. Variations are due mainly to differences in governmental organization, as described above.

In general, before any unit of government in the United States can tax property, the state legislature must give its approval. The legislatures have done this by setting up general statutes covering the use of the property tax. Through these statutes, the legislatures specifically designate what units of government may employ the property tax and often set up definite limitations as to the rates and the entire administrative procedure. The only exception to this is where the power is derived from the state constitution, which quite frequently contains elaborate provisions regarding the power of taxation.

This distinction as to source of power to levy a tax is of great importance to anyone seeking to reform the tax system. The legislature may be a stumbling block to reform, but the constitution may prove a solid wall beyond which none may pass.

Briefly outlined, the steps in administration are as follows:

1. Levy
2. Original assessment
3. Review of the original (local) assessment
4. Central assessment or equalization
5. Apportionment of taxes and setting of rates

[15] *Financial Statistics of State and Local Governments*, 1932, p. 4.

6. Collection
7. Collection of delinquent taxes
8. Appeals to some judicial or quasi-judicial body.

As an alternative to the procedure outlined above, direct state assessment is often provided for certain property, such as railroads. This outline will be easy to remember if one thinks of it (particularly steps 1 to 6) as a chronological arrangement showing how administration proceeds through the course of a year. The length of time from assessment day to the first delinquent tax day varies from 10 to 14 months from state to state.

Levy. Chronologically, the levy often comes later in the procedure than at the beginning, but logically one can best conceive the process as starting with this step. Each of the units of government discussed above has a legislative body which proceeds to make a levy on the property within its jurisdiction. The levy consists of legislative enactment to the effect that a certain specified amount of revenue shall be raised from the property tax. Sometimes instead of deciding to raise a certain amount, the legislative body merely authorizes a certain tax rate to be charged against all taxable property within its boundaries. In some states the levy for local units may be voted by the residents of the district (at town meetings, for example); for many others, and particularly the county, state and municipal governments, representative legislative bodies determine the amount to be raised.

Original Assessment of Property. Since the general property tax is based on the value of all taxable property within the taxing district, it is necessary for someone to evaluate the property. This is done by the local assessor. On a certain day of the year the assessor is supposed to value all property lying within his district. Since in practice it would be impossible for him to complete this task in one day, he usually values property, not *on* that day, but *as* of that day. Assessment day varies all the way from January 1 to October 1. In the North and East, and particularly in areas with the town unit of government, it is usually April 1 or May 1.

In all states, personal property is revalued for tax purposes every year, but real estate may be assessed annually or otherwise. About one-half the states provide for annual assessment, with the others ranging from two years in nine states to ten years in one state. If improvements are added to real estate, they are generally added to the assessment for that year even though there is no new assessment of real estate.

Review of the Local Assessment. Completion of the assessment roll by the local assessor is not always the final proceeding in the determination of the assessments of individual parcels or holdings of taxable property. Due process of law requires that every taxpayer be given the right to a hearing before the tax becomes final. This hearing may be before the original assessing agency, a separate administrative review agency, or the courts. Because original assessment agencies lack the impartiality of ideal review agencies, and because

review by the courts is too slow and too expensive, all but a few states have established special administrative review agencies to hear protesting taxpayers and to check and double check the work of the local assessor. The function performed by these agencies is commonly known as "review."

Typically, review agencies are composed of *ex officio* members such as the town chairman, town clerk, city mayor, city attorney, and so forth. Duties of review agencies may include any or all of the following: [16]

1. To raise individual assessments, after due notice and opportunity for hearing, when the agency finds that the values submitted by the assessor are too low.
2. To lower individual assessments when it finds the assessor's values are too high.
3. To add taxable properties to the assessment roll, where they have been omitted by the assessor.
4. To remove tax-exempt properties from the roll when the assessor has listed them for taxation.
5. In states classifying property for differential tax rates, to reclassify property when the assessor has listed it in the wrong class.
6. To correct clerical errors in the assessment roll.

In performing these functions, the board of review may be permitted to act on its own motion or only on appeal.[17] In some states, the board of review has no power to change assessments except upon sworn evidence presented by the taxpayer and other witnesses. In others it may do so at its own discretion. This power has been defended as a desirable check on the assessor; in practice it often results in an undesirable division of responsibility.

Central Assessment or Equalization. Unfortunately, the local assessor's work, as previously has been observed, cannot be regarded as a satisfactory basis for the distribution of state tax levies among counties or (in the case of

[16] National Association of Assessing Officers, *Assessment Organization and Personnel*, p. 239.

[17] A typical local assessment district in the United States, whether primary or overlapping, serves as an administrative review district and has its own special or ex-officio review agency. Provided this situation were universal and there were no duplication in the performance of the function of review, the number of review districts and agencies would be the same as of assessment districts and agencies. But such is not the case. Nine of the 21 states divided wholly or partially into township assessment districts (or their equivalent) are divided along county lines for assessment review purposes. "Furthermore, 6 states with township assessment districts have assessment review agencies on both township and county levels. And 26 states, including over half of the states with county assessment districts and exactly half of those with township districts, have state as well as local review agencies." (*Ibid.*, p. 244.) Not counting overlapping local assessment districts, there are 26 state review districts, 2,733 county review districts, 10,978 township review districts, and 3,190 municipal review districts—a total of 16,901 districts—and approximately equal numbers of administrative review agencies. In addition, the three or four thousand overlapping assessment districts have their own local administrative review agencies. (*Idem.*)

town, village, and city assessment) of county taxes among the smaller units. It would be possible, of course, for central units to provide a separate assessment of all taxable properties within their borders. But this would involve heavy duplication of work. On the other hand it would be possible to let the state do the assessing in the first place. But assessment has always been a local function and attempts to centralize it have been vigorously resisted. Moreover, it is claimed that local assessors have the advantage of familiarity with local property. A third alternative, and the one usually accepted, is central assessment or equalization by state and county agencies, frequently called state and county boards of equalization. These central assessments either start with the local assessments as a base and make some corrections in the totals for the counties, towns, villages, and cities, or they make a "mass assessment" of the districts as a whole. As will be more fully explained later, these assessments are based upon such knowledge concerning the towns, villages, and cities as the central agency may gather. The comparative data and analysis may be scientific or very unscientific. Under township assessment, central assessment is vital to the county in order to defeat competitive undervaluation of property by local assessors. Even in a state with county assessment and no state property tax, central assessment may fill important functions in the taxation of railroads, the distribution of state aids, and in other respects.

In practice, equalization boards often exercise functions shading into what has been described as review. They make "en masse" changes in assessments by classes of property or divisions of territory and even, in some cases, alter individual assessments.[18]

Apportionment, Setting of Rates, Collection. As soon as the central and local assessments have been completed, it is possible to apportion taxes and calculate rates. Two alternatives procedures may be followed. Under the

[18] As summarized by the National Association of Assessing Officers, the equalization process is capable of fulfilling at least six different purposes as follows: (*Ibid.*, pp. 288-289).

"1. To equalize the burden of taxes imposed by a governmental unit which is not itself an assessment district but which bases its taxes upon assessments made by two or more independent assessment agencies.

"2. To equalize the tax burden upon two classes of property which are subject to the same or related tax rates but which are assessed by two or more independent assessment agencies.

"3. To equalize the apportionment of moneys collected by one governmental unit and distributed to several other governmental units when the formula for distribution depends directly or indirectly upon the assessed valuations of these other governmental units and their assessed valuations are determined by two or more independent assessment agencies.

"4. To implement tax rate and debt limitations by preventing their nullification through overassessment and their intensification through underassessment.

"5. To equalize the tax burden upon different types of property within the jurisdiction of a single assessment agency when that agency has unlawfully discriminated between types.

"6. To equalize the tax burden upon property located in different parts of a single assessment district when the assessment agency has unlawfully discriminated between areas."

first, the taxes for the central units are divided among the subordinate units according to the central assessment. For example, if one county has been found by central assessment to have 10 percent of the state's taxable property, it is allotted 10 percent of the state taxes. Once it is known how much a given district is required to raise for the central units, a local official (probably the county or town, village, or city clerk) is prepared to calculate the tax rate for that district. He adds the central levies to the local levy and divides the sum by the assessment roll, that is, the total valuation of property in his district. The quotient obtained shows the necessary tax rate to be imposed upon each dollar's worth of property in order to raise the required revenue. Thus, if $10,000 is required and the local assessment roll is $1,000,000, the rate will be $\frac{10,000}{1,000,000} = 1$ percent. Each individual's tax is then computed by multiplying his assessment by the tax rate.

The second alternative procedure is more simple and much more widely used. Instead of deciding to raise a given amount of property tax revenue in each local unit, the central units proceed on the assumption that the property assessed valuations are correct or have been corrected, and they determine a definite tax rate which is certified to the local units for extension on the local tax rolls. To illustrate, instead of requiring the local unit to raise $1,000 of state taxes, the state sets a statewide uniform tax rate of, say, $1.oc on $100 of assessed valuation, to be paid on all taxable property in the state. Whereas with the first procedure the central units tell the local units to raise so much revenue and to set the tax rate accordingly, with the second procedure the central units say, "Here is your tax rate; all property owners in your unit must pay this tax rate on their property." To obtain the total tax rate for any particular district, all the assessor must do is to add his local rates to those certified to him by the overlying units of government.

Once the tax bills have been calculated, the taxpayer may or may not be sent a bill for the amount due. At any rate, he is expected to pay it on or before a specified date, usually to the local treasurer, one of whose tasks is that of collecting the general property tax.

Collection of Delinquent Taxes. If all the taxes levied were paid at the proper time, the only step remaining in the tax collection procedure would be for the treasurer to forward the county and state shares to the proper officials. But it practically never happens that all taxes are collected on time, and this necessitates further procedure in the tax calendar. Procedure in dealing with delinquent taxes differs widely from state to state. For instance, in Wisconsin if some of the tax "goes delinquent," the local treasurer, after an attempt to collect, must turn over the uncollected taxes to the county, which then credits the local district with their face value. The county treasurer turns over the unpaid personal property taxes to the sheriff for collection, and if the latter is unsuccessful, they may be charged back to the local

unit the following year. As for real property taxes, if they are not paid before a certain time, the county treasurer must, with some exceptions, offer the taxes for sale. The individual who buys the taxes secures a claim upon the property against which they were levied and, after several years have elapsed (five, in Wisconsin), he may obtain title to it by one of two means: he may either obtain a tax deed from the county clerk, after properly notifying the recorded owner and other lien holders; or at his own option he may, in lieu of taking a tax deed, foreclose on the tax certificate in the same manner as a mortgage is foreclosed on real estate. The principal distinction between the two is that in the former he obtains a tax deed, whereas in the latter he receives a warranty deed, that is, the deed which the recorded owner had to the property. This distinction is important because a tax deed is not nearly so secure as is a warranty deed. If no buyer is found for the taxes, the county acquires a tax certificate on the property, and, after it has acquired the required number of successive tax claims, it may obtain a tax deed in the same manner as an individual.

Judicial and Quasi-Judicial Appeals. Mention has been made of the board of review as a "court" of first resort for the taxpayer who is dissatisfied with his assessment. The taxpayer is frequently given an additional appeal to the state tax commission and always a final appeal to the courts. On its own motion or on petition from a certain percentage of property owners in a given district, the state tax commission or tax department may ordinarily consider and grant a reassessment for a district, and may in some cases appoint the assessor and charge back the cost for the work.[19]

PROBLEMS OF THE LOCAL ASSESSMENT

The Local Assessment. The need for reorganizing the assessment process is widely recognized, but such reorganization is extremely difficult to achieve. Structures, procedures, and customs of local government are as resistant to change as a granite peak to erosion.

There are two broad categories of assessment districts—primary assessment districts (those local governmental units or areas that are charged with assessing the entire area of a state) and overlapping assessment districts. Primary assessment districts may be further subdivided into classes according to the types of governmental units charged with performing this function. The accompanying chart shows that the county assessment districts are characteristic of the South, the Southwest, and the West. In the Northeast

[19] The courts exercise various degrees of judicial review of local assessments. There is a group of some 22 states in which the courts review assessments for legality alone, and there is another slightly larger group whose courts review assessments both for legality and accuracy. (A. Bristol Goodman, *Assessment Administration in Wisconsin*, doctoral dissertation filed with the University of Wisconsin, 1942, typewritten, pp. 265, 267, 270.)

and Middle West, the typical assessment district is the town, city, or village.[20]

Overlapping assessment districts are those assessing agencies exercising the privilege of assessing property within their borders despite the fact that the same property has already been assessed by the primary assessment district. As the name implies, overlapping assessment districts duplicate the work done by the primary assessment districts. They are found in nearly half the states. To the uninitiated, this duplication seems to serve no useful purpose and it could have no value if uniformity of assessment were achieved in the primary assessment. Desire for home rule, advantage gained by manipulation of assessments to meet tax and debt limitations or to attract industries, the overlapping of two primary districts by one secondary district, and a variety of other historical and political reasons account for the duplication.

The decentralized system of primary and local assessment districts accounts for the extremely large number of persons involved in assessing. Many of these assessors—all of the township, village, and smaller city assessors—devote only a portion of their time to the task of assessment, frequently not more than six weeks a year. Larger cities as well as counties, where these units perform the original assessment function, ordinarily have full-time assessors with staffs of deputies and assessment specialists nearly always too small in number for their task.

Because of the part-time character of their work and because they are often compensated on a daily or per diem basis, the compensation of part-time assessors is very low. Some studies indicate that the assessor holds one of the most poorly paid public offices in the United States. Assessors of the larger assessment districts tend to receive more adequate salaries, but there are all too many exceptions.

The critics are generally of the opinion that assessors should be appointed for an indefinite term of office, but the practice departs widely from this ideal. This problem is not confined to assessment personnel only; it applies to other local government officers. Not only are assessors commonly chosen by popular election but also they are chosen for short terms of office—too short for the good of the service. Their terms of office range from one to six years. According to a recent survey, approximately 49 percent of the primary assessment districts for which information was available selected their assessors for two-year terms, 27.5 percent for four-year terms, and 18.3 percent for one-year terms; the one-year term was found almost exclusively in townships.[21]

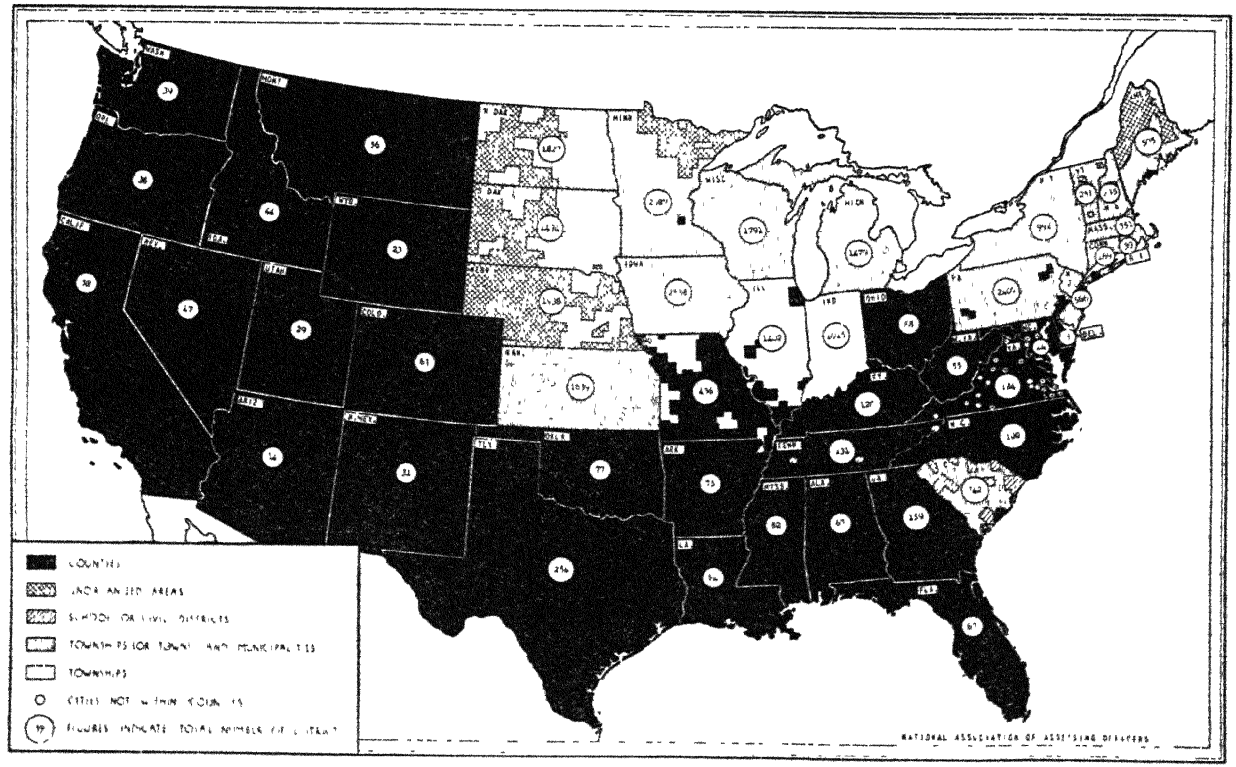
These two factors—short terms of office and popular election—have tended to make the job of assessing excessively political in character. This system

[20] On the western fringe of the Great Plains, in the forest cut-over areas of northern Minnesota, and in the wild sparsely settled forested areas of northern Maine, the town or township is passing out of existence and the assessment as well as other local governmental functions is being performed by overlying governments.

[21] National Association of Assessment Officers, *Assessment Organization and Personnel*, pp. 161, 165.

FIGURE 1

PRIMARY LOCAL ASSESSMENT DISTRICTS IN THE UNITED STATES, 1940



Source. National Association of Assessing Officers, *Assessment Organization and Personnel*, p. 42

gives the assessor uncertain tenure and makes him subject to political pressure. His is a technical job and one not well fitted to selection by political methods. In districts where the responsibilities of citizenship are taken seriously, superior assessors are the rule and not uncommonly are re-elected for a period of 5, 10, 15, and even 20 years. This is by no means universal. It is for these reasons that the part-time, low-paid, politically chosen local assessor has been the object of much criticism. It has frequently been recommended that the assessment function be given to either the county or the state, with selection of assessors through competitive civil service examinations.

The position of assessor commonly involves no special statutory qualifications. Not a word is said concerning training, ability, intelligence, or other qualifications. Eligibility requirements for office frequently have to do only with state and federal citizenship and residence in the district. Ability to get, not to do, the job appears to be the prime requisite. (Kentucky assessors, called county tax commissioners, are an exception; they must pass an examination given by the state tax commission before they can become candidates for popular election.) Removal provisions in the statutes are frequently unworkable. "It is far more probable that a man would be ousted for misappropriating $10 of the taxes collected than for failure to place a million dollars' worth of property on the assessment rolls." [22]

In summarizing present conditions, Professor Jensen commented as follows:

> "It may be said of the local assessment that the assessment area is too small where it is less than the county, or large cities. The prevailing method of electing the assessor is faulty in that it places in office men who are often untrained, unskilled, and likely to be politically influenced in their work toward either a low assessment ratio for their districts or toward assessment favoring particular interests. The compensation of the assessor is almost invariably too low, except in the larger cities where the assessment functions have expanded to require a permanent department of assessment." [23]

Special Problems of the City Assessor. A description of the technique and problems of urban assessment would require more space than can here be allotted to it. The assessor's office must be adequately equipped with maps. The most useful and important of these are the lot-and-block maps and the

[22] M. G. Toepel, *The Assessment of Property for Ad valorem Tax Purposes in Texas Cities*, Bureau of Research in the Social Sciences, University of Texas, Austin, 1939, p. 66.

[23] Jens P. Jensen, *Property Taxation in the United States*, p. 359. In passing it should be noted that the county unit system is not a panacea for all the ills of the property tax, as some would have us believe. It is significant that perhaps the best property tax administration is in states with the town assessor, whereas the poorest is in states with the county assessor. The size of the assessment unit is at least less important than good supervision by competent personnel, proper central assessment, and adequate financial support. Moreover, there is no substitute for an alert and civic-minded electorate.

land-value-unit maps. The former shows the size, shape, and location of all the lots in the city. The latter gives the key value for each block, the key being the value of a lot of a certain standard size and depth in the center of the block. Over a period of years assessors, through a study of many sales of property, have built up tables for determining the influence of depth and location at or near a street corner. These are known as depth-factor and corner-influence tables. If over a period of years it is observed that, in a business district, lots which are 125 feet deep sell on the average for 112 percent as much as lots 100 feet deep, it may be concluded, other things being equal, that the 25 extra feet add 12 percent to the value. City assessors should have an extensive file of information concerning personal property and buildings, including for the latter, dimensions, age, nature of construction, and many other relevant facts.

Much personal property is difficult for the assessor to find and some is exceedingly difficult to evaluate even after it is found. A variety of techniques are employed in the effort to get personal property on the tax rolls. In the case of merchants' and manufacturers' inventories, an examination of the company's books or of state and federal income tax returns is often effective. Intangibles cause special difficulty and are rarely, if ever, well assessed. Some jurisdictions rely on sworn returns by the taxpayer, and these have been accepted as final except for an action on the ground of perjury in some instances. The main result has been to make perjury respectable. Some states have used what is known as tax ferrets [24] in aiding property tax administration. Special agents were induced by compensation in the form of a commission to seek out and disclose information leading to the assessment of property that escaped the assessor. This system was employed in Iowa and Ohio and still survives to some degree in Kentucky. The consensus seems to be that this weapon, too, has not been very effective and certainly not popular. Some states also require the payment of taxes on credit instruments as a condition of the legal enforcement of such instruments.

Criticism of Property Tax Review. Although the purpose of review agencies is clearly apparent, there is almost universal complaint that their work is ineffectual. Being most often politically constituted, they are subject to heavy political pressure. And when such agencies are aggressive, in effect they tend to take over the assessor's work. As the clerk of one board of review once remarked, "The greatest source of trouble is the feeling that the board is a super-assessor and that they have the right to change the assessor's figures autocratically." [25] Too, duplication of review agencies in a number of states has tended to divide responsibility with undesirable consequences.

Supervision of the Local Assessment. Formerly, local assessors were left entirely to their own resources in performing their tasks. Most states now

[24] Jens P. Jensen, *Property Taxation in the United States*, pp. 353-357.

[25] A. Bristol Goodman, *Assessment Administration in Wisconsin*, doctoral dissertation filed with the University of Wisconsin, 1942, typewritten, p. 136.

have tax commissions or similar agencies to which has been given the function, among others, of supervising local assessment work. As a rule the tax commission has very limited financial resources and works at long range. Under these circumstances, supervision may be confined to the preparation and distribution of an assessment manual or some other help of this nature. Some states offer their local assessors absolutely no help whatever. However, the tax commission, if properly manned and financed, can render very effective assistance to them.

State supervision of local assessments has received much emphasis in Wisconsin. At the point of its highest development in that state, supervision was largely in charge of 11 supervisors of assessment, constituting the property tax staff of the Tax Commission and chosen by the latter under merit appointment. Each supervisor was responsible for a specific district, in which his office was located. The system still prevails except that the number of supervisors and districts has been reduced to four and the program has been so undermanned and underfinanced that it has lost much of its former effectiveness.

Among the many contributions which supervisors can make to property tax administration, only a few can be mentioned here. One is the holding of annual county meetings for the local assessors, who can then get the benefit of instruction in the fine and difficult points of property tax procedure. The local assessor can be given a field book with which to work and can be instructed as to how property should be recorded and classified. Assessors can be encouraged to compare their estimates of the same or similar properties.

Following this short course in assessment procedure, the supervisor may work in the field with the assessors. The supervisor may make himself available for consultation and advice. Supervision of this character can exercise an exceedingly favorable influence upon assessments. It follows this same general pattern in all states, but it is sometimes purely nominal and is almost universally a badly neglected aspect of property tax administration.[26]

The Standard of Value. It has been pointed out that the general property tax is based on the value of property and that it is the duty of the assessor to determine this value. The question now is what kind of value he is to determine. In the field of economics there are many kinds of value. Thus, one finds in the literature on the subject references to the following: historical cost, selling price, going-concern value, replacement value, income value, loan value, esthetic value, full value, full face value, market value, equalized value, liquidation value, cash value, true value, sound value, depreciation value, insurable value, book value, and social value. Only a few of these are used for general property tax purposes. Statutes usually make clear that mar-

[26] Harold M. Groves and A. Bristol Goodman, "A Pattern of Successful Property Tax Administration: The Wisconsin Experience," *Journal of Land and Public Utility Economics*, Vol. XIX, No. 2, May 1943, pp. 142-152.

ket value or exchange value is to serve as the standard of assessment. The law may state that real property shall be assessed "at the full value which could ordinarily be obtained therefor at private sale." [27] Another common definition is: "What a person willing and able to buy would pay a person willing and able to sell."

Market value as a standard appears entirely reasonable, at least upon first examination. Original cost would make an untenable standard since ability to pay must be measured by what the individual can get out of his investment, not what he put into it. Cost of reproduction, or replacement value, also falls short in that it takes no account of the future prospects and present productivity of the property. Moreover, it could not be applied to land. The subjective value of the owner brings in psychological and personal attitudes which are impossible to ascertain.

Nevertheless, many cases arise where market value as a basis of assessment proves unsatisfactory. This is particularly true in the case of properties which were built for a particular purpose. As such they are good investments, yet they cannot be sold on the market except for use for a less productive purpose and at a great sacrifice. A classic example is the New York Stock Exchange building. It is constructed especially for use by a very large stock exchange and would have little or at least much less value if sold for some other purpose. As far as we know, there will always be a large stock exchange in New York, since the present one does not contemplate going out of business. But one stock exchange seems all that is likely to develop. If the present exchange should undertake to sell its building, it presumably would have to sell it to some other kind of buyer.

A more common case of a similar nature is that of a very expensive home built by a very wealthy resident in a small city. Were such a residence offered for sale, it would probably go at a great sacrifice because no equally wealthy buyer would be present to bid for it. Yet, in the hands of the person who built it, the home may be fulfilling its purpose quite satisfactorily.

An interesting case involving this problem is that of Northwestern Mutual Life Insurance Co. v. Weiher,[28] in which a large insurance company in a moderate-sized city of Wisconsin sought a reduction in assessment on the ground that the home office building, designed for a particular purpose, could not be sold on the market for either its original or replacement cost. The court in this case upheld the contention of the insurance company. However, in New York State the assessment of the New York Stock Exchange building far above its market value was sustained.[29]

On the supposition that property assessment is a measure of ability to pay, it would appear that assessors should have discretion in cases of this

[27] *Wisconsin Statutes*, 1937, 70. 32.

[28] 177 Wis. 445 (1922).

[29] People ex rel. New York Stock Exchange Building Co. v. Cantor et al., 223 New York Supplement, 64 (1927).

kind to depart from market value in its strict and literal sense and to assess the property on its value for the purpose for which it is being used. It has been pointed out that insurance companies, in appraising such property for insurance purposes, do not hesitate to depart from the market-value standard. Since the decision in the insurance-company case, several attempts have been made to liberalize the standard in Wisconsin, but without success. However, the courts have qualified their decision concerning the matter by developing the doctrine that in the case of property which rarely sells, evidence of "intrinsic value is acceptable." [30]

It has been argued that, in property taxation, the standard of value should give greater weight to current earnings or earning capacity than it does at present. The clearest way to do this would be to substitute the annual or rental value of property for the sales value. This might seem to create a tax on income rather than on property, but actually it is a tax on the latter; the income tax is personal in character and looks at what A makes from his land during the year, whereas annual value looks at what a year's use of A's land is worth. Annual value is the basis of the property tax in Great Britain and other European countries. Under this system there is no attempt to tax anticipated increases in the productivity of land or other property in advance of their appearance. It tends to reduce the taxpayers' difficulty in meeting taxes without current income. Furthermore, annual value taxation tends to avoid the issue of double taxation [31] which may be involved in taxing anticipation. And finally, it avoids the injustices which are said to arise from property income being capitalized into property values at different rates for different kinds of property.

On the other hand, annual value as the basis of property assessment tends to favor increments to land values. Such increments are frequently unearned wealth resulting from increases in population or from social improvements. They have been thought a particularly apt subject for taxation. Except to some extent under the capital gains feature of some income tax laws and under the property tax as now constituted, they are not taxed in the tax system in the United States. They are even more favored in Great Britain. Of course, such increments might be taxed in other ways.[32]

The use of annual value as a standard in property tax administration also encounters a difficulty of translating personal property values into their annual equivalent. Few people in the United States think of value as an annual affair, even though more property is rented than is operated by the owner. Both the assessor and the public would be obliged to think of the tax problem in terms of a foreign language, so to speak. As the property tax

[30] Flambeau Paper Co. v. Windus, 208 Wis. 583 (1932).
[31] See Chap. III.
[32] See Chap. XVII.

moves in the direction of becoming a real estate tax, these administrative objections will cease to be so important.

Probably it would be unwise to recommend annual value as a property tax reform in the tax system as it now exists in the United States. But this proposal merits consideration and could be recommended were both the property tax itself and the tax system modified to meet the above-stated objections to this change.

THE CENTRAL ASSESSMENT AND EQUALIZATION OF PROPERTY[33]

Purpose and Nature of Central Assessment. It has been observed that the property tax is used to support the larger units of government as well as the local towns, villages, and cities and that it is necessary or at least highly important for these central units to make an independent mass appraisal of the taxable property in the smaller units. This needs to be done in order to defeat competitive undervaluation, which may be deliberately practiced by local units to reduce their share of taxes for the support of central units. The consequences of competitive undervaluation and the effect of proper central assessment may be illustrated as follows:

Assume that *A* and *B* are two assessment districts (say, two towns) which together make up a county. Within their borders are $1,000,000 and $2,000,000 worth of property respectively. Assume further that *A* district is assessed on the average of 100 percent of true value, whereas *B* district is assessed on the average at only 50 percent of true value. Assume now that, for *A*, $10,000 and, for *B*, $20,000 must be raised for local purposes and that an additional $10,000 for county purposes must somehow be divided between the two districts. Assume that *a* is a resident of *A* district with $10,000 worth of property assessed at true value, and that *b* and *b'* are residents of *B* district, each with $10,000 worth of property, but with *b* assessed at true value and *b'* assessed at 50 percent of true value. It is apparent from the assumptions that *a*, *b* and *b'* should pay the same amount of tax since each has an equal amount of property and local levies are proportional to local wealth.

With no central assessment, the county taxes would be apportioned between the districts on the basis of their assessed valuation, and in this case each district would be required to raise $5,000 for the county in addition to their local taxes. The tax rate would then be as follows:

District	*Total Levy Required*	÷	*Assessed Valuation*	=	*Total Tax Rate*
A	$15,000		$1,000,000		1.5%
B	25,000		1,000,000		2.5

[33] The first three sub-sections of this section may be omitted by students who wish to shorten their study of this subject.

The tax bill for each of the property owners would then be calculated as follows:

Owner	*Tax Rate*	×	*Assessed Valuation*	=	*Tax Bill*
(*a*)	1.5%		$10,000		$150
(*b*)	2.5		10,000		250
(*b'*)	2.5		5,000		125

Where there is no central assessment, *A* district bears an undue share of the county tax and this makes *a*'s tax bill too high. By the same token, *B* district escapes with an unfair advantage and *b*''s tax bill is lower than it should be. On the other hand, *b* is the victim of a bad error in the local assessment, having been assessed at twice the average rate of assessed to true value in his district. The lack of a proper central assessment which favored his district compensates somewhat for the local discrimination against him, but certainly there is no excuse for him to pay twice as much taxes as *b'*, his next-door neighbor.

Now suppose a system of central assessment is in operation. Instead of apportioning the county tax on the basis of total assessed valuation, the county would use true value in apportioning the taxes to each district. Since district *B* has twice as much true value, it would be required to raise twice as much county tax as district *A*. District *B* then would have to raise two-thirds of the county taxes in addition to its local levies, and district *A* would raise one-third of the county taxes in addition to its local taxes. The tax rate would then be as follows:

District	*Total Levy Required*	÷	*Assessed Valuation*	=	*Tax Rate*
A	$13,333		$1,000,000		1.33%
B	26,666		1,000,000		2.66

One will notice that, although the allocation of the county tax was based on true value, in calculating the tax rate for the district the assessed valuation is used. Why? Mere introduction of central assessment does not change the assessed valuation of property in the district. It is necessary to base the tax rate on assessed value so that when it is applied to individual taxpayers enough taxes will be forthcoming to equal the sum sought.

The tax bill for each of the property owners would then be calculated as follows:

Owner	*Tax Rate*	×	*Assessed Valuation*	=	*Tax Bill*
(*a*)	1.33%		$10,000		$133
(*b*)	2.66		10,000		266
(*b'*)	2.66		5,000		133

With proper central assessment and the county tax equitably distributed between districts, *a* bears his correct share of the total taxes. It will be

noticed that *b'*, who is assessed at the average ratio of assessed to true value for his district (50 percent), pays the same tax as *a*, which is as it should be since his true value is the same as *a*'s. But *b*, who is assessed far above the average of his district, now pays twice as much as he should (since his true value is no more than the others, he should pay no more taxes than they do).

The remedy for *b* is review rather than central assessment. That is, the local board of review should adjust *b*'s assessed valuation to the level of other property in the district, which in this case is 50 percent. Thus a proper central assessment does not correct a bad local assessment. Central assessment merely makes for a proper division of county taxes among the local units of government. With proper central assessment and review of local assessments, the tax burden on each one of the owners used in our illustration would have been the same.

Methods of Central Assessment. How is a proper central assessment made? Several methods have been tried. One of the older is that of using local assessments as a base and making corrections in the light of statistics on wealth, population, and so forth. This method involves a great deal of guesswork and is highly unscientific. A second method is to hear evidence presented by local districts. This has been called "ordeal by oratory" and has proved very unsatisfactory. The sales sampling method has been developed in several states. This method consists of selecting in each district certain properties which have recently been sold, using these as a sample, comparing the aggregate sales price of the sample with the assessment of the same, determining a ratio of assessed to sales value for the sample, and applying the ratio to the assessed value of the district as a whole to arrive at a true value. In terms of a formula, the assessed value of the sample is to the sales value of the sample as the assessed value of the village (for instance) is to its true value. If 10 properties constituting the sample were recently exchanged for $100,000 and the assessor listed these properties at an aggregate figure of $80,000, then the assessment ratio of the sample is 80 percent. If the district is assessed at $8,000,000, by the application of the formula the true value of the district would be calculated at $10,000,000.

The sales sampling method appears to be a sound and scientific way to correct local assessments. However, it is not without limitations and difficulties. One of the most obvious is that not all sales are good indications of market value. Sales of this nature include forced sales, distress sales, sales to relatives, and so on. A program of investigating the sales (sometimes called fielding) to exclude sales of this type is a refinement which can be used to meet this defect.

Another difficulty is that the property sold may not be representative of all property in the district. A good sample must be representative, as every farmer who has "tested milk" well knows. It is for this reason that the farmer stirs the milk well before taking his sample. In the case of the properties, it may be that most of the sales are small or residential properties, or the

assessor's bias may have appeared in his assessment of large properties of mercantile and manufacturing properties, as was shown in the preceding chapter. This difficulty has been met by a classification of properties and by sampling each class separately. A third difficulty may result from an insufficient number of sales, at least among certain classes of property. This has been met by the substitution of expert appraisals where the good sales are insufficient.

Equalization and Central Assessment Practice. Equalization and central assessment are probably the weakest stage in the property tax procedure of most states. In many, the functions are confused with that of review, and central agencies attempt to correct individual local assessments. In others, equalization, as the name implies, consists of superficial modifications of the total assessments of subdivisions. These modifications are often based on inadequate knowledge. In some states, nothing that can be dignified with the title of central assessment, equalization, or review is provided. Local assessors are required to assess property with full knowledge that the better they perform their task (and the more in conformity to law), the more their districts will be penalized. Such a condition is certainly true in Texas, where there is a state property tax of 5 to 7 mills and no state board of any kind to see that local assessments in each of the 252 counties are on a par with each other.[34]

Agencies of Central Assessment. The state tax department ordinarily has the responsibility of making the state central assessment of counties. It may delegate this task very largely to its agents, the supervisors of assessment. The county central assessment may be made by a committee of the county board subject to the approval of the board itself. The committee may have available the evidence of the supervisors of assessment, and if the latter's recommendations are well supported, they will usually be accepted without modification. In many states with no supervisors, or where their work is little respected, the county central assessment is a rough and unscientific procedure.

Value of Good Central Assessment. The importance of adequate central assessment in good property tax administration is often underestimated and can hardly be overstated. With competent central assessment it is possible to convince an assessor that assessment of property at true value does not mean high taxes for his district. Experience shows that undervaluation makes for unequal valuation. Assessors make their most accurate calculations when they aim at true value. Undervaluation creates difficulty for a taxpayer when he seeks to ascertain whether or not he is a victim of discrimination; he must compare his assessment not with the statutory standard but with his neighbors' assessments. If the assessors' work is to be reviewed by some outside agency with unrestricted powers to alter the local assessment, responsibility

[34] It has been well said that no one thoroughly understands the property tax administration of a particular state unless he lives in that state.

is divided. A good central assessment will do much to sustain the morale of the whole assessment process. With a proper integration of the entire assessment procedure, values can be kept very near the true value; that is, at one common level. Uncoordinated assessment can lead only to lower levels of assessment and greater inequalities among districts.

In addition, the assessment of railroads and other properties, when directly made by the state, is legally and morally difficult to defend without definite and scientific knowledge of the true value of taxable property in the state. Moreover, state aids are frequently distributed inversely according to the property valuation of districts, and for this reason alone such value should not be subject to the eccentricities of local assessment. Use of assessed value as a basis of distributing aids inversely to such value encourages lower and lower assessments.

Some states have been able to relieve themselves of the responsibility of central assessment by the separation of sources of state and local revenue. By separation is meant that the state levies no property tax but depends on other independent revenue. The hope of those who have supported separation was that it would automatically eliminate competitive undervaluation and the necessity for an elaborate central assessment. The experience with separation, as far as these objectives are concerned, has been disappointing. Where the county exists as an intermediate government between the local units and the state, the problem of county central assessment still remains. If the state is to forget all about the property tax and leave the municipalities to their own devices, the assistance of the state in supervision will be missed. Experience has clearly indicated that separation is not a successful means of circumventing the problems of property tax administration.[35]

The reaction of some critics to the entire process of central assessment has been that it is all very stupid; why not let the state assess property in the first place and avoid all this duplication of work? On paper this would seem to be a legitimate criticism and a logical conclusion. Actually, however, popular opinion is opposed to so much centralization of administration. Beyond a rather indefinite point varying from state to state, centralized machinery of assessment is likely to encounter the impediments of local suspicion and hostility.

[35] "The separation of sources has eliminated the necessity for centralized equalization of assessments insofar as inequalities in the amounts of state taxes are concerned, but the necessity still exists for such equalization whenever subventions are made to the localities on any basis of need" (T. R. Snavely, D. C. Hyde, and A. B. Biscoe, *State Grants-in-Aid in Virginia*, The Century Co., New York, 1933, p. 87). See also James W. Martin and C. M. Stephenson, "Aspects of the Movement Toward Separation of the Sources of State and Local Revenue," *Tax Magazine*, Vol. XI, No. 2, Feb. 1933, pp. 80-81.

FUNCTIONS OF THE STATE TAX DEPARTMENT IN PROPERTY TAX ADMINISTRATION

From what has been said, it can be concluded that the state tax department or some similar central agency is a very important element in efficient property tax administration. Its principal functions are: (1) supervision of local assessment, (2) central assessment of districts, (3) direct assessment of railways and other property particularly ill-adapted to local assessment, and (4) acting as an administrative "court" of appeals for aggrieved property owners and districts.

The third function—the direct assessment of certain properties—has not been discussed and will be reserved for later chapters dealing with taxes upon public utilities and mines.

In very few, if any, states is the tax commission or department equipped with powers, personnel, and finances to perform its property tax functions adequately. It can be said with assurance, however, that the quality of property tax administration will correspond quite regularly with the alertness and adequacy of the state tax commission or some corresponding state agency.

Given a tolerably intelligent and public-spirited electorate and the exemption of property which it is impossible or unjust to assess, and given good supervision and intelligent central assessment, it is possible to administer the general property tax, even with a locally elected assessor, with a high degree of efficiency and success.

PROBLEMS

1. In a county composed of one city and a considerable hinterland of rural territory, the county is so assessed that the assessed value of the city constitutes half of the assessed value of the county. Actually the value of the taxable property in the city is a third of that in the county.

A manufacturing company in the city owns 20 percent of the taxable property in the city, but its assessment is only 10 percent of the assessed value of the city.

If the city and county property tax levies are each $1,000,000, what difference in total taxes will a good central assessment (equalization) make for the manufacturing company?

2. Whitley is a city in Kingston County. In 1928, its assessed value was $1,000,000. This was 1/10 of the assessed valuation of the county.

The county board of Kingston County has evidence to show that all of the districts of the county except Whitley have been assessed at 100 percent of true value. Evidence concerning Whitley shows that 10 pieces of property

located in that city exchanged hands during the preceding year. These 10 pieces of property exchanged for $100,000 but were assessed at $33,333.33. Among the ten was the property of John Wilcox, for which he paid $10,000 but which was assessed at $3,333.33.

The city of Whitley, in 1928, had $50,000 to raise from the general property tax for local purposes; the county had $100,000 to raise for its purposes.

What difference will equalization make to the tax bill of John Wilcox?

CHAPTER V

Property Tax Modifications and Other Problems

MODIFICATIONS IN THE PROPERTY TAX

In a previous chapter it was suggested that the general property tax is not an immutable institution and that it has undergone considerable adaptation in recent years. It will now be considered from the standpoint of the modifications which it has been and is undergoing. Probably the most important of these modifications fall under four headings; classification, exemption, improvement in administration, and supplementation or diversification of the tax system. State tax limitation has also had important effects on the property tax institution. Attention will now be given to those modificaions which have not previously been discussed. Diversification need be given no special consideration since it is treated indirectly in several subsequent chapters.

Classification of Property

The application of property tax classification is illustrated in the State of Minnesota. Following the constitutional amendment of 1906 permitting classification of property, Minnesota developed an elaborate system of classification. In the main, this has taken the form of varying ratios of assessment to true value for the different classes of property. Thus, iron ore, mined or unmined, is assessed at 50 percent of true value, platted urban real estate at 40 percent, rural real estate and much urban personal property at 33⅓ percent, household goods at 25 percent, and rural personal property at 10 percent.[1] Urban homesteads up to $4,000 in value are assessed at 25 percent of true value; rural homesteads at 20 percent. The first $4,000 of the full and true value of these homesteads is exempt from the state property tax.[2] Money

[1] Roy G. Blakey and Associates, *Taxation in Minnesota*, The University of Minnesota Press, Minneapolis, 1932, p. 576.

[2] *Extra Session Laws of Minnesota*, 1937, Chap. 86.

and credits are assessed in full, but are taxed at a special low flat rate of 3 mills. Mortgages are subject to a registry tax only. Exemptions in Minnesota are minimized by the fact that they are written into the constitution and require a constitutional amendment for modifications.[3] (Thus Minnesota can classify property by statutory enactment but may exempt it only by constitutional amendment. Exactly the opposite situation prevails in Wisconsin, where exemptions are allowed by statute but where classification could be brought about only by constitutional amendment. On the merits, there seems to be no sufficient reason why the hands of the legislature should be tied in either matter.)

The classification of property, which is of basic importance in the Minnesota system, has made considerable progress throughout the United States. About one-third of the states now have a low flat-rate tax on money and credits; and Montana, Virginia, West Virginia, Kentucky, and Ohio have a more complete classification similar to that in Minnesota.[4] The classification system of Minnesota can be explained more on historical and political grounds than on any rational basis. When the system was enacted, practices then existing were more or less written into the law. Since then modifications have depended considerably upon the balance of power in the Minnesota legislature, a balance which usually has favored the rural interests.

Nevertheless, a quite rational argument can be advanced to support the Minnesota classification system. The high rate of assessment applied to iron ore can be defended on the ground that it represents gifts of nature which are subject to depletion. The low rate on household goods and money and credits may be justified on the ground that these forms of property tend to evade assessment if heavily taxed. Finally, the differentials in favor of agriculture can be defended on the ground that agriculture has suffered more or less chronic depression for many years.

Concerning the low flat-rate treatment of intangibles, the evidence indicates that it has resulted in wider assessment, but it still has not eliminated wholesale evasion of assessment. Thus Professor Blakey records the result of a study of certain probated estates in Minnesota showing money and credits taxable as compared with money and credits on which the low flat-rate tax was actually paid. His study showed that only 17.33 percent of taxable money and credits were listed; the remaining 82.67 percent escaped tax free.[5] As for household goods, a sample study showed from 53 percent to 72 percent of the properties in this class were not even on the tax rolls, and properties which were on the tax rolls were assessed from 23.24 to 34.46 percent of their appraised value.[6]

Professor Blakey very properly observes that these figures cannot be cited

[3] Minnesota Constitution, Art. IX, Sec. 1.
[4] *Tax Systems*, 1942, pp. 153-157.
[5] Roy G. Blakey and Associates, *Taxation in Minnesota*, p. 217.
[6] *Ibid.*, p. 221.

to prove any spectacular success for classification in achieving an equitable assessment of these kinds of property.[7]

According to Professor Leland, the special classification of intangibles has resulted universally in a substantial increase in the amount of such property placed upon the assessment roll. However, nowhere has the increase been sufficient to constitute a good assessment.[8] And in some cases the receipts from property taxes upon this class of property have been less under classification than without it. A few states, of which Ohio is an example, have combined special low rates with central assessment. Ohio and Michigan also assess certain intangibles under a special income tax. The special income tax has the advantage that it does not drive intangibles into hiding before the assessment date.

Classification of property, such as is practiced in Minnesota, has been criticized on the ground that it opens the gate for political pressure and abuse. But, in spite of this criticism, classification may be regarded as a step in advance of the older methods of treating property as an undifferentiated mass. However, it is no substitute for the best techniques of administration,[9] nor for the outright exemption of property, the inclusion of which cannot be theoretically justified or for which no feasible means of successful administration has been developed. Moreover, if there is to be such classification, more rational support could be given to separate ratings for land (at least urban land) and improvements than for most of the distinctions which have actually been made.

THE PROBLEM OF PROPERTY TAX EXEMPTIONS

Kinds and Extent of Exemptions

A complete account of the subject of exemption in taxation will be found in Chapter XX. Here it may be observed in passing that large and increasing amounts of property are excluded from the tax roll. Some years ago it was estimated that about one-eighth of the real estate in the United States was exempt from property tax.[10] The proportion would surely be considerably larger today. It has been estimated that the percentage of tax-exempt property in Philadelphia increased from 19 percent in 1931 to 28 percent in 1944. Included among the exempt property is much publicly owned real estate, kept off the tax rolls either because of certain rules of constitutional law or on the theory that taxing public property is taking money out of one pocket and putting it into another. The trend toward public housing and

[7] Roy G. Blakey and Associates, *Taxation in Minnesota*, p. 216.

[8] Simeon E. Leland, *The Classified Property Tax in the United States*, Houghton Mifflin Co., Boston, 1928, p. 403.

[9] *Ibid.*, p. 221.

[10] Jens P. Jensen, *Property Taxation in the United States*, p. 126.

other public works has increased the amount of public property. Some property is exempt for social reasons—such as lodges, private schools, hospitals, and cemeteries; some for developmental purposes—as new industries; some for fiscal or administrative reasons—as household furniture; some to avoid double taxation—as credits.

Exemptions create a problem because they reduce the tax base and thus make higher tax rates on the remaining taxable property necessary. Often, it is very difficult to draw the line between property which is entitled to exemption and that which is not.

Many of these exemption problems involve other taxes also, such as the income tax and inheritance tax, and for that reason they will be discussed in detail in later chapters. However, one type of exemption, namely, that of homesteads, is so intimately associated with the property tax that it will be considered in this chapter.

Homestead Exemption

For some years, there has been in the United States a strong movement seeking exemption of homesteads from the property tax. Acquiring momentum during the foreclosure period of the depression of the thirties, this movement first began to show results in 1932; now about one-fourth of the states have statutes or constitutional provisions [11] for homestead exemptions. As in all other matters pertaining to the property tax, variations in provisions for homestead exemption are very wide. They differ as to the definition of a homestead, maximum value or area to be exempt, and whether or not the exemption applies to both state and local property taxes. Iowa [12] and Louisiana [13] condition their exemptions upon sufficient receipts from certain replacement taxes. Minnesota and Montana give homesteads a favorable classification under their classified property tax laws and, in addition, the former also allows an outright exemption from state taxes. Still another variation is that of Vermont, which permits municipalities to exempt homesteads. The Texas constitution allows an exemption of 200 acres up to $3,000 of value, but the privilege extends to the state tax only.

Definition. In taxation, the word "homestead" is not used in the same sense as in land settlement of the pioneer days when one "homesteaded" a quarter-section of land. Both uses of the word "homestead" do include the expectation that the owner will be the occupier. Thus, when an owner rents out his property to some other person, the property actually loses its homestead status; it is a homestead only when occupied by the owner. As used in tax legislation, the term "homestead" includes urban as well as rural property.

Although the definition varies from state to state, it certainly includes

[11] The reader will note the very dubious propensity of some states to write their tax laws into their constitutions.

[12] *Iowa Laws* (1937), Chap. 195.

[13] Louisiana Constitution, Art. X, Sec. 4.

any dwelling occupied by the owner exclusively as a residence. Likewise it includes the site upon which the dwelling is located and a varying amount of surrounding land. For rural land the maximum area varies from 40 to 200 acres; for urban land, from one-fourth to one acre.

There is a tendency to think of homestead exemption as primarily an agricultural problem, but this is erroneous. In Oklahoma, a state considered rural in character, 56.3 percent of the homesteads were urban in 1935.[14] An Iowa study also showed that homestead exemption covered much less rural than urban property, partly because of a large amount of tenant-occupied property in rural areas.[15]

Thus the exemption may include not only the land and improvements used as a place to live, but also considerable property used to make a living. Logically it should include a mercantile establishment above which the owner lives in a room or a flat. The merchant's situation is not very different from that of a farmer, who claims exemption not only for his home but also for his contiguous income-earning property. But actually the laws do not appear to extend the merchant this privilege. In value, the exemptions range from $500 in Wyoming to $5,000 in Florida.

Fiscal Effects of Homestead Exemption. A homestead exemption may produce quite different results in different areas and for different units of government, depending upon a considerable number of variables among which are the following:

1. Amount of the exemption and the units of government affected
2. Degree of homeownership
3. Ratio of residential property to total property
4. Average area of the homestead
5. Average valuation of the homestead
6. Extent of dependence on the property tax

The student will often find more than one of these variables occurring at the same time and producing varying results. For instance, if a high degree of homeownership is characteristic of a state, it is logical to expect an exemption to have a greater effect than where tenancy is high. In the southern states, where tenancy is so high as to constitute a national problem, the effect of an exemption would be substantially less, other things being equal, than in a dairy state where tenancy is relatively low.

A district which finds a large part of its property tax base exempt from taxation has cause for both sorrow and jubilation; the former because of the greater difficulty in meeting local expenses, the latter because its share of county and state property taxes will be definitely reduced. A district with a small proportion of property exempt may also have occasion both to com-

[14] *An Analysis of the Effect of Homestead Tax Exemption in Oklahoma*, Oklahoma Tax Commission, Bul. No. 18, July 15, 1936, p. 68.

[15] C. W. Thompson and V. McElroy, *Homestead Tax Reduction in Iowa*, Iowa Studies in Business, No. XVII, State University of Iowa, Iowa City, 1937, pp. 22-25.

plain and rejoice, but for opposite reasons in each case. The exemption will add little to the problem of raising local revenue, but the district's share of state and county taxes will be increased.

In general, a loss from the tax base in a district must mean either a severe increase in local property tax rates upon the remaining base or curtailment of expenditures. Of course, the district may borrow, but this only serves to postpone an increase in the tax rates; or the state may come to its rescue by levying additional taxes (such as sales taxes) and extending the state's system of aids. The latter procedure involves not only the introduction of a new tax (or the increase of old ones), but also the extension of state authority and a corresponding relinquishment of local independence.

Pros and Cons of Homestead Exemption. Homestead exemption is defended mainly on the ground that homeownership is a community asset and needs to be encouraged. Excessive tenancy has always been regarded as inimical to the public interest. It is said by some that homes are not productive of income, but this proposition would certainly not justify exemption of agricultural land. The property tax imposes a high fixed charge upon the homeowner, which bears heavily when he finds himself without a cash income.

The homestead exemption program has had a strong political appeal. It makes the choicest of campaign bait. The sentiments that attach to the word "home" are deep-seated. "A man's home is his castle," it is said, and most any politician can arouse a following with slogans which propose to defend the home against "the vicious tax monster."

On the other side of the argument, it is contended that the homestead exemption program offers nothing to those least able to pay, namely, the tenants; that indeed the program is likely to increase their burdens insofar as increased property taxes are passed on to them by their landlords. Or if no increases in property taxes are contemplated to replace lost revenue, then the effect of substitute taxes—particularly the sales tax—may be to increase the burdens not only on the tenants but also on the poor generally, including small homeowners. Of course, the loss of revenue might be met by constructive governmental economies such as are possible through intelligent reorganization of local governmental machinery. But exemption and reorganization have rarely if ever been associated with each other. Further, the wisdom of encouraging the recipients of low and uncertain income to acquire residential property is very doubtful. These people may incur heavy loss of savings if they are unable to meet obligations. It is also argued that the exemption privilege will be capitalized by present owners, and as a result future owners will pay more for residential property, thus losing what benefit the program might offer. This proposition, however, is full of complications and uncertainties. Probably capitalization under these circumstances will be exceptional.[16]

[16] See discussion of capitalization in Chap. VI.

At a time when governmental obligations are increasing and when local governments in particular are short of independent sources of revenue, states should think twice before they slice away a large part of the local tax base. On the whole, the homestead exemption movement seems ill-advised.

Exemption of Housing

It is generally conceded that the property tax adds substantially to the cost of shelter. A strong case can be made for reducing this burden. The homeowner should perhaps be relieved of some of the fixed charge upon his premises which the property tax now imposes. More logical than a homestead exemption to accomplish these purposes would be a full exemption or favorable classification for all residential property, or at least all residential improvements. The benefit of such action would extend to tenants as well as homeowners. However, the well-to-do homeowner hardly needs this concession. At least full support can be given to an exemption from state and local property taxation of that portion of the value of governmentally sponsored housing which represents a subsidy and is not supported by anticipated rent. It is contended by some that if governments are to subsidize housing, they should do so directly and not in the form of a tax exemption. This issue is largely between the federal government and the localities. It seems that local governments should be satisfied if taxes are paid on these houses equivalent to those paid on the houses commanding equal rent. This in no way involves a loss of local tax base since the new homes, valued as suggested, are at least as valuable as the private ones the occupants could have built and supported. Of course, where governments seek to provide a yardstick for private enterprise by governmental undertakings, equality of tax burdens between public and private property appears desirable. But this is not the purpose in a housing program.

Those who take the "Georgian" approach to taxation, including proponents of the single tax, recommend tax exemption or favored treatment for all improvements (and personal property). This goes considerably farther than any of the measures discussed above. This proposal will be discussed in a later chapter.

TAX LIMITATION

Introduction. Although municipalities are in a subordinate position to the state and owe all their powers to it, they have usually been allowed to levy upon taxable property at their own discretion, both as to rates and purpose of the tax. They have been limited, if at all, by maximum statutory or constitutional limits which were too high or too loosely drawn to be effective. Within recent years, however, there has been a widespread movement in the United States to place an effective top limit upon property tax rates, one

which falls well below the range of rates customarily levied in many municipalities. The property tax has been a highly elastic source of revenue in most municipalities and the attempt to make it more inflexible, where successful, is likely to have a profound effect on the whole problem of municipal finance.

Property tax limitation is by no means an innovation in the United States.[17] Maximum rates in some form have prevailed in the majority of states for a long time. Even the "over-all limit," which has been regarded as a major innovation of the recent movement, has been applied in a few states for many years. But during the depression of the 1930's, a vigorously promoted movement for more and lower limits of the over-all type made substantial headway. This campaign was stimulated and sponsored by the National Association of Real Estate Boards. The Association sought to amend state constitutions to include a property tax limitation which would restrict the rates to a maximum of 10 mills for all units of government combined and with no exceptions. In its campaign the Association was aided by the wave of tax delinquency and the general economic distress which prevailed during the depression.

Kinds of Tax Limitation. Tax limit provisions are sometimes statutory and sometimes constitutional in their authorization. As previously stated, they may be specific or "over-all" in character; in the latter case they establish an aggregate property tax rate, leaving it usually to some agency to apportion the tax among the various units of government, such as school districts, villages, counties, and so on. The specific limit may specify the maximum rate for a given unit of government, such as a county, or it may specify a maximum for a given function within a given unit of government. In addition, the levy may be limited to a fixed percentage of that of the previous year, as in Oregon, where the levy for the current year may not exceed the levy of the preceding year by more than 6 percent. These limitation plans also differ substantially in the exceptions they provide. The most common exception is that for taxes required to pay interest and principal upon the public debt, or at least that portion of the public debt incurred before passage of the act. A number of states permit levies beyond the maximum rate fixed by law when authorized by popular referenda, though in some cases the excess itself is limited.

The over-all tax provision of Ohio, among the more drastic, may be further described to illustrate this type of constitutional restriction. It was enacted by popular vote in 1933. The maximum rates were reduced from 15 to 10 mills. Exceptions cover levies for indebtedness incurred prior to January 1, 1934, and levies authorized outside the 10-mill limitation by popular

[17] All but about 10 states have some sort of tax limit, although in a large number of these states the limits are too high either to protect property or, except in rare instances, to embarrass local finances. In many of these states, stricter property tax limitation was a lively issue of controversy in the early thirties. Indiana, Michigan, Washington, and West Virginia adopted important over-all limitation measures in 1932. New Mexico followed in 1933, while Oklahoma and Ohio were also revising their laws in the same year.

referendum. For current school expenses and certain debt services, a majority vote is sufficient to authorize an additional levy; for other purposes, approval of 65 percent of the electorate (including those not voting) is required. The 10-mill rate applies to the true instead (as formerly) of the assessed value of property.

The Ohio constitution also provides for each county a budget commission whose duty it is to apportion to each of the taxing units its proper share of the 10-mill maximum levy. The commission consists of three members: county auditor, county treasurer, and county prosecutor. Dissatisfied districts may appeal to the state tax commission, which has power to modify the apportionment of the county commission but not to raise the aggregate above the maximum set by the amendment. Certain cities with tax-limitation provisions of their own written into their charters are exempt. This, however, applies only to Cincinnati and Akron.

Results of Tax Limitation in Practice. Some critics object to property tax limitations on the ground that they do not limit. Others believe that they are less intolerable, perhaps, for the reason that they are not always entirely effective. One loophole is the exemption of levies to finance debt. Where levies to service all debts are exempt from the limit, a municipality can circumvent the limitation by borrowing freely even for operating expenses. It can levy such property taxes as it chooses provided it uses them to pay last year's bills. Where levies to service only those debts incurred before passage of the law are exempt, reduced expenditure may still be avoided by borrowing; but the difficulties of maintaining services within a balanced budget grow steadily worse under this program. Circumvention by resort to special assessment in lieu of property taxes is a common device, as is the levy of special charges for specific services such as sewage disposal. As previously mentioned, most tax limitation provisions permit levies in excess of specified limits by referendum, though how freely these referenda are used does not appear in the record. Most states with limitations show average tax rates substantially in excess of prescribed maxima, but the statistics do bear out the contention that property taxes have fallen in the tax-limitation states and that the reductions in these states are greater on the average than in the nation at large.

Adjustment to loss of revenue resulting from effective property tax limitation may involve the cutting of services, or the revenue may be replaced by the adoption of substitute taxes. In the cutting of services, two distinct periods must be distinguished in the tax-limitation states. The first is the period immediately following the introduction of limitation provisions. This has been characterized in several states by a great deal of confusion and the suspension of essential local services. Probably the most notorious case in point was that of West Virginia. There the question as to whether levies for debt service were or were not included within the limitation was left in doubt until the state supreme court decided in the affirmative. As a result

the City of Charleston suffered a cut of 54 percent in its revenues as compared with the average amount it received during the five preceding years. Many cities in the state "took sensational steps to bring the seriousness of their plight to the attention of citizens and state officials. Morgantown, home of the state university, led the movement by vacating all offices and positions as well as ordering the discontinuance of street lighting and fire protection." Other cities followed suit. As time went on, however, the state came to the rescue of these municipalities, partially at least, with new sources of revenue. The experience of West Virginia in the confusion attending the transition to property tax limitation was by no means unique.[18]

Although the tax-limitation states have come to the rescue of their municipalities, they have not, as the figures indicate, replaced the lost revenue entirely. To the extent that the latter has not been made up, either services have been reduced or deficits have grown. It has been argued in behalf of tax limitation that the latter tends to force reform of the tax system and thus to replace the "antiquated property tax" (in part) with better sources of public revenue. The sources of revenue which have been most widely adopted by the tax-limitation states are the sales and gross income taxes. Of the six states with the most drastic tax-limitation provisions—Indiana, Michigan, Ohio, New Mexico, Washington, and Oklahoma—all have either a gross income tax or a sales tax or both, several of which were enacted after tax limitation had been inaugurated in these states.

Criticism of Tax Limitations. Many states have developed a measure of home rule for their municipalities; that is, the latter are guaranteed the right to make their own decisions in their own way on matters of local interest. The proponents of home rule deeply resent tax limitation. They contend that local communities have the right to spend their own money as they see fit and that interference by the state in this freedom is undemocratic. The sales tax and net income tax cannot be successfully utilized, perhaps, by local units of government. They must be collected and divided by the state. Not only does this tend to reduce local independence; it also raises the question of whether state collection of taxes with local expenditure of the revenue will contribute in the long run to the most economical and judicious spending of public funds on the part of the municipalities.

It is also contended that much of the property tax is capitalized and that consequently a reduction will only serve as a bonanza to present owners. Future owners will get no relief. The capitalization theory, as discussed else-

[18] A. M. Hillhouse and R. B. Welch, *Tax Limits Appraised*, Public Administration Service, Chicago, 1937, Publication No. 55; G. M. Morris, *Tax Limitation Laws*, American Municipal Association, Report No. 152, Chicago, 1943; Glen Leet and R. M. Paige, *Property Tax Limitation Laws*, Public Administration Service, No. 36, Chicago, 1936; Minnesota Institute of Governmental Research, *Feasibility of Blanket Tax Limitation Laws as a Means of Reducing the Tax Burden on General Property in Minnesota*, St. Paul, 1934, p. 12; New York State Commission for the Revision of the Tax Laws, *Recent Experience with Overall Tax Limitation Laws*, Legislative Document No. 71, Albany, 1938.

where in this book,[19] holds that the value of property is related to the net income which can be earned from it; when the net income is increased, the capital value of the property rises. Relief from a property tax burden results in greater net income, which in turn is reflected in the selling value of the property. Thus, present owners pocket all the benefit that property tax relief may bring; the position of future buyers will not be changed by the program except for one point to their disadvantage, namely, that they will have to make a greater outlay to purchase the properties. The capitalization phenomenon is thought by economists to apply mainly in the case of land. Even here, however, the theory that all land taxes are immediately capitalized needs many qualifications. Nevertheless, the capitalization theory is entitled to a great deal of weight in considering the proposal for a blanket reduction of the property tax.

It is also argued against property tax limitations that they should wait upon the availability of a better tax as a substitute. Proponents of limitation usually prefer not to mention substitutes in their campaign. Of course, everybody is for relieving "the poor homeowner"—as long as no mention is made of any other tax he may have to pay. Experience has shown that the most available and readily accepted state source of revenue to substitute for the property tax is the sales tax. Is this tax to be preferred by the public to that part of the property tax which would be eliminated by limitation? Most of the tax critics have answered this negatively. The property tax is a heavy burden on shelter. But the small homeowner is also among those who would contribute most heavily under the sales tax. In fact, it is easy to calculate that, in most jurisdictions, a man with a $2,000 income and a house and lot worth $4,500 would lose rather than gain by the substitution of a 3 percent retail sales tax to provide the revenue which would be sacrificed by property tax limitation.

It seems quite possible that the tax-limitation movement is mainly a depression phenomenon and that most of its successes in the present cycle have been achieved. Be that as it may, it is a warning that all is not well with the tax system as it supplies local government revenues. Tax limitations, born of pressure politics, are not the most creditable chapter in state financial history. Rigid, negative, imposed from above, they lack the constructive qualities that should characterize state revenue systems. They are a symptom which needs to be heeded.

PROBLEMS OF PROPERTY TAX COLLECTION

Historical. One of the principal virtues of the property tax has been its dependability. During the depression following 1929 this virtue wavered

[19] See Chap. VI.

badly. Municipalities suddenly discovered that the property tax was not indefinitely elastic—that there was "a bottom to the property tax barrel." For some cities, delinquencies in 1933 ran as high as 30, 40, 50 and even 60 per-cent. On the other hand, there were cities in which delinquency continued at nominal amounts.

Cities with the most severe problem of tax delinquency had, as a rule, some or all of the following features: dependency upon a single industry—automotive, rubber, steel, railroad shops, for example; severe insolvency and threatened insolvency of banks; excessive real estate speculation and unwarranted development of subdivisions; and an unsatisfactory system of tax collection. Some of the cities with these characteristics were forced to default upon their obligations.[20]

Rural tax delinquency in some sections of the country was quite as pronounced as urban. And, in the cut-over territory of the forest states, delinquency had been a chronic problem even before the depression. In these so-called frontier areas, delinquency was caused by overassessment, high expenditures in relation to resources, and the speculative character of future land use.

It should not be assumed that all delinquent taxes are lost forever to the government making the levy. If the assessment procedure has functioned properly, taxes should represent only a small percentage of value, and delinquent taxes constitute a prior lien upon such value. The average city in 1935, because of widespread payment of delinquent taxes, collected more than its current levy despite a considerable amount of current delinquency.

Procedure in Collection of Taxes. It is not possible here to enlarge greatly upon the brief account of the tax collection procedure of certain states previously presented. With considerable uniformity the states provide for a payment period, an additional payment period with interest and penalties, a tax sale, and finally, a transfer of tax title. In most cases the owner, upon payment of certain costs, may redeem his property any time until tax title is issued. Frequently the tax title itself is not proof against subsequent legal action by the original owner.[21]

[20] Frederick L. Bird, "Extent and Distribution of Urban Tax Delinquency," *Law and Contemporary Problems*, Vol. III, No. 3, June 1936, pp. 337-346.

[21] It is not ordinarily required that all property taxes be paid on a single day. In those states permitting installment payments, the payment period may be extended over as many as nine months, but in those requiring a single lump-sum payment, the period varies from one to three months. Some states, for example, North Carolina, offer a discount of taxes if paid by a certain date. If not paid by a definite date, the tax becomes delinquent and in time is offered for sale.

The length of time between delinquent date and tax sale date varies from a few days in some states to 18 months in Virginia. Penalties begin with the first day of delinquency and are thought to be a major incentive for prompt payment. Sometimes this amounts to as much as 15 percent of the tax. For the same reason, in order to create a constant incentive to payment, usually an interest rate is also imposed upon the unpaid balance.

After a lapse of a definite time, the tax is offered for sale to the public. Competition at these sales follows a number of alternative procedures in the different states. In some the competition is on the basis of the lowest amount of interest which any bidder will offer; in others it is according to priority of bids; in still others, according to the least portion of property upon which the bidder is willing to accept a lien. Tax sales must be advertised and must be conducted strictly according to law or otherwise the tax title may easily be invalidated.

Not all states have tax sales, at least of the type described above. Some provide for government purchase of tax liens and the sales of the property after a period of time.

The purchaser at a tax sale is usually given some kind of legal instrument which shows his interest in the property. After a certain time has elapsed or the purchaser has a number of liens on the same property, he may either obtain a tax title or foreclose and obtain a warranty deed.

For a period after the sale the original owner may clear his title to the property, insofar as taxes are concerned, by payment of certain penalties; the usual provision is that he must pay the price at the tax sale plus an additional flat rate penalty or interest (or both) from the date of sale. This redemption period ranges from one to five years, with two years the most common.[22]

Even the acquisition of tax titles does not always mean an end to delinquency proceedings. Tax titles are usually insecure for a definite or indefinite additional period, depending upon the presence or absence of a statute of limitation designating the period beyond which such titles cannot be upset. Upsetting such title consists of establishing some imperfection in the procedure followed during the delinquency period and, in some cases, irregularities preceding this period. This procedure is quite complicated and some error can usually be found. The courts have often gone very far in allowing the original owner to re-establish his claim.

Needed Improvement in Tax Collection Procedure. Existing tax collection procedure has been subject to much criticism, and delinquency laws have been characterized as "one of the worst exhibits of government of the lawyers, by the lawyers, and for the lawyers." To make payment more convenient and less onerous, about half the states have developed semi-annual or quarterly payment of taxes. Many advocate severe penalties for the nonpayment of taxes. Others place the emphasis upon the certainty of the penalties and deplore the precedents created by "indulgences" to the delinquent taxpayer during the recent depression. Moratoria of many kinds were said to make a philanthropist of the prompt taxpayer. Probably some concessions were necessitated by economic conditions, but many were excessive and im-

[22] H. K. Allen, "Collection of Delinquent Taxes by Recourse to the Taxed Property," *Law and Contemporary Problems*, Vol. III, No. 3, June 1936, p. 403.

proper.[23] The best moratorium appears to be one that allows the payment of back taxes without penalty, providing current taxes are paid in full.[24]

The tax sale appears to be a somewhat antiquated institution and presents several controversial issues. The Model Real Property Tax Collection Law, drafted by a committee of the National Municipal League, recommends that investors compete for tax liens upon the basis of the rate of interest they will accept.[25] This may be criticized on the ground that it results in different rates for different taxpayers. Probably this objection to the Model Law's proposal could be met by charging all taxpayers the same interest but providing that only the difference between the bid and the statutory rate be retained by the state. Sale to the first bidder creates confusion and opportunity for favoritism at the sale. Competition on the basis of greater and lesser portions of property included in liens has proved unsatisfactory because in practice all the property has usually been included in the bids. In other words, this type of competition has degenerated into no competition at all.

Going further, the tax sale might be abolished. The unwillingness of private tax buyers to bid during emergency periods or to take any but the best risks during less stringent times necessitates a program for the public management and disposal of land for which there are no buyers. The security in delinquent taxes is good enough so that the public can borrow directly for

[23] Classes of moratoria laws were summarized by a recent writer as follows: "laws extending the original due date, laws extending the date the penalty attaches, laws reducing the amount of the penalty or interest or both, laws postponing tax sales, laws authorizing installment payment of back taxes, laws adjusting the date and terms of redemption after sale but prior to foreclosure, laws altering the terms of foreclosure, and laws compromising the amount due" (*Law and Contemporary Problems*, Vol. III, No. 3, June 1936, p. 372).

[24] During the depression of the thirties, several states—Illinois, Ohio and New Jersey, and in milder form, Minnesota and Tennessee—enacted "tax receivership" statutes. In case of delinquency the collector may, if he believes collection can be made through a receivership of rents and other income from the property, petition a court for a grant of such status. If the conditions stated in the statute are complied with, the court must grant the receivership, whereupon the collector becomes manager of the property. He may be authorized by the court to pay out of funds collected from the property such expenses of maintenance and operation as are deemed necessary to secure the greatest income from the property. These laws are aimed particularly at property owners who can, but will not, pay taxes. They have proved a valuable aid in tax collection, more as a threat than in their actual application. (Earl H. Delong and Brendan Q. O'Brien, "Tax Receiverships," *Law and Contemporary Problems*, Vol. III, No. 3, June 1936, pp. 382-396.)

Undoubtedly personal property tax collection is more difficult and hazardous than real property tax collection. In the long interval—8 to 15 months—that elapses between assessment and collection, the property may have disappeared through sale, consumption, or waste. The suggested remedy, other than repeal of the personal property tax, is to shorten the interval between assessment and collection.

[25] Report of the Committee on a Model Tax Collection Law of the National Municipal League, *A Model Real Property Tax Collection Law*, National Municipal League, New York, 1935, p. 299 (reprinted from *National Municipal Review*, May 1935).

current cash during emergency periods. The tax sale provides no essential or very useful function.

The redemption period should be reduced in some cases—certainly three years is sufficient—and the acquisition of tax titles should be simplified and made more secure for the party acquiring title. Probably the most detrimental consequence of antiquated collection procedure is that it results in tying up large quantities of real estate for long and indefinite periods in a maze of uncertain tenure. Once a reasonable redemption period has expired, the government should be in the position immediately to take and give a secure title to the property.[26]

SPECIAL PROBLEMS IN TAXING MERCHANTS' INVENTORIES

Annual Inventory v. Average Inventory. One of the principal kinds of taxable tangible personal property is merchants' inventories. The present system of property taxation as it applies to merchants is criticized on a number of grounds. It is alleged that the assessment as of a particular day is unfair. The theory of the assessment as of a single day seems to be that much capital is constantly in motion and, as in the game of musical chairs, someone will halt the procession for a moment and take account of the situation. At that moment the usual amount of capital will be about and in somebody's hands. Since the property tax is an impersonal tax, it makes little difference in whose hands it is found. If a livestock shipper happens to have on hand a large consignment of stock, even for only a day—assessment day—he can be assessed upon this property. The merchant who sells agricultural machinery may be heavily stocked on May 1, whereas the merchant who sells coal may be virtually "cleaned out" at that time. This does not mean that one has more business or capital than the other or that one has more "ability

[26] The division of responsibility for collection and the loss of current revenue due to nonpayment among the several units of government is a difficult problem. The concentration of the burden of delinquency upon one unit of government, for example, the county, creates great financial embarrassment for that unit. Some states divide the current burden of delinquency among the units according to the relative share of each in the taxes imposed upon the delinquent property. In any event, it is necessary that one unit have the power to foreclose on delinquent property after the redemption period is over. The concentration feature gives at least one unit of government strong incentive to collect, though frequently it appears that cities are better equipped and have more interest in the task than counties.

Land which is open to tax foreclosure by governmental units is often not foreclosed. Frequently the government has no program and no facilities for the management or sale of tax-delinquent land. This is bad both because it results in negligent management of land and because it keeps property off the local tax rolls. Some laws provide that, after a certain period, land becoming available for foreclosure may be entered on local tax rolls even though owned by a higher unit of government. A program for converting chronic delinquent rural lands into forests and zoning such land for settlement is a highly commendable feature of tax delinquency procedure.

to pay" or "benefits received" than the other. It is thus alleged that a snapshot picture of all businesses on a particular day gives no fair evidence of their taxpaying power. The contention is that a time exposure might give a very different picture. In view of the fact that the day of the snapshot is advertised in advance, some merchants, if they are able, try to have as little on hand as possible. When and where automobiles in the hands of merchants are assessed as merchants' stocks, active selling campaigns are postponed until after assessment day so as to avoid large inventories on that day. Commercial storage warehouses, when their contents are assessable, experience a rapid falling off in business about assessment time, particularly when they are in competition with warehouses in states which exempt such property from taxation.

As a partial remedy for some of these difficulties, certain states now attempt to assess merchants on the basis of their average inventories for the year. This appears to be a sound innovation but is dependent, of course, upon the keeping of accurate books. Moreover, the average inventory is not very easy to calculate. If it is interpreted to mean the average of the inventories on hand during the first day of each month, merchants can still manipulate their stock to some extent if they take the trouble to watch 12 days instead of one. No easy method of calculating an average for all 365 days of the year has yet been devised.

Rapid v. Slow Turnover. Merchants with a large capital and a slow turnover complain that they are highly penalized by the general property tax. For example, assume a situation as shown in the accompanying table:

	(I)	*(II)*	*(III)*
Store	*Operating Capital*	*Gross Sales*	*Profit*
A	$30,000	$30,000	$3,000
B	2,000	100,000	4,000

Store A is engaged in a trade which has a very slow turnover, such as the furniture business; store *B* is one with a rapid turnover, perhaps a meat shop. The property tax which is gauged by column (I) gathers many times as much from A as from *B*. However, *B* has a much larger volume of business than A and under the sales tax would pay more. Thus far nothing has been said about net income or profit. *B* has the advantage here, and this fact would be taken cognizance of only through a net income tax. Those interested in the A store are likely to feel that a merchant's personal property is a poor measure of ability to pay or benefits received.

The Chain Store. The independent merchant often complains of the property tax upon inventories on the ground that it favors the chain store. Chain stores are said to enjoy the following advantages under the property tax:

1. The chain store as a rule operates with a relatively small stock and a rapid rate of turnover. There may not be very much in such a store at any

one time but, like snow in Montana, "a great deal passes through." At the very time when the assessor is getting his information, huge trucks on the highways may be bringing in a fresh stock of supplies to the chain store.

2. The chain store offers little or no information to the local assessor who, when compelled to guess, does so conservatively. The independent merchant has books which the assessor can force him to disclose, and in some states income tax returns show facts concerning his inventory. Neither of these sources of information is available in the case of the chain store. Most of the bookkeeping is done in some distant city, and the income tax returns are submitted by the chain as a whole rather than by individual units.

3. The chain store system has a considerable portion of its investment in intangible property, such as "organization value," which does not show up in assessments of unit stores.

4. Assessors frequently access stocks of goods at the cost to their owners; any advantage which the chain store may have in buying may be reflected in a lower assessment, whereas the independent merchant, compelled to buy in smaller lots, must pay a higher price and be taxed on this disadvantage. Cost of wholesaling which enters the inventory values of independent merchants may be omitted in assessing inventories of chain stores.

5. Chain stores have an opportunity to manipulate their stocks between one store and another, and between stores and warehouses. Differences in assessment dates (as between states) or in tax rates (as between cities) can thus be used to a certain extent to reduce burdens.[27]

The contention that the chain store obtains an unfair advantage under the property tax has been one of the grounds, and perhaps the most plausible ground, upon which special taxes on chain stores are based. These special taxes will be discussed in a later chapter. Here it can be said that vigorous supervision by the tax commission, and assistance in securing information from the central office of chain stores and checking such information at least occasionally by means of auditors, may greatly facilitate a fair assessment.

THE PROPERTY TAX AND MUNICIPAL REVENUES

Many local governments, particularly city governments, were very hard pressed in the prewar years to make ends meet. "The spectacle of a city like New York, popularly regarded as 'the gold coast' of a rich country, going through one financial crisis after another, obliged to adopt a sales tax which

[27] Finally, it is contended that chain stores usually rent their quarters and thus pay no real estate taxes, at least not directly. This argument is unsound, however, both because the landlord probably passes on some of his taxes to the tenant and because, if it is cheaper to rent than to buy, the alternative of doing business in rented quarters is also open to independents.

its mayor had successfully attacked in Congress, and frankly conceding its future dependence on federal revenues," is evidence enough that all is not well with local revenue institutions.[28] In 1942, New York City's share of total collections from New York City (including state and federal) was about 25 percent. The city received considerable in return from the central units of government as shared taxes and aids. But this involved a circuitous routing of the revenue and left the New York City treasury, at least according to its officials, inadequately supplied with funds. New York's financial problem is not unique. Most cities have been living from hand to mouth in the hope that something would turn up.

Major cause of the failure of municipal revenues on the score of adequacy is the general property tax. Although the tax proved the mainstay of local support for many years, it broke down badly during the depression of the thirties, and limits to its elasticity are apparent. Some of this has been "self-inflicted" through property tax limitation laws and constitutional amendments. Exemptions of personal property and of real estate used for public and "philanthropic" purposes have whittled away the tax base. Finally, there is the widespread view that the property tax is an onerous and overworked means of raising revenue in the first place.

There are, of course, ways and means by which cities can broaden their property tax bases. One is by annexation of suburbs. This would enlarge both expenditures and the tax base, but frequently there would be a net gain to the tax base. Between 1930 and 1940, the population of suburban areas grew at a rate nearly three times that of the central cities.[29] Differential growth will probably be even greater in the future. The desire for light and space is not decreasing, and improvements in transportation make commuting easier year by year. Frequently the suburb could not exist without the central city though, of course, the proposition is not true in reverse. How irrational city boundaries may become in some cases is illustrated by suburbs partially and even entirely surrounded by the central city. Frequently the central city provides services for the suburbs at less than costs. The organization of metropolitan areas represents a major unsolved problem in American life. Certainly the "Wilsonian principle of self-determination" in setting the boundary lines for cities works badly. Some appeal to a neutral authority, such as the judiciary or a state commission on municipal affairs, might be an improvement.

Municipalities have relied for revenue, to some extent, on state and federal aids and shared taxes. Usually the municipalities have not fared too well in these programs. It is a well-known fact that they are underrepresented in

[28] Committee on Intergovernmental Fiscal Relations, U. S. Treasury, *Federal, State, and Local Government Fiscal Relations*, Senate Document No. 69, 78th Congress, 1st Session, 1943, p. 403.

[29] Leverett S. Lyon, "Economic Problems of American Cities," *American Economic Review Supplement*, Vol. XXXII, No. 1, March 1942, pp. 307-322.

state and federal legislative bodies and that this abuse yields slowly, if at all, to attack. State and federal assistance involves a sacrifice in financial independence and self-reliance for cities. It involves going "hat in hand" to the central units of government when the municipalities wish to expand their programs of public services.

What the municipalities most need is an enlargement of their taxing powers and an improvement of their taxing techniques so that they can supplement the property tax and spend their own money as their citizens wish. Supplemental sources of revenue might include local income, business, or sales taxes, either independently administered or state administered, with local discretion as to rates. Such development would involve its own set of difficulties (some of which will be considered later in this book). Here it may be concluded that the solution of the municipal finance problem along lines which will revive the virility of local government is a matter of general and first-rate public concern.

Property Tax Problem of Rural Governments. The impression should not be conveyed that the revenue problem of municipalities is confined to cities. Rural property owners complained bitterly (and with reason) about their tax burdens during the twenties and even more so during the early thirties. This was a period in which farm income was trending downward and farm taxes were mounting. State aids and shared taxes and the assumption of highway costs by larger units of government have, in many cases, substantially relieved the rural tax burden. The problem may return, however, if farm income takes a "nose dive" after the war.

Depleted and underendowed areas also have a place in the property tax problem. These communities have usually been the recipients of large amounts of state and federal aids, without which they could not have maintained even a semblance of decent standards of public services. These areas are a problem to the state with respect to land use, reorganization of local government, and avoidance of perpetuating obsolete communities.

The property tax problem of depleted and underendowed areas is fundamentally different from that of the cities. The former suffer because of inadequacy of the resources with which to support government; the latter because of inability to tax usually ample resources. The fiscally weak communities can be assisted by central governments primarily through grants-in-aid. Some reorganization of governmental machinery, attending or preceding the grant program, would reduce the size of the problem.

SUMMARY OF PROPERTY TAX CHAPTERS

Up to the present, except for war periods, the general property tax has been, by a considerable margin, the most important member of the tax system in the United States and it has been particularly outstanding as the

main and frequently the sole support of the local units of government. In its broadest form, it seeks to tax all goods owned that have exchange value and to tax them uniformly and universally. General property is classified according to certain characteristics into real estate and personal property, of which the latter is subdivided into tangible and intangible personality. The property tax is primarily an impersonal tax and, except on intangibles, is levied at the location of the property rather than where its owner resides.

The property tax is criticized on theoretical grounds because it is said to correlate badly with both benefits received and ability to pay. The latter contention is supported on many grounds, perhaps chief of which are that the taxation of tangible property and equitable rights in such property is double taxation (when modified, the criticism usually is that the creditor is favored over the debtor), that the tax is inconvenient in timing and form, and that it creates a heavy burden and a high fixed charge upon shelter. On practical grounds, the property tax as administered is usually regressive, shows other inequalities, and is characterized (particularly in its application to personal property) by a high degree of evasion. In spite of these criticisms, the property tax is retained, a fact which can be explained on many grounds, among which are that the tax is thought to impose a reasonable condition of ownership, is considerably capitalized, and is less unfair than some of its principal alternatives. Nevertheless, it is too general in scope and, except as applied to urban land, it is overworked.

Analyzing the problem of property tax administration in more detail, we find quite a complicated pattern. First, there are many units of government which rely simultaneously upon the same tax base. Second, there are a considerable number of steps from the levy to the collection of delinquent taxes and appeal to state administrative bodies and courts. Third, many problems are encountered in the local assessment of property, including the part-time, poorly paid, politically chosen assessor, multitudinous forms of personal property and real estate, and imperfect standards of value. In the local assessment process many helpful aids may be provided, among the most important of which is adequate supervision by a central agency.

A highly important and badly neglected feature of property tax administration is the central assessment and equalization of property values. This is necessary to defeat competitive undervaluation among districts, to preserve the morale of those engaged in the assessment process, and so on. Preferably, it involves only the assessment of districts by a central agency and does not disturb local assessments of individuals. The central assessment can be based on scientific information through a process of comparing a sample of recently sold or appraised property with local assessments of the same property. In supervision of local assessments and the central assessment process, the state tax commission plays a vital role in property tax administration.

The property tax has undergone considerable modification in recent years, including improvements in administration, limitation of rates, exemptions,

and classification. The latter may take the form of applying different rates or ratios of assessment to different kinds of property and is particularly common in its application to intangible property. Among the exemptions which have gained considerable foothold in recent years is that of homesteads. This form of exemption relieves one class of shelter of a high fixed charge and favors homeowners over (usually poorer) tenants. However, it unduly limits the local property tax base, particularly in certain districts. Probably some tax concession to low-cost housing would be preferable. Tax limitations, especially those of the "over-all" type, have reduced property taxes, but they are criticized because they violate home rule, result in precipitous curtailment of services or the adoption of inequitable replacement taxes, and (through capitalization) provide present owners with an undue share of the benefit from reduced taxes.

Tax collection procedure is one of the weak spots in the property tax. It is highly complicated, contains antiquated features such as the tax sale and the unduly long redemption period, and generally offers many opportunities for improvement.

As applied to merchants, the property tax is usually erratic in gauging inventory values (due to assessment as of a particular day), is prejudicial to the merchant with a slow turnover, and discriminates against the independent merchant as compared with the chain store.

Many municipalities, particularly cities, have been hard pressed for revenue in recent years, largely because of the growing inelasticity of the property tax. The problem of the cities has been aggravated by suburban development. The cities need new supplemental sources of revenue through which they can tax their own ample resources without relying on aids and shared taxes from central units of government.

In conclusion, although the general property tax is cracking badly in places, it is probably destined to continue for many years as a major, if not the major, source of public revenue in the United States. While the search for other and better sources of public revenue should go on, we should also continue improving this source so it may work with that degree of equity and efficiency which a modern revenue system requires.

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CHAPTER VI

Shifting and Incidence

INTRODUCTION

One cannot probe very far into either the theoretical or the practical problems of taxation without running head on into the problem of incidence. For example, it is not infrequently asserted that high income and inheritance taxes are a great burden upon the poor because these taxes are shifted and ultimately borne by all people. Or to take another illustration, it is a common practice to divide up the total cost of government by the population and leave the impression that each working man and woman donates to the government so many days' work a month, calculated according to his relative share of the total tax bill. Now, it is impossible to agree or disagree with these allegations unless one knows who is expected to and actually bears the burden of the taxes involved. To be sure, there are those who in their thinking on taxation ignore shifting entirely, assuming apparently that no tax is ever shifted. Or instead of this negative position, they may assume a questioning attitude and say that the intricacies of shifting are so involved and so difficult that no one can ever know what is shifted and what is not, and that it is futile to try.[1] Indeed, the students of the subject have done a far from satisfactory job in baring the secrets of shifting and incidence, but, nevertheless, the attempt to sift truth from fiction in this problem is a highly important part of any study of public finance.

DEFINITIONS

Students of the subject usually distinguish three stages in the process of shifting; the *impact*, the *incidence*, and the *effect* of a tax.[2] The taxpayer

[1] Perhaps David Hume's was somewhere between these two attitudes; he expressed himself on the subject as follows: "Everyman, to be sure, is desirous of pushing off from himself the burthen of any tax, which is impos'd, and laying it upon others. But as every man has the same inclination, and is upon the defensive; no set of men can be suppos'd to prevail altogether in this contest" (David Hume, *Political Discourses*, Edinburgh, 1752, Chap. VII).

[2] This terminology was used and first carefully defined by E. R. A. Seligman in his

who makes out the check in favor of the government is the one who always bears the impact of the tax. The incidence of the tax is at the point where the ultimate money burden lies. More precisely, the impact is the initial burden and the incidence is the ultimate money burden of a tax. If there is no shifting, both the impact and incidence are borne by the same person. The effect of a tax includes all of its consequences not included under incidence and impact. Up to this point the distinctions are clear—by definition. Actually, however, the distinction between the incidence and the effect of a tax is anything but clear. It is said that a tax may be entirely shifted from *A* to *B* and still leave some scars on *A* or his business. To mention a relatively insignificant point, *A* has the burden of making reports to the government and keeping an additional account. Also, he may lose financially through a contraction in the volume of his trade due to higher prices. Professor Plehn uses as an illustration a tax on a bartender so high as to kill his business. In this case there is no shifting, since no tax is paid. But there is an effect, nevertheless.

The boundary line between incidence and effect is at times hazy; few writers have taken the pains to elaborate on where one ends and the other begins, or why. An excise tax imposed on the processing of fuel oil may boost the price of that commodity and appear to be paid at least in part by the consumers of fuel oil; but as fuel oil goes up in price, the demand for coal is increased, which in turn brings about an advance in the latter's price. Do the consumers of coal bear part of the incidence of the tax or do they merely suffer from its effects? Since the oil dealers and coal buyers engage in no exchange, it will probably be said that the latter's losses must be an effect of the tax rather than its incidence. But if the oil sellers are able to share their burden with those interested in another commodity, of what significance is it that no exchange takes place between the parties? Higher prices for fuel oil and coal mean reduced purchasing power for the consumers, who in turn may respond by buying fewer shoes. A decrease in the demand for shoes will result in a drop in the price of shoes. Assuming this to be thereby the result, have the consumers shifted part of the tax to the producers of shoes, and if not, why not? Or, to carry the argument further, the government may spend the money upon public works, which in turn may create an increase in the demand for labor and thereby decrease unemployment and possibly raise wages. Many of the consumers of fuel oil and coal are also laborers. Do these people now shift part of their tax to the manufacturers or other consumers in the form of higher wages? Most critics would say that all of these secondary reactions have to do with effect rather than incidence, but the critics have never made clear the reason for this distinction. The effects of a tax which have nothing to do with prices and

Shifting and Incidence of Taxation, published in 1892; see the 4th edition, Columbia University Press, New York, 1921, Chap. I.

changes in income are clearly outside the domain of incidence. But price changes which are a matter of tax incidence and those which are a matter of tax effect are not clearly distinguishable. Nor is it very important to distinguish them, since the important point is what happens when a tax is levied rather than how it shall be labeled. What actually concerns us in the analysis of incidence is the changes in prices and income which follow the imposition of a tax.

DIRECTIONS AND FORMS OF SHIFTING

Shifting takes place through a change in prices. The shift may be *forward*, in which case the taxpayer bearing the impact adds the tax to the price of the goods he sells. Thus, a tax imposed upon the manufacturer of cigarettes may be shifted to the wholesaler, by the wholesaler to the retailer, and from the retailer to the consumer, all in the form of prices higher than those prevailing before the tax.

Shifting is thought to take place most commonly along the line of exchanges by which a commodity is moved from the producer of raw materials to the final consumer. But shifting may also be *backward* in the form of a reduction in the price of raw materials purchased by the processor. A processing tax imposed on butter or pork may thus result in lower prices paid for milk and hogs by the processor to the farmer. In fact, it may even occur by passing a tax on to factors of production other than raw materials. For example, it is conceivable that an employer may relieve himself of his taxes by cutting wages. Ordinarily the employer can do this only to the extent that the tax gives him an excuse for driving a harder bargain. Occasionally, however, as in the case of certain taxes imposed by the Social Security Act, the demand for labor may be reduced as a result of taxation, so that unemployment and lower wages may follow as a fairly likely consequence.

A third form of shifting, known as *capitalization*, covers the case where the present owner of a commodity absorbs the taxes which its future owner must pay. When the commodity is sold, all the predictable future taxes on it are discounted by the purchaser. Because ownership of the commodity carries with it a responsibility for the payment of a certain amount of taxes, it is regarded as less desirable, and thus the purchaser is in a position to discount the taxes accordingly. *A* may have a plot of land which brings him a net income of $600 each year. Assuming a 6 percent rate of interest, he calculates that this land is worth about $10,000. If he and other investors can get 6 percent on investment of equal risk, it is reasonable to assume that $10,000 is not too much to pay for land which ordinarily yields an income of $600. Now, if the taxes on the land are increased $100, so that the net in-

come from it becomes only $500, a prospective buyer, who presumably can still obtain 6 percent on his money elsewhere, can afford to pay only $8,333.33 $\left(\frac{500}{.06} = \$8{,}333.33\right)$ for this land. If this transaction actually takes place, the new purchaser will receive the same interest on his money as would have been the case had the additional tax not been levied. Thus, the buyer is said to "buy free of the tax." Actually, of course, he buys free of and capitalizes only the differential tax burden on the particular as compared with alternative investments. It is as though the government had imposed a mortgage on the land and the buyer had purchased only the original owner's remaining equity.

A subsidy is the opposite of a tax, and the benefit of the former, like the burden of the latter, may be shifted. During the Second World War, one of the devices for "rolling back" retail prices in some countries was subsidies paid to processors.

THEORIES OF SHIFTING: THE PHYSIOCRATIC THEORY

Tax incidence has been a fertile source of speculation to theorists for a long time. Particularly during the past two hundred years a number of theories purporting to explain it have developed. Some of these have had wider acceptance than others, while a few extended even beyond the field of economic thought and exerted considerable influence in the sphere of politics. Besides the standard current theories, space permits the presentation of only a few of these.[3]

A school of French economists known as the Physiocrats, writing in the eighteenth century, held that in the last analysis all taxes come out of the net income from land. They believed that if a tax were levied upon wages, the wage earners would have to be compensated for the tax in the form of higher pay; otherwise the supply of labor would be depleted. In this case, the monetary burden would have to be borne by others. This theory assumed that the productivity of the *sterile* class—which included all people other than the landed proprietors and farmers—was just sufficient to meet its immediate needs. "The product created by the artisan is only equal to the subsistence destroyed by him. Here, then, in the case of industrial production, there is no augmentation of riches, because the value of those products is only increased by the price of the articles consumed by the workman."[4] If, now, a tax were levied on any one of these classes, it would mean a reduction

[3] For a full account of the history of incidence theories, see E. R. A. Seligman, *The Shifting and Incidence of Taxation* (4th ed.).

[4] *Oeuvres economiques et philosophiques de F. Quesnay* (ed. A. Oncken, 1888, pp. 233-234), quoted from Jan St. Lewinski, *The Founders of Political Economy*, P. S. King & Son, Ltd., London, 1922, p. 38.

of consumption by the amount of the tax and, in turn, curtailed production in the future. Again, if the tax were imposed on the farmer, he would have less capital with which to produce and therefore curtailed production would follow. Thus, in the last analysis a tax must be imposed upon those who receive a surplus income. Since, according to this theory, only the landed proprietors are in receipt of such income, they must necessarily bear all taxes. The shifting process involves friction and waste, and thus it is far better to impose all taxes upon land directly, or rather the income from land (the *impot unique*), than indirectly through other sources. The Physiocrats were also aware of the capitalization principle and thought that its operation would save the landed proprietors from excessive burdens which might otherwise result from a concentration of taxes upon them.[5]

Like the Physiocrats, the proponents of the Single Tax in our day believe that all taxes should be imposed upon the economic rent of land or natural resources. These neo-physiocrats, as a rule, place less emphasis on shifting than did the early French economists, but they stress the theory that taxes on land tend to be capitalized and thus in time become burdenless. Place a tax on land, they say, and it will make land cheap. But place a tax on most any other good and it becomes more expensive.

HOBSONIAN THEORY

John A. Hobson, a contemporary British economist, holds with the Physiocrats that all taxes must come out of surplus and cannot ultimately rest on the necessary costs of production. But, unlike the Physiocratic view, his theory includes many kinds of surplus beside land rent. He holds that a surplus element may be found in profits, interest, and professional and salaried income as well. Also, like the Physiocrats, he believes that indirect taxes are unsound. "The notion that any sound political end is served by making everybody appear to contribute to the State revenue, irrespective of the fact that many persons have no ability to pay, is mere feeble-mindedness." [6] The theories of surplus taxation, on the other hand, came in for a great deal of criticism in the writings of Gustav Cohn, a German economist, whose opposition to the principle, however, was on political rather than economic grounds. He opposed the exemption of a minimum standard of living as advocated by earlier writers. Taxes, he said, are as necessary as any of the other costs involved in providing us with goods and services. It is as absurd to exempt a poor man from paying for the costs of government as it would be to exempt him from paying for his food or clothing. Moreover, he said, it is

[5] Charles Gide and Charles Rist, *A History of Economic Doctrines* (English Translation, rev. ed.), D. C. Heath and Co., New York, 1913, pp. 38-45.

[6] J. A. Hobson, *Taxation in the New State*, pp. 66-67.

politically dangerous in a democracy since those who vote and pay no taxes are likely to demand extravagant public expenditures.[7]

The theory that all taxes must come out of surplus (rather than necessary costs) is true by definition, but the shortcoming of the Hobsonian theory lies in the difficulty of distinguishing between necessary costs and surplus. The theory properly emphasizes that surplus is not confined to the landlord's income, as the Physiocrats had contended. Many writers[8] have emphasized that most saving involves a saver's surplus, that is, a greater reward than is necessary to call forth the saving. Similarly, there are probably sizable elements of surplus in large salaries and even in some wages. The logical conclusion to be drawn from Hobson's theory (the conclusion which he himself drew) is that, to a great extent, revenue should be raised from graduated income and inheritance taxes. However, because of the uncertainty as to where surpluses lie, to say that taxes must come out of surplus is only a preliminary step in the analysis of shifting.

THE DIFFUSION THEORY

Another Frenchman, Nicholas François Canard, writing in 1801 in criticism of the Physiocrats, stated what has come to be known as the diffusion theory of taxation or shifting. Canard contended that the imposition of a tax is like extracting a bit of blood from one of the veins of a human being; although taken from a single vein, the loss is carried throughout the body by the circulation of the blood. Similarly, taxes are diffused throughout the economic system by economic transactions such as buying and selling.[9] An American economist, David Wells, phrased this theory as follows: ". . . and thus taxes levied uniformly on things of the same class, by the laws of competition, supply, and demand, and the all-pervading mediums of labor, will be distributed, percussed, and repercussed to a remote degree, until they finally fall upon every person, not in proportion to his consumption of a given article, but in the proportion his consumption bears to the aggregate consumption of the taxed community." According to this theory, as Wells pointed out, a great capitalist, like John Jacob Astor, bears no greater burden of taxation than anyone else except as his consumption may be somewhat greater. Mr. Astor may seem to bear more taxes, but actually he is only a tax collector or conduit for the government.[10] By this theory, "every old tax

[7] Gustav Cohn, "Income and Property Taxes in Switzerland," *Political Science Quarterly*, Vol. IV, No. 1, Mar. 1889. pp. 37-65; see also his *Science of Finance* (translated by T. B. Veblen), University of Chicago Press, Chicago, 1895, pp. 327-332.

[8] For example, see A. B. Wolfe, "Savers' Surplus and the Interest Rate," *Quarterly Journal of Economics*, Vol. XXXV, Nov. 1920, pp. 1-35.

[9] *Principes d'économie politique*, Par N. F. Canard, Paris, 1801, cited by E. R. A. Seligman, *Shifting and Incidence of Taxation* (4th ed.), pp. 159-163.

[10] David Wells *Theory and Practice of Taxation*, D. Appleton and Co., New York, 1911, p. 584.

is good, every new tax is bad," because any change in the tax system tends to upset the established equilibrium and causes friction and hardship until the equilibrium is re-established. If this sweeping theory were accepted, there would be no point in discussing the principles of shifting or, indeed, little point in discussing many of the other intricate and difficult problems of taxation. Most of the extensive class-conflict which is apparent in taxation would have to be charged up to ignorance of economic principles. Few people, expert or otherwise, accept this interpretation at present.

Nevertheless, like most time-honored theories, the diffusion theory does carry an important element of truth. Anyone who knows the tax system in practice must observe that taxes are never "so hard to take" after the taxpayers have become accustomed to them. The adjustment is psychological as well as economic. Businessmen frequently complain as much about the uncertainty of future tax liabilities as of their present burdens. Tax burdens which, to early writers on public finance, would have seemed quite beyond the capacity of any nation are now borne with fair composure by the taxpayers, since they have gradually adjusted their affairs accordingly.

THE PREVAILING THEORY

The theory now to be considered is based upon the marginal analysis of value and price as refined by the neo-classical economists, particularly by Alfred Marshall, late in the nineteenth century. The application of this theory to tax-shifting is the work of many writers, of whom E. R. A. Seligman and F. Y. Edgeworth especially may be mentioned. This is the prevalent theory of shifting at the present time. There are many versions of this theory. The differences, however, consist principally only in the emphasis laid on particular points, manner of presentation, and minor matters of logic. No attempt will be made to copy the exact analysis of any one writer. Rather, the theory will be presented in the manner which seems most clear and plausible to the writer.

Shifting Under Conditions of Perfect Competition

Preliminary Considerations. According to the prevailing theory, shifting takes place only when the imposition of a tax results in price changes. Shifting is thus a price phenomenon and cannot occur where there is no exchange or price transaction. However, the price transaction need not involve the same good, service, or person upon which or whom the tax is originally imposed. To be sure, some have argued that once a tax reaches the final consumer of a good it cannot be shifted any further. But this does not seem a necessary conclusion. The final consumer quite frequently (though not always) is engaged in selling certain goods or services himself, and it is possible

that he will charge more for his goods because of the tax he pays. A tax imposed directly or indirectly upon an automobile in the hands of the final consumer cannot be shifted through its sale. But the consumer may be selling his labor and thus may possibly pass on the tax in higher wages. There is seldom a dead end to the possibilities of shifting.

Some statements regarding shifting imply that, since the businessman is a free agent, every time the government imposes a tax upon him he needs only to raise his prices in order to recoup his payments to the government. Under conditions of perfect competition the businessman does not set the price; he ascertains it from the market. He charges not what he would like to, but what he has to. When a farmer (who is the best example of a producer selling in a highly competitive market) brings in a case of eggs to the village merchant, instead of telling what he is willing to sell it for, he asks what the market price is. It matters not at all that he would like to get more for his eggs or that actually his cost of production has been more than the going price.

Under competitive conditions the factors determining price are supply and demand. The taxes are usually imposed upon producers or suppliers. Obviously, when they are subjected to a new tax, it is their move first. The "demanders" are not concerned as yet. What the suppliers can do is to go on strike, so to speak; that is, they can curtail the supply,[11] which will tend to result in a price increase. Of course, it should not be assumed that the sellers form a conspiracy to effect this purpose. There is no collaboration on a strictly competitive market. One possible form of curtailment comes as a result of the forced withdrawal of the marginal producers from the market. They were "hanging on by the ragged edge" before the tax was imposed, but now the going is "too tough" for them. In this case one might say that shifting takes place over the dead bodies of marginal producers. The supply might also be curtailed without the elimination of producers if some of the suppliers cease producing the marginal portion of their former output. In any event, it is the marginal supply which is eliminated. Thus, "marginal economics" plays a major role in the theory of shifting now under consideration.

The supply may be inelastic because the suppliers may not be in a position to move or quit even when subjected to new burdens. They may be equipped with specialized plant and machinery which cannot be adapted to other purposes and had better be operated at some loss rather than completely discarded. Even business bankruptcy does not always result in the immediate curtailment of capital in a particular field of production. In this case the curtailment of supply may have to wait until the forces of depreciation and

[11] Of course, it is true that the suppliers of one product may be the demanders of another. Conceivably, they can curtail the demand of what they buy as well as the supply of what they sell (in fact, perhaps they must do so), but for the sake of simplicity we may ignore this alternative for the time being.

obsolescence have reduced the supply of capital. But new investment at least will shun this field until conditions are more attractive. It is this immobility of capital, and for that matter, labor also, which leads to the conclusion that shifting is often a slow and uncertain process.

Conditions Favorable to Shifting

Universality Among Competitors. Other things being equal, shifting is most likely to occur when the tax strikes all competitors equally, and particularly when the marginal competitors are included. Thus a tax which is universal among competitors is most easily shifted. When some taxpayers must compete with untaxed rivals, the latter are the ones who set the price. Thus, special chain store taxes do not afford this favorable condition to shifting.

The above proposition can be supported by a simple illustration contrasting a special excise or sales tax with a net income tax. Let us suppose that *A, B, C, D, E,* and *F* are industrial concerns supplying a given market. Let us further suppose that their costs of production are as indicated in column 1, Table 2. Assuming a single price on the market (column 2), the net profit of each of these concerns will be as indicated in column 3.

TABLE 2

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Industrial Concerns	*Cost of Production*	*Price*	*Profit*	*Sales Tax*	*Profit After Tax*	*Net Income Tax (40%)*	*Profit After Tax*
A.....	50	100	50	10	40	20	30
B.....	60	100	40	10	30	16	24
C.....	70	100	30	10	20	12	18
D.....	80	100	20	10	10	8	12
E.....	90	100	10	10	0	4	6
F.....	100	100	0	10	−10	0	0

A special excise or sales tax as, for example, a cigarette tax of so much per package, will strike each of the concerns uniformly, including the marginal concern *F*. The profits after the tax will then be as shown in column 5. It will be observed that concern *F* now incurs a deficit. This may cause concern *F* to retire from business, in which case the supply will be curtailed, and the price will then rise.

On the other hand, a net income tax, as indicated in column 6, would impose no extra hardship upon concern *F*, and the burden on each competitor would be different. Under these conditions, *F* would not be forced to withdraw from the business, and therefore the supply and prices would tend to remain the same.

Inelastic Demand. So far no mention has been made of the part played by the demand in the process of shifting. Since the suppliers bear the impact

of the tax, the buyers are not concerned unless the supply is curtailed and prices rise. Only when this happens is it propitious for the "demanders" to act. Some of them may buy substitute commodities or simply curtail their purchases altogether. Since price is a function of both supply and demand, the withdrawal from the market of part of the demand is likely to have repercussions in the form of lowered prices. When the price has reached a new equilibrium as a result of the revised supply and demand, it is likely to be less than the original price plus the tax.

The demand for different commodities is not equally sensitive to changes in price. The demand for cigarettes is relatively inelastic because cigarette consumption is a matter of habit. And the demand for salt or bread is much more inelastic because these are necessities of life. People will have their salt even if they must pay more for it. The demand for gasoline is more elastic, but experience seems to indicate that within reasonable limits people will not drive automobiles much less, as the higher price of fuel increases only slightly the cost of operation. On the other hand, the demand for butter and pork is elastic. This is due to the fact that substitutes for these foods can be readily found, and the consumer does not regard them as very essential. Thus it may be seen that the more elastic the demand, the more difficult it is for suppliers "to crawl out from under" a tax by raising prices.

Production Under Conditions of Decreasing Costs. According to most versions of the theory of shifting now under consideration, taxes are most likely to be fully (or more than fully) reflected in increased prices when they are imposed upon industries of decreasing costs.

In some industries production follows what is known as the law of increasing cost. By this is meant that the cost of production per unit is greater as more is produced and sold. This rule is said to prevail in agriculture and other extractive industries where poor land or other natural resources must be drawn into production as the need for greater volume of output increases.

Certain industries, on the other hand, are thought to follow the opposite principle of decreasing costs, at least within limits. In such industries, as production increases, the cost per unit decreases. These are the industries, such as manufacturing and transportation, in which fixed costs play an important part.

There are also industries, such as the hand trades, like tailoring and laundering, in which the costs per unit are relatively constant regardless of how much is produced. An industry may have constant costs because certain factors in the industry follow the principle of decreasing costs, whereas others follow that of increasing costs, with the result that the two offset each other.

A tax imposed upon an industry of decreasing costs is likely to augment the costs of production in that industry, not only by the amount of the tax but also by the higher per unit costs (without the tax) resulting from the reduced volume produced. The suppliers will seek to pass on not only the tax but also their increased per unit cost of doing business. Thus, if all the

other conditions of shifting are favorable, this may result in an increase in price greater than the amount of the tax.[12] Under conditions of increasing cost the opposite tendency prevails, and if the consumer secures the benefit of the lesser cost per unit that goes with a smaller volume, the price will rise less than the amount of the tax.

Because of the theory that taxes raise costs and prices in an industry of decreasing costs, it has been considered wasteful to impose taxes (at least excise taxes) upon a developing industry.[13] Thus, the British taxes upon the use of automobiles are said to have prevented economy in domestic manufacture. The British, it is claimed, have adapted themselves to this situation in two ways; one, by manufacturing smaller cars upon which the taxes are less burdensome, and the other, by importing them from the United States.

The exact explanation of the nature of industries of decreasing costs and what happens when taxes are imposed upon them is somewhat obscure. It has usually been passed over with very general comments by writers on taxation and general economics. The situation in such industries may perhaps be conceived as illustrated in Table 3.

TABLE 3

Production Costs of Various Firms

Units Produced	*A*	*B*	*C*	*D*	*E*	*F*	*G*	*H*	*I*	*J*	*K*
1	16	18	20	22	24	26	28	30	32	34	36
2	14	16	18	20	22	24	26	28	30	32	34
3	12	14	16	18	20	22	24	26	28	30	32
4	10	12	14	16	18	20	22	24	26	28	30
5	8	10	12	14	16	18	20	22	24	26	28
6	6	8	10	12	14	16	18	20	22	24	26
7	4	6	8	10	12	14	16	18	20	22	24
8	2	4	6	8	10	12	14	16	18	20	22
Average cost	9	11	13	15	17	19	21	23	25	27	29

Here 11 firms are engaged in production. Some have higher costs than others, and presumably concern K is marginal. In this case each individual firm operates under conditions of decreasing costs, but this is not true of the industry as a whole.

The cost figures in Table 3 indicate the additional cost resulting from the production of an additional unit. Thus it will cost concern A 16 cents to produce 1 unit, but only 14 cents more to produce 2 units, so that the aver-

[12] Of course, ultimate curtailment of volume assumes an elastic demand which ordinarily is a condition adverse to shifting. Under conditions of decreasing costs, an elastic demand is favorable to shifting, and the more elasticity the more the shifting. It is the elasticity of demand which causes the reduction of volume when prices advance and this, in turn, causes increased cost per unit which tends to cause further increases in prices.

[13] This sounds very much like the infant industries' argument for the protective tariff; however, in the case of the tariff the proposal is to tax foreign competition and exempt the home industries.

age cost per unit if 2 units are produced is 15 cents, and so on. If the price is 29 cents, firm K can stay in the competition and produce its capacity output of 8 units, but if the price drops to below 29 cents, it can no longer remain in the competition.

On the basis of the above assumptions, assuming further that average costs must be covered, the supply which might be forthcoming can be presented in tabular form as follows:

TABLE 4

Supply of the Various Firms at Given Prices

Price	*A*	*B*	*C*	*D*	*E*	*F*	*G*	*H*	*I*	*J*	*K*	*Total Supply*
30	8	8	8	8	8	8	8	8	8	8	8	88
28	8	8	8	8	8	8	8	8	8	8		80
26	8	8	8	8	8	8	8	8	8			72
24	8	8	8	8	8	8	8	8				64
22	8	8	8	8	8	8	8					56
20	8	8	8	8	8	8						48
18	8	8	8	8	8							40
16	8	8	8	8								32
14	8	8	8									24
12	8	8										16
10	8											8
8												0
6												0
4												0
2												0

Assuming now a demand schedule as in column (3), Table 5, the equilibrium price will be 16 cents. If now a tax of 4 cents per unit is imposed,

TABLE 5

(1) *Price*	(2) *Supply*	(3) *Demand*	(4) *Supply After Tax of 4¢*
30	88	0	72
28	80	0	64
26	72	0	56
24	64	0	48
22	56	8	40
20	48	16	32
18 **	40	24 ⟷	24
16 *	32 ⟷	32	16
14	24	40	8
12	16	48	0
10	8	56	0
8	0	64	0
6	0	72	0
4	0	80	0
2	0	88	0

* Price before tax—16¢; amount of tax—4¢

** Price after tax—18¢; increase in price—2¢

⟷Supply and demand in equilibrium

production will be curtailed, as shown in the revised supply schedule in column 4. With the additional cost, and the demand price schedule remaining the same, neither concern *K* nor *J* (see Table 3) is able to stay in the market, and as a result the supply is reduced by 16 units. The new equilibrium price is 18 cents, an increase of 2 cents over the former price. This, it will be observed, is only half of the tax.

However, it is possible that an industry of decreasing costs may show a different situation, for instance, as presented in Table 6. Here, as before, the cost figures are the additional cost of producing another unit. There is a difference in the assumption, however, in that here all firms are equally efficient so that there is no marginal concern.

TABLE 6

Units Produced	*Cost of Production of Various Firms*								*Ave. Cost of Production*	*Supply at Price as in Preceding Column*
	A	*B*	*C*	*D*	*E*	*F*	*G*	*H*		
1	16	16	16	16	16	16	16	16	16	8
2	14	14	14	14	14	14	14	14	15	16
3	12	12	12	12	12	12	12	12	14	24
4	10	10	10	10	10	10	10	10	13	32
5	8	8	8	8	8	8	8	8	12	40
6	6	6	6	6	6	6	6	6	11	48
7	4	4	4	4	4	4	4	4	10	56
8	2	2	2	2	2	2	2	2	9	64

Assuming a demand as given in column (3), Table 7 shows the effect of imposing a tax of 2 cents per unit upon such an industry. Column (4) shows the minimum amount the industry can supply and still cover average costs, including the tax. It will be observed that as a result of a tax of 2 cents the price has advanced 4 cents.

TABLE 7

(1) *Price*	(2) *Supply*	(3) *Demand*	(4) *Supply After Tax of 2¢*
16	8	32	24
15	16	36	32
14 **	24	40 ⟷	40
13	32	44	48
12	40	48	56
11	48	52	64
10 *	56 ⟷	56	
9	64	60	

* Price before tax—10¢; amount of tax—2¢

** Price after tax—14¢; increase in price—4¢

⟷ Supply and demand in equilibrium

It seems probable that conditions of somewhat this character prevail in a well-developed industry of decreasing costs such as the automobile industry. Price-cutting would seem the logical course in an industry of decreasing costs, but the practice is tempered by the fear of retaliation. Here we have

that state of monopolistic competition which has been the subject of so much thought and comment in recent years. Indeed, it may be doubted whether it is proper to consider industries of decreasing costs under the heading of perfect competition.

Shifting, a Slow and Uncertain Process. Most expositors of the prevailing theory of incidence hold that shifting is likely to be a slow and uncertain process. It may take a long time for the suppliers to quit business or shift their capital and labor to other lines. Capital and labor are hardly ever free to move at a moment's notice, nor is it always true that producers want to discontinue a line as soon as they find that they are losing on it; much more likely, they will be waiting in hopes that the tide will turn in their favor again. It may also be possible for a producer who bears the impact of a tax to improve the efficiency of his business so that further adjustments are unnecessary. These are the reasons for saying that taxes "tend to stick where they fall."

Conditions Favorable to Tax-Capitalization. It has already been explained that tax-capitalization occurs when the purchaser of a good "buys free of the tax" by discounting it in his purchase. This happens most frequently on the occasion of an investment in a capital good.

If the seller is able to pass on the tax to the consumer in the form of higher prices for the product of the capital goods, the purchaser of the capital good has no burden to discount. Thus capitalization may occur only where other forms of shifting do not.

The capitalization theory is particularly applicable in the case of a non-reproductive good. The supply of such goods is fixed and the market value of any unit or its use for a time does not increase as a result of scarcity prompted by the imposition of the tax. Consider, for example, the different results of a tax on land and buildings. A tax on buildings, which are reproducible, will presumably raise rents and therefore also their selling price. Following the imposition of the tax, new building slackens and, given sufficient time, there will be an inadequate supply unless the rewards for owning buildings are increased. The latter will take place automatically after a building shortage develops.[14]

[14] It is conceivable that the tax might be capitalized during the time interval required for the shifting. For example, the shares in a corporation which owns apartment houses may suffer a drop in value by virtue of the low current return in this line of business after the imposition of the tax. Insofar as an improvement is not foreseen and taken into account by the market, a purchaser may buy securities of the apartment house corporation at a discount. In that event he would reap a capital gain when the income in the apartment-house business improved as a result of a building shortage and the shares advanced in value accordingly. Professor Simpson has argued plausibly that during certain phases of the business cycle, and particularly during periods of feverish speculation, building proceeds without much regard to present cost or income. When this is true, taxes on buildings tend to "stick where they fall" (see Herbert D. Simpson, "The Incidence of Real Estate Taxes," *American Economic Review*, Vol. XXI, No. 2, June 1932, pp. 219-230).

In the case of land, on the other hand, the supply is relatively fixed. With some qualifications and exceptions, no new land is being manufactured and no old land allowed to go into discard. Insofar as this is true, the purchaser of land buys an irreproducible good. He will pay for it according to its anticipated future income, and, if heavy taxes detract from the prospects, he will pay less on that account.

It should be emphasized with some haste that the supply of land is only relatively fixed. Rural land, especially, is subject to depreciation and may be reclaimed through the replenishment of its fertility. Farm and range land depreciates when it is damaged by erosion. However, insofar as land represents mere space, as is generally true of city sites, it is genuinely nonreproducible. But, in fact, even in this case it may to some extent be supplied or, rather, made available by grading, draining, and so on.[15]

Capitalization may occur in the case of a good that is nonreproducible in the sense that it represents an investment irrevocably made. Thus, a tax on a particular bond would afford a perfect case for the application of the capitalization theory. Moreover, where burdens are imposed which cannot be shifted and there are alternative untaxed investments, the theory may have application to goods which are reproducible. Thus, if a single state imposes a high corporate net income tax which results in a reduction in the return to investors, prospective buyers of the securities of corporations operating in the state (with untaxed alternatives) may pay less for them than they would if the tax had not been imposed.

It is sometimes claimed that because of the capitalization process a new purchaser buys free of an old tax. The capitalization theory only holds, of course, that he buys free of the differential between the burden imposed upon the investment in question and that imposed upon other alternative investments. The market simply evens up the burden on alternative investments through adjustments in the price of such investments.

But the capitalization process may yield the present owner of capital goods a bonus as well as a burden. If an old tax is suddenly eliminated or mitigated —as in the case of a state property tax limitation law which sets a maximum rate for the general property tax substantially below what many properties

[15] It is argued by some that taxes on the selling value of land, as distinguished from its rental value or economic rent, may occasionally be shifted because no-rent or marginal land is assessed and taxed upon its capitalized prospective future income. The distinction and exception appear entirely logical (see Herbert Dorau and Albert G. Hinmann, *Urban Land Economics*, The Macmillan Co., New York, 1928, pp. 358-365).

It is also contended that the supply of land for a particular use is not fixed. Thus, land employed for mercantile purposes may be augmented by converting to this use land now used for residential purposes. This is true but not ordinarily significant in the problem of incidence because taxation is usually based on value rather than use. Taxation or exemption of a particular use of land might affect the supply of land for particular uses. This might occur where urban land pays higher taxes per dollar of value than rural land. The difference in tax burden might tend to prevent conversion from one class to the other. However, here flexibility in the boundaries of governmental units is involved as well as that in land use.

have been paying—the present owner of land may receive a substantial benefit in an increase in the value of his land. By the same token, of course, a future buyer will secure no benefit at all from lightening the property tax burden.

Shifting Under Monopolistic Conditions

So far this discussion of the prevailing theory of incidence has been under the assumption that a state of perfect competition prevails. As a matter of fact, perfect competition is only a theoretical concept. Even in fields usually considered highly competitive, it exists only in degrees. Certain producers, particularly public utilities, have been thought for many years to enjoy a "natural monopoly." Others "have the field to themselves" because of the patents or copyrights granted to them by the governments. Still others, particularly in manufacturing, have attained such dominating positions in their fields that they exercise a commanding position of control over supply and price. These concerns are sometimes referred to as semi-monopolies or "oligopolies."

A monopolist, however, may control prices only with limitations and qualifications. In the public utility field, for instance, regulatory bodies exert an important restraint on him. Generally, he also must take account of substitute services and commodities. A street railway or bus transportation company competes with taxicabs and private automobiles. Thus, monopolies must contend with the elastic demand of consumers, particularly when the consumer may turn to available substitutes. In addition, monopolists may have to consider public opinion and potential competition.[16]

Under conditions of monopoly the producer sets his price at a point where his total net profit will be the largest. According to the prevailing theory, any tax which increases directly with the volume of the business, such as a unit tax or a gross income tax, may change the monopoly price, whereas a tax on net income will be less likely to affect it. For example, let us assume a certain business which produces five units of a given commodity at 10 cents

[16] In the public utility field the possibility of shifting taxes is much affected by the decisions of the United States Supreme Court, under which all taxes—including income and profits taxes—may be reckoned as expenses of doing business when the net earnings of such utilities are compared with their capital by public utility commissions in the determinatoin of their rates (Galveston Electric Company v. Galveston, 258 U. S. 399, 1922). This means that all public utility taxes tend to be passed on to the consumer. Undoubtedly, this process takes time. It is a well-known fact that utility rates are not revised immediately or with perfect precision. It is quite possible, due to these imperfections in regulation, that utilities may have to bear a considerable part of the taxes imposed upon them. It is quite possible that a temporary emergency tax on utilities might never be reflected in rates at all. In addition, utilities may have to consider the demand. Not all of them charge all that they are allowed to by public authority; or public authority itself may take account of elastic demand and the competition of substitutes in determining rates. Economic law may take precedence over governmental law, in which case the company charges what the traffic will bear regardless of the fact that it is permitted to charge more.

each. This price is selected because it is the point where the producer derives the greatest profit from his investment in the business. Assuming a variable cost (which increases with the units) of 25 cents, or 5 cents per unit, and a constant cost (which does not vary with the units) of 10 cents, the total cost of the 5 units is 35 cents.

TABLE 8

Price	*Units Sold*	*Variable Cost*	*Constant Cost*	*Gross Income*	*Total Cost*	*Profit*	*Tax (1)*	*Total Cost Plus Tax (1)*
9	6	30	10	54	40	14	12	52
10 *	5	25	10	50	35	→*15*	10	45
11 **	4	20	10	44	30	14	8	38
12	3	15	10	36	25	11	6	31

Profit after Tax (1)	*Tax (2)*	*Total Cost Plus Tax (2)*	*Profit after Tax (2)*
2	4.66	44.66	9.33
5	5.00	40.00	→*10.00*
→*6*	4.66	34.66	9.33
5	3.66	28.66	7.33

* Price before tax = 10¢
** Price after tax (1) (2¢ per unit) = 11¢
* Price after tax (2) (33⅓% income tax) = 10¢
→Maximum profit at the given price and cost

Since the gross income of the business is 5 × 10 cents = 50 cents, the net profit is 15 cents. As indicated in the table above, a charge of 11 cents instead of 10 cents would be slightly less profitable because of the lesser demand at the higher price. Now if a tax of 2 cents per unit is imposed (Tax 1), the situation is reversed; it has become more profitable to do business at a higher price and with a smaller volume. However, if a net income tax of 33⅓ percent is imposed (Tax 2), the price at which it is most profitable to do business remains at 10 cents.

It thus appears that shifting under conditions of monopoly may reach the same result as shifting under competition, though through a somewhat different process. It is sometimes emphasized, however, that monopolists in practice do not always set their prices at the point of greatest profit. They may consider potential competition as well as heed public opinion. They may even seek to keep prices down as a long-run program for avoiding unemployment and depression. The effect of taxes imposed upon monopolists is less a matter of objective factors and even more uncertain than the effect of levies on competitors.

The capitalization theory also may have some important applications in the monopoly field. For instance, extraordinary monopoly profits and the taxes which reduce them tend to influence the selling prices of securities. Thus, one who buys the stock of a monopolistic concern may pay a price for his securities which allows him only a normal return even though the

earnings of the monopoly itself may be excessive. His return might have been no less had the monopoly paid more taxes, since in that event he could have bought his securities at a lower price.

PREVAILING INCIDENCE THEORY CRITICIZED

The theory of shifting explained above is widely accepted but is open to certain criticisms and limitations, some of which have been pointed out by the proponents of the theory themselves. No consideration will be given here to all these criticisms, particularly since shifting is a price phenomenon and therefore an exhaustive study of the subject would involve a thorough analysis of the various theories of value and price, including the current criticism of the marginal analysis. Limitations, both of space and the writer's qualifications, preclude any such analysis here. It may be said, however, that orthodox value theory is undergoing both criticism and refinement and that some attention is being given to the adaptation of the theory of incidence to these developments.

Evidence Concerning Shifting Largely Deductive. One of the limitations of most theories of shifting, including the prevailing one, is that they are supported almost entirely by deductive reasoning; that is, they are based upon pure logic and never have been proved or disproved by observation and experimentation. To be sure, this is not entirely the fault of the theorists. Inductive or experimental proof of the incidence of taxation is extremely difficult to procure. The price changes which follow in the wake of new taxes may be due to either taxation or a variety of other causes. Under these circumstances, conclusions concerning shifting must be drawn with some reservations. The whole marginal analysis, upon which so much of the prevailing theory of incidence is based, has a certain academic atmosphere of unreality about it which makes it suspect. Deductive reasoning has so often been contradicted by inductive evidence, once it became available, that one must hesitate to state conclusions which rest upon the former.

Inadequate Emphasis Upon the Role of Demand. The prevailing theory of incidence looks to variations in the supply as the primary cause of price changes attending tax changes. After a temporary price change takes place (or at least threatens), a curtailment of demand (or a threatened one) may become very important in the determination of a new equilibrium and a final price. Changes in demand may take the form of a curtailed market for raw material, which follows when a tax upon some intermediary stage of production results in a shrinkage in volume of output at the level taxed. Thus a processing tax on pork, if it decreases the output, will cut the demand for hogs and may affect not only the prices paid by consumers for the finished product but also the prices paid to farmers for raw materials. This is the ordinary case of backward shifting to which reference was made in the

section of this chapter dealing with definitions. All this is covered quite adequately by the prevailing theory of incidence. But this analysis only begins to trace the complicated effects of a tax upon demand. A change in demand may be the primary result of a decrease in the purchasing power of those who bear the impact or the intermediary burden of the tax. These people may rearrange their budgets or curtail their total expenditures. Thus, a heavy graduated tax on income, which appears not to be shifted, may affect the demand for yachts and with it the prices and profits in the yacht business. It will probably be said, to be sure, that these are the effects rather than the incidence of the tax. Whatever they may be called, consequences of this sort are too important to ignore.[17]

Governmental Expenditures and the Incidence of a Tax. Another way in which demand is affected by a tax is through governmental expenditures of its proceeds. Most of the writers presenting the prevailing theory of incidence appear to assume that taxation is a unilateral phenomenon and that the consequences of taxation cease as soon as the government is in receipt of the cash. Even those who do not share this assumption minimize the effects of governmental expenditures upon the market for goods and services. The government is part of the economic system and one of the principal buyers and sellers of goods and services. It affects prices not only by siphoning revenue off from the system but also by pouring it back. Taxes which involve a substitution, for the businessman, of a public for a private cost (as, for instance, public for private research) constitute no net burden nor any occasion for migration or any other adjustment.

It requires an exceedingly complicated analysis to exhaust the effect of a combination of taxes and public outlays upon prices (the essential problem). A few examples, selected more or less at random, may illustrate this. Suppose a state levies a cigarette tax and spends the revenue upon vocational education. Let us assume that the tax raises the price of cigarettes. Can we stop at this point and say that the final effect of the legislature's program in imposing the tax is its incidence, which is upon the consumers? If this were true, the net effect of the government's program would be to reduce the real wages of labor. However, this ignores most of the price effects of the government's bilateral transactions. Surely, the expenditures for vocational education will have some effect, at least in the long run, upon wages. To mention one or two of the simpler effects only, it will remove from the labor market some youth who would otherwise be seeking jobs. This will decrease the supply of labor and thereby raise wages. Moreover, good vocational education imparts new skills to both youths and adults. This should increase the productivity of labor and help to sustain real wages, if not money wages.

Within limits, a tax imposed upon automobiles to provide funds for road

[17] An analysis of shifting which gives great (not to say exclusive) weight to the effect of taxes upon demand will be found in Antonio de Viti de Marco, *First Principles of Public Finance* (English Translation); Book II, Chap. IV.

building increases the demand for automobiles. Since the latter are made under conditions of decreasing cost, the tax may tend to reduce rather than increase their price.

A tax upon wheat farmers to build concrete highways may or may not decrease the supply of wheat, but it certainly increases the demand for concrete.[18]

Explanation of Short-time Shifting. The theory that shifting takes place through migration of capital or the failure of a new supply of capital to enter a taxed field is much more plausible as applied to long-term than immediate or short-term shifting. Considerable shifting appears to occur with a fair degree of promptness. A 3 percent sales tax imposed upon merchants in one state for a year may not be entirely passed on to the consumers, although for the most part it probably is. This shifting cannot be accounted for on the ground that a large number of merchants are forced out of business by the tax. Possibly the anticipation that in the long run the prices charged must be sufficient to cover costs is sufficient explanation for the price increases. The explanations offered by the prevailing theory as to just what happens in a case of this kind are neither clear nor convincing.

The "short run" itself is an indefinite period; it may cover the time necessary to dispose of an existing stock or it may cover the time necessary for an exodus of some or all of the factors of production. It is agreed that the adjustment to taxes is greatly facilitated by time. Suppliers would appear to have little or no recourse in marketing an existing supply of a perishable commodity. In the case of an existing nonperishable stock, a choice between present disposition and withholding for a future market may be practical. Producers may continue, temporarily, the further production of a commodity to be sold at a price which covers operating costs but not overhead costs.[19]

Insufficient Weight Given to the Strategic Factors. Probably the prevailing theory of incidence gives too little weight to the strategic factors in the price bargain. These have to do with the bargaining power of buyers and sellers. This power may depend upon the knowledge and resources of the bargainers, and it is particularly enhanced by "collective bargaining." It may also depend considerably upon the prevailing phase of the business cycle when the tax is levied.

Taxes are more easily shifted in a sellers' than in a buyers' market; more easily during booms than depressions. When times are good and buyers are clamoring for goods, as they did during both the First and Second World Wars, sellers have high bargaining power. They may seize upon a tax as an

[18] Antonio de Viti de Marco, *First Principles of Public Finance*, Book II, Chap. IV; also M. Slade Kendrick, *Taxation Issues*, Chap. V; A. G. Buehler, "Public Expenditures and the Incidence of Taxes," *American Economic Review*, Vol. XXVIII, No. 4, Dec. 1938, pp. 674-683.

[19] See Elmer D. Fagan, "Tax Shifting in the Market Period," *American Economic Review*, Mar. 1942, Vol. XXXII, No. 1, pp. 72-86; Otto von Mering, *The Shifting and Incidence of Taxation*, Blakiston Co., Philadelphia, 1942, pp. 70-71.

excuse for adding substantially to the prices of goods they sell. This is the sellers' market. On the other hand, during a severe depression the tables are turned. Now they eagerly scan the horizon for possible buyers to take surplus goods off their shelves. Prices are falling and any delay in unloading their stocks may involve heavy losses. Under these circumstances—a buyers' market—the sellers are likely to absorb new taxes rather than run any chances of losing their much-coveted orders.[20]

General and Special Taxes. General and special taxes present fundamentally different problems in shifting and incidence. Special taxes involve the prospect of migration of the factors of production; general taxes involve the elasticity of supply of the factors of production. Perhaps, since these factors in the last analysis are interchangeable, the ultimate consideration is their relative elasticity of supply. Elasticity of the supply of the factors is a matter of alternatives and of incentives. Obviously, land (representing space) is very inelastic. It is an existing factor, the supply of which cannot be expanded or contracted. Labor must be paid some wage to maintain the supply of manpower. Both the birth rate and the death rate may be affected by the rewards for labor, and, in addition, leisure competes with work. Saving is probably more dependent on incomes than on the rewards for saving (interest); its supply is relatively inelastic. Enterprising—including new business ventures, leadership, and equity capital—is much more sensitive to attack.

Incidence and Monopolistic Competition. The prevailing theory of shifting has been built largely on alternative assumptions of perfect competition or complete monopoly. In recent studies of economics, increasing recognition and emphasis have been given to the fact that much modern industry is neither entirely competitive nor entirely monopolistic, but, rather, a cross between the two. A few large concerns in an industry are likely to set their prices in the light of the prospect that their price policies will greatly influence the policies of their competitors. Considerable refinement in the theory of value and price has resulted from awareness of such a condition.[21] It may be that the prevailing theory of incidence, with its two alternatives of perfect competition and complete monopoly, is adequate for industries engaged in monopolistic competition. However, it seems likely that some adaptation of the theory of incidence in accordance with refinements in the theory of prices may be in order. Some such refinements have begun to

[20] Professor John R. Commons rates cyclical trends as the major factor in shifting. He says: "If the curve of gross sales rises . . . then evidently taxes have little or no effect in suppressing quantities produced. But in the opposite period of falling prices, of reduced volume of sales and employment, the tax burden eats up even more than the margin for profit, because the 'mark-up' of prices is then only a useless gesture, and taxes can be avoided only by suppression of production and employment." (John R. Commons, *Institutional Economics*, pp. 835-836; see also, Herbert D. Simpson, "The Incidence of Real Estate Taxes," *American Economic Review*, Vol. XXII, No. 2, June 1932, pp. 219-230.

[21] See Edward Chamberlin, *The Theory of Monopolistic Competition* (2nd ed.), Harvard University Press, Cambridge, 1936; also Joan Robinson, *The Economics of Imperfect Competition*, Macmillan and Co., Ltd., London, 1933.

appear. On a consideration of the entrepreneur engaged in setting prices under conditions where every act may produce a reaction on the part of his few competitors, many subtleties, strategic factors, and uncertainties enter into the analysis. For example, a tax might precipitate a price war and a drastic reduction of prices; or it might strengthen the feeling of mutual dependence and make for a more perfect oligopoly, which in turn would permit prices to rise by more than the amount of the tax. Uncertainty as to the reaction of other firms might prevent any price rise; on the other hand, each firm might raise prices for fear that not doing so would cause a price war. In specific situations, the outlay for advertising might be curtailed or increased, with various possibilities as to prices. Even if one firm should embark upon a price-cutting program, the effect upon the demand for the slightly different products of other firms would be uncertain.[22]

In spite of these and other criticisms which might be made of the prevailing theory of incidence, it is the best available tool to apply to many important problems in taxation and one which probably yields fairly reliable answers.

THE SHIFTING OF SPECIFIC TAXES; OTHER PROBLEMS OF SHIFTING

Income and Profits Taxes. It is generally agreed that the net income tax family of taxes offers great resistance to shifting. This is particularly true of the personal net income tax. Over much of its range among individuals, it applies to the final receipt of income by persons or families and is not readily associated with any act of exchange. It is a highly differentiated tax, affecting recipients differently according to the number of dependents and the amounts of net income.

The corporate net income tax is not so surely nonshiftable, but even in its case there are strong grounds to support the view that the burden remains with the stockholders. The tax does not affect all competitors, and a graduated tax may place a different relative burden on each of them. The marginal competitors (of great importance in prevailing incidence theory) are not affected by the tax. In addition, the general character of the net income tax makes escape by migration impossible. A study by the National Industrial Conference Board affords some inductive evidence to support the proposition that corporate income taxes are not usually shifted. The Colwyn Committee of England arrived at the same conclusion.[23]

[22] See John F. Due, *The Theory of Incidence of Sales Taxation*, King's Crown Press, New York, 1942, pp. 51-88.

[23] National Industrial Conference Board, *The Shifting and Effects of the Federal Corporation Income Tax*, New York, 1928, Vol. I; *Report of the Committee on National Debt and Taxation*. H. M. Stationery Office, London, 1927, pp. 108-119. As previously

On the other hand, there are also grounds for the view that the corporate net income tax is shifted forward to consumers or backward to wage earners. Some businessmen have referred to the corporate tax as "a sales tax in disguise." Net business income often includes elements of imputed interest and rent; these are clearly cost factors and are recognized as such when the business employs them contractually. Economists have often argued that entrepreneurial services have a "supply price" like any other factor of production; that some part of business income is properly designated "necessary profits"; that this is a social cost rather than a surplus; and that a tax imposed on this element of profits must be recouped in higher prices or reduced costs in order to maintain the supply of "enterprise." Alfred Marshall was of the opinion that the costs of a "representative firm" rather than a marginal concern are most significant in price analysis.[24] Professor Seligman at least conceded that "If the government . . . demands too large a percentage of . . . anticipated profits, the individual may prefer not to subject himself to the risk and may decide to be content with a smaller but a surer return." [25] Under modern conditions, with a highly organized labor market, it seems quite probable that wages are affected in some degree by the level of corporate profits, which in turn is affected directly by taxes.

Taxes which burden one kind of investment more than another (investment in stocks more than investment in bonds, for instance) may, by changing the flow of capital from one line to another, end in a diffusion of the differential burden over all the investment field. Moreover, graduated income taxes may bring about a redistribution of purchasing power, which may, in turn, have far-reaching effects upon prices in many lines of business. Where prices are set with an eye on public opinion, labor unions, and unemployment (long-run considerations), this may be particularly true.

Excess profits taxes fall more largely on surplus than do corporate income taxes, and the former are probably less likely to be passed on to consumers. On the other hand, there is some support for the view that even levies of this type are shifted, particularly in a "sellers' " market and in the absence of price controls.[26]

indicated, a net income tax on a public utility would appear to offer an exception to the general rule concerning shifting of income taxes (see Chap. XI). Here there is no competition in a given market (as a rule), and the utility may count its net income tax as an expense when maximum rates are set by public service commissions. Mention has also been made of the possibility that income taxes under certain special conditions may be capitalized.

[24] Alfred Marshall, *Principles of Economics*, Macmillan and Co., Ltd., London, 7th ed., 1916, p. 317. See also Dennis H. Robertson, *Economic Fragments*, P. S. King & Son, Ltd., London, 1931, pp. 23-41.

[25] E. R. A. Seligman, "Income Taxes and the Price Level," *Academy of Political Science Proceedings*, Vol. II, 1926, pp. 19-20.

[26] K. E. Boulding, "The Incidence of a Profits Tax," *American Economic Review*, Vol. XXXIV, No. 3, Sept. 1944, pp. 567-572.

One of the major objections to any business tax, including the corporate income tax, is the uncertainty of its incidence.

Business Taxes. Business taxes, such as gross income and capital stock taxes, are much more readily shifted than the corporate net income tax. They are more general and uniform in their scope and are quite commonly regarded as costs of production. On the other hand, these taxes are not entirely uniform among competitors; they may be several steps removed from the consumer, and they may be too universal to be escaped by migration. Probably they are less likely to be passed on in full than retail sales taxes.

Poll Taxes. It is usually thought that a uniform tax levied on every person can be shifted, if at all, only through changes in the death rate, birth rate, or some other factors which affect the supply of labor. The consequences following from the operation of such factors would be very remote and uncertain. Possibly labor unions might seize upon a poll tax as an occasion for exerting pressure. The fact that such taxes are usually small in amount reduces the likelihood of their being shifted.

Property Taxes. The general property tax is a complex phenomenon and affords a great variety of possibilities of shifting. In its application to land, the important fact is that the supply of land is relatively fixed. Except in the form of tax capitalization, shifting is not likely to occur here. Even the tendency toward tax capitalization may be defeated if all investments bear an equal tax burden. However, other investments are not usually taxed equally, at least in practice, and some relieve themselves of the taxes through other forms of shifting.

Taxes on buildings are thought to decrease the supply of buildings and thus to become a factor in rent, the purchase price of buildings, and the cost of doing business. Personal property taxes on consumers' goods are not easy to shift because these goods are held for use and not for sale. Personal property taxes on goods in the process of manufacture and sale would appear to be readily shiftable insofar as such taxes are universal among competitors. In such a case, like wages and interest, they constitute a part of the regular costs of production. Of course, if universality and equality in the general property tax are assumed, that is, if all producers pay at the same rate on all business capital, shifting cannot take place by migration from a point of high to one of low pressure. But if prices in the long run tend to cover all costs of production, at least of a reasonably efficient firm, then there is no reason to believe that the inventory tax is an exception.

Taxes on intangible personal property are affected by a combination of many elements. It has often been claimed that a tax on mortgages is shifted from the mortgagee to the mortgagor through an increase in interest rates. People will not loan money, it is said, unless they receive the going rate of interest over and above all taxes. Probably in the analysis of this problem some weight must be given to the alternative opportunities of investors. If only one state were to tax mortgages, and the tax were to follow the domicile

of mortgagee, lenders within that state would be at a disadvantage because borrowers could obtain credit from untaxed sources outside the state. Under these circumstances the creditor might have to bear the tax. If one state alone exempted mortgages from taxation, the reverse would be true and the creditors could probably retain their advantage. If the tax were universal both as to territory and all other investments, the lender could recoup himself only through the roundabout and uncertain process of more spending and less saving.[27]

Inheritance Taxes. Death taxes are generally thought to offer great resistance to shifting. They are not levied in the course of business and the principal way in which their shifting might occur would be through reduced saving and the higher rates of interest which might follow therefrom. The factors here involved are remote and uncertain in their operation and effects.

If it be accepted that the death tax burden cannot be shuffled off to disinterested parties, the question may still be raised whether the incidence of this tax is ordinarily on the heir or the deceased. It is fairly apparent that each has a concern in the reduction of the estate which results from the tax.[28]

Consumption Taxes. The consumption taxes, including excises, tariffs, special and general sales taxes (possibly also gross income taxes), are regarded as the most easily shifted of all taxes. Indeed, they are called consumption taxes not because they are levied upon the consumer (the impact is usually on the merchant or manufacturer), but because it is thought that he will bear the ultimate burden. For the same reason they are also called "indirect," though the term is not a very happy one since the taxes covered by this name are probably not the only ones that can be shifted. These taxes rest proportionately, as a rule, upon all competitors.

One should not jump to the conclusion, however, that all taxes classed as consumption taxes can always and under all circumstances be shifted to

[27] The incidence of mortgage taxation is one of the few cases in the field of incidence which has been subject to some inductive study. In Wisconsin, mortgages were taxed prior to 1903, and were exempted (in effect) after that year. Professor Thomas S. Adams, then at the University of Wisconsin, made a study of interest rates, comparing those prevailing within the state before and after the exemption, and those prevailing within the state after the exemption with those in other states where mortgages were still taxed. His findings were inconclusive, stating that "the mortgage rate has displayed an inertia and stability hitherto unsuspected by the majority of students of this problem" (T. S. Adams, "Mortgage Taxation," *Third Biennial Report of the Wisconsin Tax Commission*, 1907, p. 310). On the other hand, Plehn asserts with assurance that at one time when California taxed no investments except the mortgage in the hands of the mortgagee and exempted the mortgagor from taxation upon the mortgagee's equity in his property, it resulted in a shifting of the mortgagee's burden to the mortgagor, along with some additional burden which represented the cost of shifting (C. C. Plehn, *Introduction to Public Finance* (5th ed.), p. 130). Had taxes been imposed successfully on all investments in California, the conclusion might have been different.

[28] James K. Hall, "Incidence of Death Duties," *American Economic Review*, Vol. XXX, No. 1, Mar. 1940, pp. 46-59.

the consumer. The elasticity of demand and supply may have a bearing here as elsewhere. That the processing tax on pork, under the recent Agricultural Adjustment Administration, was solely a burden upon the consumers was by no means generally accepted. Some held that the tax really fell back on the farmer, who absorbed at least a large part of it because of the reduced demand for his hogs. The program also called for controlled production, and the restricted supply involved in this part of the program tended to offset the diminished demand which grew out of the tax. Some held that because of the elastic demand the tax bore heavily on the processor. The net effect of the program upon the interested parties was very obscure.[29]

Incidence of Sales Taxes. Sales taxes probably rest on the consumer, but there are exceptions to this rule. Where the demand is highly sensitive, merchants may bear the tax rather than raise prices, particularly if the tax is small. An objection to the sales tax is sometimes raised on the ground that the consumer bears the burden only in the case of the necessities of life for which the demand is inelastic; whereas in the case of the tax on luxuries, which is more justifiably borne by the consumer, the merchant will absorb the tax rather than lose his trade. In the case of state retail sales taxes, merchants in borderline cities may have to compete with untaxed sales from across the border. Even further within the states, merchants may have to compete with an untaxed mail-order business. These factors are impediments to shifting.

Incidence of the Tariff. The tariff is a tax upon the foreign supply of the domestic market, and it is often concluded that the domestic consumer has to pay the tax in full along with other costs of the foreign producer. But the matter is not as simple as this. To mention one complication only, the commodity may be one which can be produced at home for less than the former price plus the tariff. In that case the foreign producer must either absorb part of the tax or expect to lose his market to a domestic producer.

Professor Taussig's analysis [30] of the incidence of the tariff, or the effect of tariffs upon domestic prices, divides the problem according to three different conditions of trade. The first condition prevails when a tariff is imposed upon a commodity which can be produced in sufficient supply as cheaply at home as abroad. The commodity may or may not be upon an

[29] In the case of the proposed tax on butter, so much doubt prevailed as to the incidence of the tax that the dairy farmers vetoed the proposal.

A universal production tax or sales tax might be shifted either to the consumers or to the factors of production. The former would involve a general rise in prices of consumers' and producers' goods. On the theory that prices are strictly limited by the quantity of money, this might encounter monetary impediments. However, these impediments are probably likely to be less serious than those (such as labor organizations) obstructing backward shifting. For a different view see H. G. Brown, "The Incidence of a General Output or a General Sales Tax," *Journal of Political Economy*, Apr. 1939, Vol. 47, pp. 254-62.

[30] F. W. Taussig, *Some Aspects of the Tariff Question*, Harvard University Press, Cambridge, 1929, pp. 3-17.

export basis, but in any event the tariff should have small, if any, effect upon domestic prices of the commodity taxed. If the United States can produce enough of commodity X to supply the domestic market at world price, the domestic price will remain the world price regardless of how much tariff is imposed. The world price itself may be somewhat affected by the new source of supply encouraged by the tariff.

The second condition exists when a considerable volume of imports of a taxed commodity continues to come in over the tariff wall. This is usual when the tariff is levied for revenue upon a commodity which cannot (at least within reasonable limits of practicality) be produced at home. The British tax on tea is a familiar example. In this case the tariff does not differ very greatly from an excise tax imposed upon the domestic producer. As in the case of an excise tax—let us say a processing tax—the burden may be shifted backward, but it is usually shifted forward to the consumer. Because of the conditions of increasing and decreasing costs in some industries, the cost and price may rise more or less than the tax. And, of course, the elasticity of domestic demand may also have a bearing on prices.

Imports in considerable quantity may continue even though domestic production contributes part and, under the influence of the duty, an increasing part of the supply. As a rule,[31] this means that the domestic price is maintained at a figure equal to foreign price plus the tariff. Importers would not forsake the alternative of disposition on the world market unless they could command a price in the taxing country equal to world price plus the tariff which must be paid. On the other hand, if one of the effects of a tariff is to influence foreign suppliers to sell part of their products upon the world market rather than in the taxing country, the world price itself will be affected.

Finally, there is the case where a duty keeps out all imports. Here, of course, no tax is paid at all, but prices may still be affected. A one hundred percent tariff will not affect domestic prices more than a 50 percent tax, providing the latter is sufficient to exclude all imports. How much the prices will rise depends entirely on the conditions in the country imposing the tax—particularly on the cost which must be covered in order to meet the demand.[32]

[31] There are important exceptions, see Taussig, *Some Aspects of the Tariff Question*, Chap. I.

[32] All rules of tariff incidence usually need qualification and elaboration when they are applied to a concrete situation. What has been said, however, covers fairly well the case of the sugar tariff. For many years producers of sugar in the United States and its "colonies"—Hawaii, the Philippines, and Puerto Rico—have been under the shelter of a high protective tariff. Cuban producers have had some differential advantage in rates over other outside producers. Most but not all of the outside supply has come from Cuba, but there has usually been a small percentage of sugar from the outside paying the full duty. Under these circumstances, one would expect the domestic price to be above the world price by the extent of the tariff, and such seems to have been the case. Stimulation of supply, however, by tariff protection has, among other causes, depressed the world price. Thus, it is possible to determine the price differential within and without the protected area, but

Social Security Taxes. Many interesting problems of shifting are raised by the federal Social Security Act. This law imposes several taxes on payrolls, all paid by the employers except one, which is deducted from the pay of employees. One of the taxes is so administered as to induce the states to enact unemployment compensation laws. That is, taxes imposed by the states and used therein for unemployment compensation are allowed as a credit against the federal tax.

There has been much argument as to whether these payroll taxes are shifted to the consumer or (in the case of the employer's tax) to the employees, or whether they remain a burden on the parties who pay them in the first instance. The consensus of much published opinion favors the conclusion that the wage earner bears most of these taxes, but the argument is not very convincing. Some of the factors in the situation which have an important bearing on the incidence of these taxes may be mentioned. State unemployment compensation laws which are acceptable for credit purposes may provide for a reduction in the tax to employers who operate with little or no unemployment. Under the situation thus created, it is likely that the tax will be borne by the employer who is unwilling or unable to give steady work, insofar as his contribution is greater than that of his more efficient competitor. State laws may exclude employers of less than eight employees, which again introduces an element of untaxed competition in certain cases. The employer may employ less labor and more machinery as a result of the law since the latter makes the employment of labor more hazardous and costly than heretofore. Here the decreased demand for labor may force wages down. On the other hand, wages may offer some inertia due to the resistance of employees who have become accustomed to a given scale and a standard of living based thereon. Moreover, something may also depend upon the degree to which labor is organized to resist a cut. The fact that labor is more

not possible to say with certainty how much greater the domestic price is than it would have been had no tariff been imposed (Lippert S. Ellis, *The Tariff on Sugar*, The Raw leigh Foundation, Freeport, Ill., 1933, pp. 142-145).

On the other hand, in the case of the tariff on wool, some very different and unexpected results are found by inductive study of the facts. About 40 percent of the wool supply of the United States is imported from abroad in spite of the substantial tariff on such imports. On first thought it would be supposed that the differential between the price of wool upon the American market and that upon the world market (allowing for transportation costs) would be the amount of the tariff which the consumer would pay as a result of increased prices. Neither conclusion, however, seems to be borne out by inductive study. Actually, the American price plus the tariff is only about 80 percent of the foreign price, and it has been calculated that the foreign price itself is considerably reduced as a result of the American tariff. The first factor—failure of the differential to equal the tariff—is due perhaps to the unstandardized character of wool; the latter—the partial shifting to the consumer—is due to the very considerable effect of American production upon the world market (Haldor R. Mohat, *The Tariff on Wool*, Tariff Research Committee, Madison, Wis., 1935, pp. 140-162. But compare Henry Schultz, "Correct and Incorrect Methods of Determining the Effectiveness of the Tariff," *Journal of Farm Economics*, Vol. XVII, Nov. 1935, pp. 625-645; see also Walter A. Morton, "Tariff Theory," *ibid.*, Vol. XIX, Nov. 1937, pp. 845-860).

important as a cost in some lines than in others and that mechanization is feasible in some cases and not in others may result in shifts of labor and capital that diffuse the effects of the tax considerably. The above factors apply particularly to the payroll taxes for unemployment compensation, but they also apply to the payroll taxes for old-age annuities, except that in the latter case the employer cannot reduce his burden by providing regular, as well as less, employment. Furthermore, the old-age taxes apply to all employers and not only those with eight or more employees.

When the tax falls on the employees (as is true of half the old-age insurance tax), the probability that the ultimate burden will be borne by the wage earner is greater than when the impact is on the employer.

The incidence of these taxes cannot be predicted with any great degree of assurance. On the whole, the safe conclusion would seem to be that it is divided among employers, labor, and consumers; but in what proportion cannot definitely be said.[38]

Homestead Exemptions and Property Tax Limitation. What would be the incidence of an exemption of homesteads from taxation? Would the advantage be capitalized so that future purchasers of homestead property would gain no advantage? This seems unlikely because the exemption attaches to the owner and his use of the property rather than to the property itself. It seems possible that all property available for owner-occupier use might become more desirable to own because of the exemption feature and that this might temporarily increase the selling value of land and buildings of this character. Eventually, however, the forces of competition would tend to eliminate this advantage. Probably the safest conclusion is that the exemption would remain a special benefit and privilege for persons who choose to exercise the function of homeownership.

On the other hand, a constitutional or statutory limitation upon property tax rates, effective in reducing such rates, presents a situation more favorable to tax capitalization. The limitation should make real estate a more attractive investment and thus raise its price. Under these circumstances the present owners are likely to get all the benefit from the change. Eventually, however, more building would cut down the income from improvements. But insofar as such limitation is applied to land, the tax relief will probably be capitalized.

Shifting and Incidence Applied to Farm Taxes. Most of the farm taxes are levied on land and improvements. If the land tax were capitalized according to the widely accepted capitalization theory, and the tax on improve-

[38] James K. Hall, "Incidence of Federal Social Security Pay Roll Taxes," *Quarterly Journal of Economics*, Vol. 53, Nov. 1938, pp. 38-63; Russell Bauder, "The Probable Incidence of Social Security Taxes," *American Economic Review*, Vol. XXVI, No. 3, Sept. 1936, pp. 463-465; Herbert D. Simpson, *Compulsory Health Insurance in the United States*, Northwestern University, Chicago, 1943, Chapter IV; Eveline M. Burns, "Financial Aspects of the Social Security Act," *American Economic Review*, Vol. XXVI, No. 1, Mar. 1936, pp. 12-22.

ments were shifted according to the widely accepted theory that taxes on reproducible capital must eventually be passed on, then the farmer would be in the highly privileged position of having no tax burden at all. Certainly, the farmer has no such impression of his status, and, if he were confronted with the contention that all of his taxes were really borne by others, he would probably question the sanity of his interlocutor.

Can taxes on farm land be capitalized? Several points may be raised against this theory. One is that the value of farm land consists partly of fertility, which is a reproducible factor and subject to exhaustion. A tax on fertility would operate like a tax on any other reproducible item of capital used in production; that is, it would tend to be shifted in increased prices of the products rather than capitalized in lower prices for land. It is important to note also that farmers do not buy farm land solely as an investment. They are interested in farming as a mode of life as well as a means of making a living. They may not adapt themselves readily to other modes of life. Thus a reduction in net farm income due to taxes may not be reflected in a reduced demand for farms and a reduction in the price of land. Finally, much farm land remains for many years in the possession of a single family. Of the 3,800,000 farm operators who owned their farms in 1935, about 44.5 percent had been operating their farms for a period of 15 years or more.[34] Some farmers who sell their farms merely exchange them for new ones. The capitalization theory requires a decrease in the demand for farm land in favor of other investments. Insofar as farmers retain their farms, or merely exchange one for another, the capitalization process does not operate.

Can taxes on farm improvements be shifted? Several points may also be raised against this theory. One is that farmers sell considerable produce abroad, and the prices for commodities thus sold are determined on the world market. Farmers may have to compete with lightly taxed produce in other countries. Again, farmers do not readily migrate from a field which yields them less than their costs of production. Many of them are scarcely engaged in commercial agriculture at all and regard their farms as a direct means of subsistence. It is possible that taxes make farmers produce more rather than less. Taxes may serve as a stimulant as well as a narcotic.

It should be remembered that capitalization and shifting, even under the most favorable circumstances, do not entirely absolve the taxpayer from burdens. Capitalization relieves only to the extent that taxes on one investment are higher than those upon others. It leaves the owner, new or old, with a fixed charge to meet and from which he cannot be absolved. Shifting, which occurs through a rise in prices, may nevertheless destroy enough of the producer's business to reduce his net return.

In general, the conclusion that may be reached regarding farm taxes is

[34] *United States Census of Agriculture*, U. S. Department of Commerce Bureau of the Census, 1935, Vol. III, p. 182.

that probably only a minor part of them is escaped through shifting and capitalization. In this, as in other cases, the rules of shifting and incidence must be applied with circumspection.

SUMMARY

Shifting and incidence form one of the most important aspects of taxation. It is practically impossible to distribute the public burden with any degree of equity unless we have some knowledge of the shifting process.

There have been many theories purporting to explain this process, including that of the Physiocrats, who believed that all taxes regardless of where imposed come to rest upon the landlords; that of John A. Hobson, who stressed the distinction between necessary costs and surplus, contending that taxes must fall on the latter; and the diffusion theory, which held that all taxes are paid by all people according to what they consume.

The prevailing theory of incidence, based on the marginal analysis of prices, holds that shifting begins when the taxed producers cut down on the volume of supply. Under conditions of perfect competition, this ordinarily occurs by the migration of capital from high-taxed to low-taxed areas. Conditions favorable to shifting are universality of the tax burden among competitors, an inelastic demand for the commodity taxed, production in the taxed industry under conditions of decreasing cost, and universality of the tax within a given field only. Under conditions of monopoly, where the monopolist sets the price at the point where his net profit is at the maximum, taxes which vary with volume tend to be shifted; those which vary with net profit tend to stay put. Tax capitalization takes place when a purchaser discounts the special tax burdens which are attached to his investment. This usually happens in the case of goods the supply of which is a relatively fixed quantity, as, for instance, land.

The prevailing theory is open to many criticisms and limitations, among which are that it is based almost exclusively upon deductive evidence, that it gives insufficient weight to the effects of governmental expenditures and of fiscal policy generally, and that it has yet to be adapted to refinements in price theory such as the theory of monopolistic competition. Nevertheless, it is the best available tool to apply in dealing with many specific and practical problems in taxation.

Applying this tool to some of the major sources of the tax system, it is found that net income and inheritance taxes offer the most, and sales taxes and other consumption taxes the least, resistance to shifting. Business income taxes are more easily shifted than personal income taxes. Property taxes are made up of many elements, some shifted in higher prices to customers, some capitalized, whereas others probably remain on the taxpayer.

The social security taxes present a very complex problem of incidence; the safest conclusion in this case is probably that the burden of these taxes is divided among the interested parties in unknown proportions.

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CHAPTER VII

The Income Tax—Background and Procedure

LEGAL AND HISTORICAL DEVELOPMENT

The Federal Income Tax

The income tax as a regular and important source of revenue in the United States is a recent development. Until the Civil War the federal government subsisted largely upon receipts from the tariff and the sale of public lands. During the Civil War, under the pressure of sudden necessity, it resorted to income, inheritance, and a series of excise taxes. Several of the latter, particularly those on alcoholic beverages and tobacco, were retained after the war and continued to provide substantial revenue. Nevertheless, the tariff still held the leading position as a federal revenue source. In 1894 an unsuccessful attempt to reintroduce the income tax and make it a permanent feature of the federal revenue system was due not so much to the need of funds as to the tariff controversy between the two major political parties; the antiprotectionists promoted the income tax as a substitute for the tariff. But it was not until 1913 that the country finally accepted the net income tax—through a constitutional amendment. Then, before the tax had a chance to get properly under way, it was put to a rigorous test by the financial emergency of the First World War. It proved successful, even beyond expectation, and since then has remained the backbone of the federal revenue system.

The Civil War Income Tax. Although a new source of revenue to the federal government, the income tax of 1861 was by no means a novel device in the fiscal history of the American people. At the time of its enactment there were six states with such legislation on their statute books, and four others where the experience was still fresh in mind.[1] In none of these states was the tax popular or successful, a fate which, as will soon be seen, was to some extent also to befall the federal government's first attempt at drawing

[1] K. K. Kennan, *Income Taxation*, Burdick and Allen, Milwaukee, 1910, p. 210.

upon this source. The income tax of 1861, along with much other fiscal legislation included in the same law, was an emergency measure to finance the Civil War. It was adopted as a lesser of two evils and only after long bickering over a proposed bill to levy a direct tax on real property alone. A tax on real property would have required apportionment among the states according to their population. This would have been a time-consuming process and also was thought to involve special burdens upon the agricultural states of the West and Southwest.[2] On the other hand, the "indirect tax" levied upon income would be speedier, requiring no apportionment among the states and, further, would fall upon those best able to bear it.[3]

The Civil War income tax went through many changes in the course of its duration. Between its enactment in 1861 and its expiration in 1872 it was amended six times. However, the basic features of the 1862 Act remained predominant throughout the period. This Act allowed a personal exemption of $600 and had a slightly progressive rate structure with a 5 percent top rate applying to incomes exceeding $10,000. This 5 percent top rate was exceeded only in the acts of 1864 and 1865, of which the latter imposed a 10 percent levy on incomes above $5,000.[4]

Notwithstanding certain gross receipts levied on corporations, the Civil War income taxes applied mainly to personal incomes. Both corporate and partnership earnings were regarded as taxable income to the stockholder in the year the income accrued, regardless of whether or not such earnings were distributed. A similar provision applied to accrued interest, even when

[2] Actually, in addition to the income tax, there was also a property tax levy of $20,000,000, to be apportioned among the several states and territories, including the states in secession. Only about two-thirds of this sum was ever collected, and almost thirty years were consumed in the attempt. Eventually, however, even this sum was refunded. (H. E. Smith, *The United States Federal Internal Tax History from 1861 to 1871*, Houghton Mifflin Co., Boston, 1914, pp. 23, 38-44.)

[3] This income tax law expressed the great haste in which it was drawn. No provision was made in it for exemptions above $800, or for credits and deductions other than certain specified taxes, with the result that its enforcement would have amounted to a levy on gross receipts rather than net income. The Secretary of Treasury, aware of the great confusion which would accompany its execution, made no attempt to place the law in operation, and in the following year it was succeeded by a new act. The income tax of 1862 was a revised version of the former law, with some refinement in the definition of taxable income; in estimating the latter it allowed the deduction of all national, state, and local taxes paid upon property or the source of income; further, it allowed for the deduction of gains derived from manufactured goods upon which a stamp tax had been levied; and finally, it allowed a deduction of all gains for which a tax had been collected at the source. The latter feature followed the British practice of collection at the source. This, however, applied only to salaries paid by the United States to its employees, including members of Congress, and to dividends and interest of certain specified corporations.

[4] K. K. Kennan, *Income Taxation*, pp. 242-250.

Certain other notable features of these taxes were: income from United States securities was taxed 1½ percent under the 1862 law and at full rate under the later acts; various types of corporations paid on gross receipts and at different rates—for instance, under the 1864 Act insurance companies were subject to a gross receipts tax of 1½ percent, express companies to 3 percent, and telegraph companies to 5 percent.

not realized. These features of the law resulted in the taxation of both realized and accrued income and thus involved considerable double taxation.[5] It is interesting to observe that, after a long period of trial with the taxation of corporate income, there has recently been some support for a return to the Civil War practice of disregarding the corporate entity and taxing the stockholder upon his share of corporate earnings whether or not distributed.

In general, the administration of these taxes was an arduous task for which the federal government was ill-equipped in both experience and organization. The expected yield was slow in being realized but by 1866, when the tax reached the peak of its productivity, it produced over $73,000,000, whereas the total for the entire period attained the impressive figure of about $376,000,000, or 20 percent of all internal revenues collected by the federal government during this time. The law abounded in confusing provisions, the application of which was somewhat tempered by the rulings of the Commissioner of Internal Revenue.[6] These features helped to make the tax onerous and unpopular. Antagonism against it was strong even while the war was on, but it became still stronger after the war. This public sentiment against the tax lingered long after its repeal and was a large factor in retarding the development of a permanent federal income tax.

Briefly, the Civil War income tax laws carried the imprint of hastily drawn emergency measures; they were characterized by crudity, anomalies, and bad administration. But, in spite of their defects and with only moderate and mildly progressive rates, they aided materially in financing what was then thought to be a very expensive war.

The Ill-Fated Income Tax of 1894. In 1894, some thirty years after the Civil War experiment, an attempt was made to reinstate the income tax into the federal revenue system. During this interval the nation had been following a policy of high protection, which incidentally provided the federal government with ample funds for its needs. Cleveland, who had been elected in 1892 on a tariff-for-revenue-only platform, proposed to lessen the tariff's fiscal role and substitute an income tax to make up the difference. He was aided in this effort by the depression of 1893, which caused a temporary de-

[5] W. W. Hewitt, "The Concept of Income in Federal Taxation," *Journal of Political Economy*, Vol. XXXIII, Apr. 1925, pp. 159-160.

[6] Thus, although the statutes were at first silent on the subject of deductions for losses, repairs, depreciation, and other business expenses incurred in the course of carrying on one's business or vocation, they were nevertheless deductible (*Ibid.*, p. 158). However, no administrative measures could eliminate the many loopholes and annoyances which characterized these laws. Among the annoyances was one requiring the farmer to list his produce sold or on hand for the purpose of computing his income. Congress allowed house rent paid as a deduction, to put the tenant on a par with the homeowner whose taxable income did not include the rental value of his house; but this turned out to be a source of abuse in the administration of the tax. These provisions illustrate the crudity of these early laws. Logically, rent paid on a house is a personal expense or utilization of income, not properly deductible in computing income. And by the same token, rent saved on the ownership of a house might properly be counted as positive income. (See discussion later in this chapter.)

cline in governmental receipts. Essentially, however, the income tax grew out of the tariff controversy of the period. It was at this time that the anti-monopoly movement was becoming powerful. Along with resentment of concentration in business went resentment of concentration in wealth. It was alleged that the tariff was the mother of trusts and millionaires, and the income tax was advocated, particularly in the South and West, as a preferable source of revenue. After long and bitter debates in Congress over questions of class and sectional interests, the Wilson Tariff Bill, of which the income tax was a part, finally passed both houses. But it was no longer the bill originally introduced; it was badly mutilated, especially in the Senate, and President Cleveland allowed it to become a law without his signature.[7]

The actual features of the income tax of 1894 need not long detain us, as an early Supreme Court decision declared it void before it was put into operation. In general, it was patterned after the law of 1867, and such innovations as it showed indicated no great advance in the understanding of income tax techniques and principles.[8] It applied to both personal and corporate income, with a $4,000 exemption for the former. Gifts and inheritances were included in the base.[9]

Unconstitutionality of the 1894 Act. The income tax statute of 1894 was speedily tested and found unconstitutional by the United States Supreme Court in the case of Pollock v. Farmers' Loan and Trust Company.[10] The federal constitution provides that representatives and direct taxes shall be apportioned among the several states according to their population. In this case it was contended that an income tax, at least insofar as it applied to the income from real estate and personal property, was a direct tax. If this contention were established, it would follow in effect that a federal income tax could not be levied.

A prolonged argument took place among the attorneys and judges as to what the Fathers meant by the phrase "direct tax" as used in the Constitution. One side quoted at great length the economic literature of the time to prove that income taxes were generally regarded in 1787 as direct taxes. The other side relied more heavily upon a long line of precedents reaching back to Washington's administration, when a levy on carriages was accepted by the Supreme Court as an indirect tax.[11] Many legal statements and decisions were marshaled to support the view that only land and capitation taxes were "direct" as the term is used in the Constitution.

[7] E. R. A. Seligman, *The Income Tax* (2nd ed.), pp. 499-505.

[8] K. K. Kennan, *Income Taxation*, p. 259.

[9] Under income was also included interest, both realized and accrued, on all securities except those specifically exempt by law, and gains from real estate sold within two years of its purchase; deductions for certain taxes, interest on indebtedness, losses, worthless debts, and other necessary expenses incurred in carrying on one's business; collection at source was also provided, but only for salaries of United States employees. (E. R. A. Seligman, *The Income Tax* (2nd ed.), pp. 508-518.)

[10] 157 U. S. 429 (1895); on rehearing 158 U. S. 601 (1895).

[11] Hylton v. United States, 3 Dall. 171 (1796).

It appears fairly clear that the final outcome of this dispute turned in large measure upon the economic rather than the legal opinions of the justices. Thus, Chief Justice Fuller expressed the conservative view of his time when he said: "The original expectation was that the power of direct taxation would be exercised only in extraordinary exigencies, and down to August 15, 1894, this expectation has been realized." [12] The attempt, he added, to use the income tax in time of peace created reason for circumspection and care. Justice Field went further and said: [13]

> The income tax law under consideration is marked by discriminating features which affect the whole law. It discriminates between those who receive an income of four thousand dollars and those who do not. . . . The legislation, in the discrimination it makes, is class legislation. Whenever a distinction is made in the burdens a law imposes or in the benefits it confers on any citizens by reason of their birth, or wealth, or religion, it is class legislation, and leads inevitably to oppression and abuses, and to general unrest and disturbance in society. It was hoped and believed that the great amendments to the Constitution which followed the late civil war had rendered such legislation impossible for all future time. But the objectionable legislation reappears in the act under consideration. It is the same in essential character as that of the English income statute of 1691, which taxed Protestants at a certain rate, Catholics, as a class, at double the rate of Protestants, and Jews at another and separate rate.

Justice Harlan, in an equally vigorous statement for the dissent, showed the influence of a different economic philosophy upon his legal opinion. He said: [14]

> The practical effect of the decision today is to give certain kinds of property a position of favoritism and advantage inconsistent with the fundamental principles of our social organization, and to invest them with power and influence that may be perilous to that portion of the American people upon whom rests the larger part of the burdens of the government, and who ought not to be subjected to the dominion of aggregated wealth any more than the property of the country should be at the mercy of the lawless.

The Corporation Excise Tax of 1909. Fifteen years after the 1894 income tax was declared unconstitutional, Congress passed a law providing for a corporate income tax of 1 percent on income in excess of $5,000. This was not called an income tax, but an excise on the privilege of doing corporate

[12] Pollock v. Farmers' Loan and Trust Co., 157 U. S. 429, 574 (1895).
[13] *Ibid.*, p. 596.
[14] *Ibid.*, 158 U. S. 601, 685 (1895).
A further discussion of the legal aspects of this case will be found in Chap. XIX.

business, the privilege to be measured by net income. This act was sustained by the United States Supreme Court.[15] Fifteen years' change in public opinion since the 1894 decision may have had a bearing upon the outcome. The Court, in order to sustain the measure, had to resort to the doctrine that there is a distinction between the subject and the measure of the tax and that, if the former clearly conforms to constitutional requirements, the Court will be more lenient in judging the latter. Thus, Congress might do indirectly what it could not do directly. Although the Court probably reached a proper conclusion in this case, it resorted to exceedingly fine distinctions and doubtful reasoning.

Constitutional Amendment and the Statute of 1913. When in 1909 Congress passed the corporation tax bill, it also proposed a constitutional amendment to enable Congress to levy an income tax unhampered by the apportionment provision of the Constitution. With its adoption in March 1913, this amendment brought to a close one of the longest chapters in the constitutional history of the income tax. The amendment provides that: [16]

> Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

It was not known at the time this amendment was adopted that within the next few years an emergency would arise which would stretch all the revenue-raising resources of the government to the limit. Only seven months after the power was granted to Congress, a levy was imposed on both personal and corporate incomes. This first federal income tax under the amendment now seems like a very mild affair with its normal rate of 1 percent upon personal incomes in excess of $3,000 ($4,000 for married person or head of family) and a top surtax rate of 6 percent upon incomes in excess of $500,000. During the First World War, however, the income tax was heavily relied upon to yield a large part of a very large revenue, and it has never since returned to anything like its prewar level of rates.

Development of State Income Taxes

In 1911, Professor Seligman, a national authority on taxation, wrote: "More and more it has been realized by state officials and commissions that any hope of a satisfactory state income tax is illusory." [17] He further pointed out that where state income taxes had been tried in the United States they had proved a failure. A state income tax in Virginia yielded only slightly more than $100,000 in 1909 and 1910, and in over

[15] Flint v. Stone Tracy Co., 220 U. S. 107 (1911).
[16] United States Constitution, Art. XVI.
[17] E. R. A. Seligman, *The Income Tax* (1st ed.), The Macmillan Co., New York, 1911, p. 419.

30 percent of the counties of the state no tax was collected at all. Undaunted by this experience, Wisconsin adopted an income tax law in 1911, the year in which Professor Seligman drew his conclusion. It attempted to profit by the mistakes of other states and, therefore, framed the administrative provisions of its new income tax law with great care. Early state income tax laws had relied for assessment of income upon local assessors, usually the same assessors who assessed property. The Wisconsin income tax law of 1911 inaugurated central administration of the income tax through a state tax commission with civil service employees. Thus, as early as 1912 the Minnesota Tax Commission was impelled to observe: [18]

> That the Wisconsin income tax law has been a remarkable success for the first year is now generally admitted. Not only has it resulted in a large increase in revenue, but it has unquestionably distributed the tax burdens more equitably among those able to bear them than ever before in the history of the state.

The success of the Wisconsin income tax law started a new movement in state taxation. In 1917 four states, Delaware, Massachusetts, Mississippi, and Missouri, and, two years later, New York and North Dakota, followed Wisconsin's example. At present more than two-thirds of the states have a state income tax applicable to either individuals or corporations or both.

FEDERAL INCOME TAX ACCOUNTING

The Individual Income Tax

Refining Gross Income to Net Income. The net income tax, as its name suggests, is based upon net income, a quantity obtained by starting with all that a taxpayer receives between two points of time (e.g., Jan. 1-Dec. 31) and making certain refinements or subtractions therefrom. There are three main classes or kinds of subtractions. The first might be called "income not taxed." It consists of certain receipts which are ignored for purposes of income taxation. Congress prescribes that they shall be excluded for certain legal, social or other reasons. Within this category, one of the most important items is interest on state and municipal bonds. The interest on some of the older federal bonds is also partially or entirely exempt. The policy of issuing federal bonds with a tax-exempt feature was discontinued in 1940. Other income not taxed includes life insurance received by a beneficiary, inheritances and gifts, pensions paid by the United States, and damages received in action for personal injury.

The exemption of the interest on state and municipal bonds is a very important one. It is not a matter of congressional discretion but is based on a

[18] *Third Biennial Report of the Minnesota Tax Commission*, Minneapolis, 1912, p. 164.

long line of court decisions extending back to the case of McCulloch v. Maryland in 1819.[19] The Court in this case denied the right of a state to tax the notes of a federal bank. Justice Marshall in his decision emphasized the sovereignty of both the federal government and the states. He spoke of the power to tax as the power to destroy, holding that if the states could tax the instrumentalities of the federal government, they would be supreme over the latter. Because of this decision and others that have followed and extended the principle involved, taxation of the income from state and municipal securities by the federal government is beyond the powers of Congress as now interpreted, and similarly the income from federal securities may not be taxed by the states. Recently the legal doctrine protecting state and local instrumentalities was revised by the Supreme Court to permit the taxation of salaries of state and local officials.[20] The federal government may tax its own securities and salaries, as may the states theirs, although the latter often exempt them on the theory that to tax them is to take money out of one pocket and put it into another. The states may also tax the income from salaries and securities of their subdivisions (e.g., municipalities).

Deductions. The second set of subtractions from gross income are the deductions. These are the expenses incurred in creating the income—the negative items that must be offset against the positive ones to give an algebraic total. As a rule, all business and professional expenses are deductible. These include wages paid out, depreciation on capital, business insurance, interest, taxes, rent, bad debts written off, and so on. Professional expenses include cost of operating automobiles necessary for professional use, subscriptions to professional magazines and books, expenses of attending professional conventions, and so on. As a rule, the living expenses of the taxpayer and his family are not deductible. These include such items as wages to chauffeur, caretaker, maid, most medical expenses,[21] life insurance premiums, household costs, commutation expenses, expenses of sons and daughters at college, dues to a lodge (as distinguished from a business association), and the like. Logically, interest on a loan acquired to purchase a house or an automobile should not be deductible, nor should the taxes upon these consumption goods. Actually the federal government allows both of these items, although some state laws disallow the taxes on residences. The federal government permits the deduction of all taxes except death, gift, federal income and excise taxes, and taxes assessed against local benefits (special assessment).

Obviously there are border-line items. For example, a teacher may deduct the expense of attending a professional convention but not the expense of

[19] 4 Wheaton 316 (1819). But see Chap. XIX for discussion and qualification of this rule.

[20] Graves v. O'Keefe, 306 U. S. 466 (1939).

[21] In the 1942 Revenue Act, medical expenses in excess of 5 percent of net income and not to exceed $2,500 for a married or $1,500 for a single taxpayer were allowed as a deduction.

attending a summer school. Cost of uniforms which conductors are required to buy and wear in lieu of other clothing is not deductible.

Included among the deductions are contributions to educational, religious, charitable, and other similar organizations. These contributions, however, may not exceed a certain percentage of the taxpayer's net income.

The new system of simplified reporting allows most taxpayers a minimum of 10 percent of net income for deductions. This not only simplifies compliance with the net income tax; it makes the deduction allowance in many cases virtually an addition to personal exemptions. The innovation has important advantages of simplification but it does ignore certain real differences among taxpayers which were formerly recognized.

Personal Allowances and Other Credits. Gross income minus these various subtractions give the taxpayer's net income (for tax purposes). However, certain additional credits are allowed before the actual tax base is reached. The principal credit is an allowance to the individual for his personal expenses and those of his family. For example, the law may allow the taxpayer an exemption of $500 for himself and each of his dependents. Dependents as now defined include anyone earning less than $500 and relying mainly on the taxpayer for support. Formerly the dependency status was largely confined to children below 18 years of age and others incapacitated from employment. Other credits formerly permitted included an allowance for dividends and for earned income. The former were exempt from the normal tax on the ground that the tax imposed upon corporations (as later explained) should absolve the stockholder from at least part of his personal responsibility. Earned income (or income from services as distinct from property) was granted certain concessions in the application of the normal tax on the ground that such income gives its recipient less ability to pay than alternative forms of income.

Normal and Surtaxes. Federal income tax statutes have usually provided for two taxes—one called a normal tax, carrying a low rate (usually flat) and applicable to all income as defined for normal tax purposes; the other called a surtax, carrying a graduated scale applicable to successive brackets of income as defined for surtax purposes. The division introduces a very substantial complication but lends itself easily to manipulations to accomplish certain objectives. Thus, certain interest on government bonds is by contract exempt from the normal tax but not from surtaxes. Under the Revenue Act of 1944, the normal tax carried a rate of 3 percent and applied to a base of net income for tax purposes minus a credit of $500 for the taxpayer only, with no allowance for dependents. The surtax base, on the other hand, allowed a credit of $500 for each dependent. Surtax rates ranged from 20 percent on the first $2,000 of taxable income to 91 percent on taxable income in excess of $200,000. A maximum effective rate of 90 percent on taxable income was provided.

Calculation of the Tax. If Mr. Smith has a gross income of $15,000, of which $1,000 is not subject to tax, and if he has deductible expenses of $5,000 and credits of $2,000, his tax base will be derived as follows:

Gross income	$15,000
Income not taxed	1,000
Gross income for tax purposes	$14,000
Deductible business expenses	5,000
Net income for tax purposes	$ 9,000
Personal allowance (credit)	2,000
Tax base	$ 7,000

If this base is subject to a normal tax of 3 percent and a surtax of 20 percent on the first $2,000 of taxable income, 22 percent on the second $2,000, 26 percent on the third $2,000, and 30 percent on the fourth $2,000, the tax would be computed as follows:

Normal tax: $7,000 × 3%		$ 210
Surtax: $2,000 × 20%	$400	
2,000 × 22	440	
2,000 × 26	520	
1,000 × 30	300	
Total surtax		1,660
Total tax		$1,870

Corporate Taxes

By far the greater part of American business is now carried on by corporations. For taxation purposes these corporations are treated as entities separate from their stockholders. However, most of the procedure in calculating income taxes, as described above, applies also to corporate income taxes.

For many years corporations were taxed at a flat rate, but in 1935 a graduated rate scale was introduced. The 1936 law added another innovation in the imposition of a special surtax on undistributed corporate income, graduated according to the ratio of such income to total income. This feature proved highly controversial and was first mitigated and then dropped. More recently a surtax was added to the corporate tax system; this feature is distinguishable from the normal tax mainly in that certain government bond interest is subject to the former only. During the Second World War, the combined rates of these two taxes ranged from 25 to 40 percent. A war excess profits tax supplemental to the income tax was also levied at a rate of 95 percent of the *excess* profits as defined. The very severe rate of this tax was somewhat softened by a postwar credit (10 percent of profits taxes) and by the provision of an over-all maximum of 80 percent for all corporate taxes.[22]

[22] These taxes and other levies which apply in certain circumstances will be explained in more detail later.

PRESENT STATE INCOME TAXES

The character and procedure of state income taxes are similar in many respects to that of the federal tax, although the rates of the former are much lower and the personal exemptions are generally higher. In 1942, top rates ranged above 7 percent in only seven states and up to 15 percent in two.

Exemptions for a single person in 1942 ranged from $500 in North Dakota to $1,500 in New Mexico, Alabama, and Arkansas. For married persons, they ranged from $1,200 in Utah to $3,000 in Alabama, and, for dependents, from $200 in several states to the equivalent of $500 in one, Iowa.[23]

Most states having a tax on personal income also levy a corporate income tax. The rates of the latter are usually lower than on personal incomes and are predominantly proportional, although a substantial number of the income tax states apply graduated rates.[24]

MUNICIPAL INCOME TAX

The inauguration in 1939 of the Philadelphia net income tax marked the first and only use in the United States of this revenue source by a municipality. Pennsylvania has no state income tax and permits its cities to tax any subject not taxed by the state. The tax was originally at a 1½ percent rate (later 1 percent) and applied to residents and nonresidents alike. Much was made of the fact that this enabled the city to collect from those who earned in the city but lived in the suburbs. The base included the earnings of independent business and the professions but did not cover corporations. No exemptions were allowed and deductions were confined to expenses involved in making the income. Much of the tax was collected at the source. Property tax valuations had dropped from 3.5 to 2.4 billion dollars and the city had incurred persistent budgetary deficits. The revenue derived from the income tax was ample to solve its financial problem.

CONCEPTS OF NET INCOME

Although the authors of the Civil War income tax laws, the statutes of 1894, of 1913, and of subsequent years, have all sought to tax net income

[23] *Tax Systems*, 1942, pp. 134-137.

[24] The following states do not tax net income at all: Florida, Illinois, Indiana, Maine, Michigan, Nebraska, Nevada, New Jersey, Rhode Island, Texas, Washington, and Wyoming. New Hampshire taxes only income from intangibles, and Ohio from intangibles and rent. South Dakota and West Virginia abandoned their taxes during the Second World War.

as it represents ability to pay, the measures have differed considerably in their concepts and definitions of a proper income tax base. The failure of the legislators to follow a consistent rule has been due partly to the difficulty of deciding what constitutes net income. This is not surprising since even special students of the subject cannot come to an agreement on it. The following paragraphs will be devoted to a discussion of some of the problems which must be faced in deciding what constitutes net income.

Receipts in Kind. Need receipts be money to constitute net income? The answer is clearly no. Receipts in the form of house use, services, produce, or securities are quite as much net income as money. Money's worth is equivalent to cash as far as net income is concerned.

Irregular Receipts. Need receipts be regular in order to constitute income, or does income include such sporadic acquisitions as prizes won, gain from the sale of investment, and so forth? In the United States it has always been held that irregularity is no "defense" in determining net income. In Great Britain the opposite rule, with some exceptions, prevails.

Illegitimate Receipts. Must receipts be legitimate in order to constitute income? Again the answer is no. On one occasion the United States Supreme Court was asked to pass on the question of whether a bootlegger must report his "bootleg" income. It was argued in defense of the taxpayer that no one is required under our law to incriminate himself. Justice Holmes, in delivering the opinion of the Court, stated that the income must be reported but that the taxpayer, to avoid incrimination, might object to labeling its source in the return. Justice Holmes then played with the question of whether the bribery of public officials would constitute a proper deduction against such an income, that is, whether an illegitimate expense is a legitimate deduction from an illegitimate income. The Justice concluded that "it will be time enough to consider the question when a taxpayer has the temerity to raise it." [25]

Services Without Exchange. Must there be an exchange to create an income? The answer in this case is mixed and confused. One phase of the problem concerns the value of produce raised in the taxpayer's own garden and consumed by him and his family. Under the federal law this need not be reported, but under some state laws, Wisconsin's, for example, the contrary rule prevails. In Wisconsin, if no adequate account of such direct consumption is kept by the farmer, the law prescribes that an arbitrary figure of $90 for each adult and $60 for each minor residing on the farm must be added. In the United States, as contrasted with England, the rental value of a house occupied by its owner is not included as income. This creates inequality between the person who has invested in a home and one who has invested in other property and lives in rented apartments. The first need not report the rent saved as income, whereas the latter must include the rent or

[25] United States v. Sullivan, 274 U. S. 259 (1927).

interest received as positive income and cannot deduct rent paid out as an expense. Thus, one way to "beat" the income tax in the United States is to own one's home. The services of the housewife to her family are nowhere counted as income, to the author's knowledge, but ignoring them produces the anomalous situation that, were housewives to keep each other's houses for pay, the national income (for taxation purposes) would rise sharply.

Obviously, a line must be drawn somewhere in reckoning as income the services of consumption goods used by their owners. The services of one's own automobile, clothing, and furniture are income in the broadest sense. One writer has suggested that we should consider the use of leisure time as income.[26] If *A* and *B* receive the same amount of money each year but *A* gets a week's vacation, does not *A* receive more than *B*? Similarly, if *A* is able to earn in 8 hours what *B* earns in 10 hours, does not *A* receive a larger income?

Probably practical considerations make it inadvisable to refine the income tax base to include many of the services which the taxpayer receives without exchange. The British rule with regard to houses, however, seems much better than that of the United States and worth its extra administrative difficulty.

Receipts of Cooperatives. An interesting problem of definition arises in the application of income taxes to cooperative business. Under the cooperative system of doing business, a group of consumers may unite to buy or manufacture goods at cost. Frequently the prices of these goods are so adjusted that a surplus remains, the disposition of which is within the discretion of the board of directors. It may be distributed to consumers in proportion to their purchases; it may be distributed to stockholders in proportion to their stock (not exceeding, in some cases, a top rate); or the board may retain the surplus as a reserve, to be used for expansion of the business or to dispense free services of a social or educational character. Cooperatives contend that when business is carried on by and for consumers there can be no profit or net income in any true sense. They say that this is particularly true of patronage dividends, which are the cooperative way of buying at a bargain. Competitors of cooperatives are likely to feel that acceptance of this view in income taxation would give cooperatives an unfair advantage; that the latter produce the same kind of services which give rise to taxable income when produced by ordinary businesses. However, even the competitors of cooperatives and their customers pay no tax on refunds similar to patronage dividends, such as those occurring through the use of trading stamps. Under the present federal income tax, cooperatives are exempted provided they are farm marketing or purchasing associations and not more than half of their business is done for nonmembers. Other cooperatives are exempt only on income paid out as patronage dividends. Under the Wisconsin state income

[26] Henry C. Simons, *Personal Income Taxation*, University of Chicago Press, Chicago, 1938, p. 111.

tax law, all cooperative associations are exempted, but all cooperatives must limit dividends on stock to 8 percent. However, under both the state and federal laws, dividends on cooperative stocks (but not consumers' patronage dividends) are subject to the individual income tax.

Inclusion of Savings. Another question concerns the inclusion of savings in the income tax base. John Stuart Mill thought this involved double counting, a point of view for which Professor Irving Fisher is probably the most vigorous modern proponent. The latter asserts very positively that income consists of that which a man spends rather than that which he receives from his labor or the services of his property; that income tax laws should recognize this interpretation by an exemption of savings; and that their failure to do so has resulted in injustice, ambiguities, misunderstandings, and other unfortunate consequences.

Suppose that in any given year *A* and *B* each receive $10,000 as a result of a year's labor. *A* spends all of his income, but *B* saves and invests his. Let us ignore the interest and simply assume that *B* "postpones the enjoyment" of his $10,000 for ten years. Now, under present income tax laws both *A* and *B* are treated as having received $10,000 in the year when it is earned. But this is unjust, according to Professor Fisher, because *B* really received no enjoyment or "real income" during that year. Moreover, the present value of $10,000 worth of enjoyment ten years hence is substantially less than $10,000.[27]

Granting the original premise, namely, that income consists of consumption, there is no escaping the logic of Professor Fisher's analysis. But the original premise is the matter most in dispute. As far as taxation is concerned, net income is recommended for a tax base because it is thought to indicate ability to pay. Ability to pay is not a simple concept; probably it includes consideration of the taxpayer's sacrifice in parting with a certain portion of his income, his power to meet his tax bills, and the privileges he enjoys as indicated by his earnings. If a taxpayer postpones the consumption of his income, he may be thought to have already made a sacrifice, though in a sense saving is its own reward. At any rate, the saver's earnings indicate as much faculty or power to earn as does the spender's. They also indicate, other things being equal, the enjoyment of the same privileges. The accepted concept of income is not concerned with what the taxpayer does with his money, but rather, with the money he has at his disposal.

It would undoubtedly be very difficult to convince the public that a man who spends his money on the education of his children sacrifices less and has greater ability to pay when he is called upon to support the government than the bachelor who puts his money into bonds.

From a practical standpoint, the objections to Professor Fisher's proposal are very great. It would eliminate the corporate income tax entirely, since

[27] Irving Fisher, "Income in Theory and Income Taxation in Practice," *Econometrica*, Vol. V, Jan. 1937, pp. 47-48.

corporations are not in a position to spend money for enjoyment. It is a well-known fact that saving is concentrated to a large degree in the higher ranges of income. Excluding savings from the tax base would defeat the equalizing effect of a graduated income tax, not to mention the serious effect which it would have upon the yield of the tax. As has been previously observed, there is some ground for thinking that saving is overdone (collectively speaking) and needs no stimulus from the tax system.

Personal Outlays versus Business Expenses. It has already been mentioned that the line between an outlay for consumption, which is the *utilization of income*, and an outlay for production, which is *negative income*, is a very indistinct one. The subscription price of a professional magazine is negative income; the subscription price of a nonprofessional magazine is the utilization of income, or a consumption expense. The difference may be largely one of degree and is dependent on the psychology of the taxpayer. The professional magazine is probably purchased to maintain the taxpayer's professional efficiency. But the nonprofessional magazine may also contribute to that efficiency; the subscriber may require for his health the recreation which it affords, or he may require for his professional efficiency some general knowledge of what is going on in the world. Of course, the tax laws do allow a flat credit for personal maintenance. But they usually do not recognize very real differences in the cost of such maintenance. *A* and *B* both have $5,000 incomes, but *A* has an invalid wife who requires constant and expensive medical attention, whereas *B*'s wife enjoys good health. No one would contend that their ability to support the government is equal. The 1942 Federal Revenue Act took cognizance of this point for the first time. Its provision for the deductibility of medical expense is limited almost to the point of inapplicability, but the principle involved has at least been recognized.

The outlays for maintenance, depreciation, and depletion of capital are permitted as deductions in arriving at net income on the ground that capital must be maintained intact before income can be reckoned. If our economic order were operated for machines instead of for men, then human maintenance would be a cost of doing business, and the wear and tear of machinery would be a consumption expense. The cost of feeding a horse or a slave, or the maintenance, depreciation, and obsolescence of such instruments of production, are negative income. These same costs as applied to free men are a utilization of income rather than factors in arriving at income.

Capital Gains and Losses. There has been considerable discussion of whether capital gains and losses should be included in income for taxation and other purposes. Capital gains and losses occur when an individual sells for a profit or loss what is ordinarily retained as a source of income. They arise not as a flow of income from the fountain, but from the sale of the fountain itself. More specifically, they arise as a rule when an owner sells real estate or securities. They may also arise when the owner sells a factory

or a machine.[28] If the owner of a shoe factory sells shoes, his receipts are ordinary income, but if he sells a shoe machine, he may have a capital gain or loss. On the other hand, a factory which manufactures shoe machines makes ordinary income rather than a capital gain or loss from their sale. A dairy farmer should count the gain on the sale of a cow as a capital gain, but a beef farmer should count it as ordinary income.

It is contended by some that a capital gain is not income. Before discussing this matter it must be pointed out that there are many definitions of income, but that most of them fall under three classes. First, there are the definitions which contemplate income as economic achievement, as a flow of goods and services, measured in utility, which in turn is measured in values or prices. This is the concept of income used by the statisticians who attempt to measure "the national income" from year to year. Second, there are the definitions which contemplate income as consumers' satisfaction. This is the concept of Professor Fisher, already discussed. Third, there are the definitions which contemplate income as economic power for the recipient. It is this latter definition which is most often applied in taxation.

Now, capital gains may not represent an addition to the flow of goods and services, nor to the real stock of wealth. Furthermore, they may not represent an increase in the scale of living or consumers' satisfaction. But they do represent, at least in most cases, a real increase in economic power and, as such, an increase in their recipient's ability to pay. Under the third type of definition cited above, they are most assuredly income.

Approaching the matter from another angle, it is possible to conceive income from either of two viewpoints—the social or the individual. There may be considerable doubt as to whether capital gains should be reckoned as income from the social point of view. There is, however, far less question about including such gains as income from the individual point of view.

"Unrealized" Gains and Losses Excluded. Viewing income as power, theoretically capital gains should be included as income, whether they are "realized" or not; that is, whether or not there has been an exchange. This would necessitate an inventory of all one's capital goods each year and the change in inventory values from one year to another would be reckoned as income. Such procedure may be now followed in the case of merchandise inventories, but it would involve very great (not to say insuperable) difficulties of appraisal insofar as capital goods are concerned. Thus, because of the practical difficulties, only realized capital gains, as appraised by an exchange, are considered as income. A recent tax study recommended that capital gains, whether or not realized, should be included as income, but the consensus would probably hold the suggestion impractical.[29]

[28] Under the 1944 federal income tax law, capital gains and losses are defined to exclude those on real estate used in a business if held for less than six months.

[29] Twentieth Century Fund, Inc., *Facing the Tax Problem*, pp. 477-484; 490-491.

Contention That Capital Gains "Income" Is Illusory. Those who argue that capital gains are not income may contend that these receipts do not represent real increases in the national wealth or welfare. It is argued that capital gains represent the present value of expected future income and that to tax both them and the future income is most assuredly double counting. If an owner's real estate doubles in value, it is probably because a prospect for higher future rents has developed. It would be double counting to consider both the anticipation and the realization as income.[30]

Suppose that Smith goes into business and invests $100,000 in the venture. Suppose he loses money steadily for five years, say $20,000 each year, but that at the end of this period he has built up such fine prospects for the future that he is able to sell his business to Jones for $100,000 more than he originally invested. The layman would certainly conclude that Smith had come out even on his five-years' venture and that at the moment of sale neither he nor Jones, nor the country, were any poorer as a result of the venture. Yet some would consider it double counting to offset Smith's capital gain against his operating loss. This is the same double counting which some economists object to in treating saving as income. A $100,000 saving and investment adds to economic power only because it offers prospects for the future. However, if we accept power as the criterion of income, we need not be concerned about double counting in either case.

It is true, of course, that capital gains may be due to changes in the general price level and that in this case they are illusory gains. For example, a building may rise in value for no reason other than that the measuring stick has changed; that is, that the value of money itself has fallen. The building may represent the same purchasing power in terms of all other goods (except money) that it did previously. In this case the owner of the building has really gained nothing in terms of economic power. But there are many real changes in economic power which result from changes in the general price level. Unfortunately, it does not seem possible to segregate the real gains from the illusory ones.

Receipts Must Be Realized. Usually receipts must be realized in order to constitute income. As previously stated, mere increments to capital assets without any exchange of the latter are not realized income and are not taxable.

In the case of inventory profits, receipts ordinarily must be realized to be counted as income, but they may afford the recipient no cash with which to pay taxes and they may disappear in the later fluctuations of the business cycle. A business may require a basic inventory of goods in order to continue as a going concern. The profit that is made on the sale of old inventory is likely to become "tied up" immediately in replacements. The company then has a more valuable stock than previously but even this gain may

[30] C. C. Plehn, *Introduction to Public Finance* (5th ed.), p. 272.

be lost if prices fall to their former level. Since 1938, for tax accounting purposes, the government has allowed companies with certain qualifications to use the "last-in, first-out" method of inventory valuation. This means that units last added to the basic stock are presumed to be the first sold. The system reduces fluctuation in inventory profits, but it does not eliminate them and it is not always available. An inventory reserve system would be the most efficient way to eliminate such gains, but administrative difficulties have prevented its adoption.

Other cases involving the problems of realization will be discussed in the next chapter.

Impairment of Capital. Most income tax laws accept the proposition that receipts may not be considered as income until allowance has been made for maintenance, depreciation, depletion, and obsolescence. These allowances are based on the theory that all impairment of capital must be considered as negative income. *A* starts in business with $100,000 of capital and makes $10,000, but at the expense of a reduction in the value of his capital to the extent of $5,000. He is less fortunate than *B*, who, with the same capital and the same receipts, suffers no impairment of capital. Now, capital may be impaired in a number of ways. One is that it may wear out as a result of service. This is called depreciation. Another way in which impairment occurs is through the sale of capital, piece by piece. This is called depletion; it occurs in the case of mineral and forest resources. A third cause of impairment presents itself when capital gradually becomes antiquated, or out of date. This is called obsolescence.

The income tax makes allowance for all these impairments. Reasonable maintenance and depreciation are legitimate deductions before arriving at net income. This is also true of obsolescence, although as an administrative matter the law may require that it must be realized (rather than anticipated) before a deduction will be allowed. Theoretically, depletion should be calculated at the cost (to the taxpayer) of capital units sold. Actually, sometimes it is calculated on the basis of cost, market price at time of discovery, or an arbitrary percentage of gross income. The federal law allows full depletion in case of discovery, in spite of the fact that little or no cost to the taxpayer may have been involved. The depletion features of the federal law are criticized frequently on the ground that they are overgenerous to the taxpayer.

ADMINISTRATION

Collection at the Source. The phrase "collection at the source" is used to describe the method of collecting taxes from the payers of income rather than from the payees. For example, in the case of wages, taxes are collected from the employer rather than the employee; in the case of rent, from the tenant rather than the landlord; in the case of interest, from the debtor

rather than the creditor; and in the case of dividends, from the corporation rather than the stockholder. Instead of paying a workman his full wages, the employer may pay him wages minus the tax, which goes to the government.

Collection at the source offers the advantages of convenient payment, minimum delinquency, and minimum avoidance. Third parties usually have no interest in defeating the claims of the government. The disadvantages are the complications of applying a scale of exemptions and graduated rates to payments by third parties in such a way as to collect the proper tax without supplementary returns or refunds. The latter can be avoided by confining the collection to only part of the expected tax. A further disadvantage is that a substantial compliance cost is created for those who collect at the source.

For many years after the adoption of the American income tax, collection at the source was not applied, although precedent for its successful application had long existed in Europe. During the Second World War, the federal government inaugurated the use of the system in the taxation of wages and salaries. This is called a withholding levy. The states still rely on the older system of reporting and collection.

The war also inaugurated "current payment" of the tax. Under the former practice, income earned in January 1940, was not reported until fifteen months later (March 1941) and the tax could be paid in installments after reporting. This permitted ability to pay to become "cold" before it was "tapped" by the tax system, and it impeded the use of the income tax as an anti-inflation device to draw off excess purchasing power. The present system collects currently from wage and salary earners through withholding and from others by advance estimates and quarterly payment of taxes as they accrue.

Information at the Source. In lieu of collection at the source, income tax statutes may employ what is known as information at the source. Taxpayers who pay out interest, wages, or rents to others are required to report such payments, together with the names and addresses of the payees. This would seem to be an effective substitute for collection at the source, at least as far as the ascertainment of income is concerned. Sometimes, however, a vast amount of information is collected and not utilized. Where the information-at-the-source reports are filed with the individual's reports, which is now the rule in the case of the federal and some state administrations, they are a very great aid to income tax administration.

Audits. Neither collection at the source nor information at the source can be applied to all income. It cannot be applied, for example, to business and professional income because to do so would decentralize rather than centralize collection. Objective information concerning such income is usually obtained from the taxpayers' books. The federal law prescribes that taxpayers must keep books at their own peril and that the books be available to government field auditors at any time. It is the practice in federal ad-

ministration, and under the best state administrations, to audit the books of nearly all corporations regularly and to audit the books of individuals when the taxpayer's income is large or when there is reason to doubt the veracity of the return. Income tax administrators are usually able to demonstrate that the additional outlay for auditing individuals' books pays the state handsome returns and improves the morale of all taxpayers, not only those audited.

Does the business and professional man usually keep honest books? The answer is affirmative, at least as far as large businesses are concerned. Books are used for a variety of purposes; they serve as the basis of credit as well as taxes, and for this reason it is not very feasible to keep false records. This is not equally true of small businesses or of professional men, but it is doubtful if there are many who keep two sets of books or who deliberately falsify their records. Occasionally, items of income may be omitted from the records, and as a rule there is no check upon such items except for the net worth assessment explained below.

Application to Farmers—Presumptive Income. Farmers are notoriously lax about keeping books; frequently their records of income consist of some notations on the back of a calendar or other equally informal accounts. To be sure, relatively few farmers in peacetime have had income which exceeds the exemptions allowed in the federal law, and not many of them have paid a tax under the state laws. If the income tax were to become the important source of revenue that some of its proponents desire and if its base were broadened to include a much larger proportion of the population, bad bookkeeping by farmers would become a serious problem. The problem has already been precipitated to considerable degree by war prosperity and the reduction in personal exemptions in the federal law. But patriotism facilitates honest reporting in wartime. Possibly, a feature might be borrowed from the British law, under which a farmer is taxed on his presumptive income—what a farm would ordinarily yield under ordinary management—unless exemplary accounts are kept by him, in which case he may upset the presumptive income.

Net Worth Assessment. Another device used to obtain an objective check upon income is the net worth assessment. Anyone who is suspected of failure to report income may be audited as to his net worth at two different points of time. The net increase plus estimated living expenses afford a basis for estimating his income. Books and bank deposit boxes must be made available for such an audit.

Self-Reporting. It will be observed that there is very little income for which there is no objective information and for which complete reliance must be placed upon the honesty of the taxpayer. Only a few items, such as donations, are not open to some kind of objective check, and even in this case the donee must be stated so that a follow-up investigation might be made. It should be said, however, that in practice much reliance is placed

upon self-reporting since there are many returns of small businessmen, professional men, and farmers which are never supplemented with a personal audit.

Exchange of Information. The federal government receives much more complete information at the source than do the states. States receive no information concerning interest, dividends, and wages paid to residents of the state from sources outside the state, or, in the case of interest, coupons payable to bearer from sources within the state. In recent years the federal government has cooperated more than formerly with the states in supplying the latter with copies of federal returns for administrative purposes. The providing of federal audit information by the federal government to the states at nominal cost has greatly strengthened state administration and is an outstanding example of successful federal-state cooperation. Much improvement is still possible in the exchange of information between governments.

Penalties. One administrative device which remains to be considered is the penalties provided for violation of the law. Many states give the administrators either discretionary or mandatory power to "double rate" a taxpayer guilty of fraud, that is, of willful intent to defeat the law. The federal law imposes a 50 percent penalty of and in addition to the deficiency resulting from such evasion. The administration has also what is called the "doomage power," by which is meant the power to assess on the basis of the best information available those who refuse to cooperate in giving information. The federal statute and most of the states have also criminal penalties for fraud, including fines or imprisonment or both. These penalties, of course, cannot be enforced without criminal proceedings. Practically all state laws contain a penalty (administrative) for failure to file returns on time. Some discretionary power in administrators to set penalties seems entirely warranted. It has been suggested that something less than fraud (possibly gross negligence) ought to be grounds for some additional tax. The federal government allows the administration to add from 5 to 25 percent to the tax as a penalty for negligence, unless the fault is shown to be due to good cause and not to willful neglect.

Public Inspection. Much argument has surrounded the question of whether income tax returns should be available for public inspection. The prevailing practice both in the United States and abroad is to treat the information upon income tax returns as highly confidential. In Great Britain this is carried to the point where a taxpayer may report by code rather than by name, the purpose being to eliminate all knowledge of one's personal affairs except by a single administrator.

Federal returns have usually been confidential documents available only to public officials and committees of Congress, although at intervals federal statutes have permitted a limited inspection; that is, they have given the public access to a summary sheet which omitted the detailed accounts of the taxpayers' incomes. Even this limited inspection privilege has now been

discontinued. However, state administrators now have access to the full information. All of the American states except Wisconsin hold income tax information strictly confidential.

Arguments for Free Inspection. It is argued that free inspection is an aid to administration since it makes it possible for individuals to check each other's income and for the public to check the administration. Experience in Wisconsin has shown that the former of these checks has been seldom used but that the latter has resulted in important exposures on several occasions. The federal government makes huge refunds—millions of dollars at times—to many taxpayers. It is often claimed that these refunds are principally to campaign contributors—men and corporations who have helped to put the existing administration into power. These accusations never have been proved true, and it is possible that they are entirely groundless. It is difficult, if not impossible, to disprove them when the returns are closed to public inspection. Confidence in the honest administration of the income tax is important and the secrecy feature may considerably lessen it.

There is another strong argument for free inspection; namely, that facts regarding income have an important bearing upon many public issues and may be put to legitimate use by those who seek them. The taxation of certain corporate dividends, for example, have been an important question of taxation policy in Wisconsin. The governor, members of the legislature, and candidates for public offices have gone to the income-tax files for specific information concerning this question. Or to choose a very different illustration, farmers, puzzled over what they might do to rescue the dairy industry, have gone first of all to the tax commission to find out what the middleman's profits have been. The income tax files are a reservoir of information, some of which can be used to good advantage by those engaged in research; at present probably only those on the staff of the United States Treasury or state tax commissions may utilize federal data for this purpose. It is true that nonidentified statistics would often do as well as specific information, but this is not always true, nor are the former always available.

Further, it is contended that the distribution of wealth and income is certainly one of the main economic problems of our time and that the public is entitled to all the facts it can get bearing upon this problem. What Mr. X received as president and principal stockholder of the XYZ Company and precisely how he obtained it may have been no one's concern but his own 50 years ago. However, it is not necessarily so today.

Arguments Against Free Inspection. Partisans against free inspection believe that taxpayers will more readily supply information and more completely report their income if they know that their returns will be kept strictly confidential. Where free inspection prevails, taxpayers sometimes return very incomplete information, not because they wish to evade taxes but because they refuse to disclose detailed information and business secrets to their rivals, creditors, and others. The incomplete return hinders ad-

ministration, particularly at the office-auditing stage. Moreover, information on income tax returns is used for building up "sucker lists" from which commercial or investment houses solicit patronage for goods or investments often of doubtful repute.

Conclusion. Both of these negative arguments have some validity, particularly the first one. Nevertheless, it seems to the author that the scale is tipped in favor of free inspection. The privilege of having the facts about one's income known only to the recipient, the Treasury, and God, is one of the "rights" of private property which might well be eliminated. It is possible that a satisfactory dividing line between legitimate and illegitimate uses might be drawn by administrators without mandatory legislation by Congress. Unfortunately though, administrators usually underestimate the public interest in the accessibility of returns.

Simplicity. The federal income tax has been much criticized because of its alleged unintelligibility to the lay taxpayer and citizen. An equitable income tax law under modern conditions could not possibly be simple. But it seems quite probable that improvements could be made both in the form and the substance of the taxpayer's report. It seems hardly necessary, for example, to have both a normal and a surtax at the present time.

An illustration of how involved income tax English may become is here submitted from the Revenue Act of 1926:

> NET INCOME OF CORPORATIONS DEFINED
>
> Sec. 232. In the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by sections 234 and 206 (back in part I) [Sic], and the net income shall be computed on the same basis as is provided in subdivisions (b) and (d) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.[31]

Recently the federal government devised and authorized a simplified return for taxpayers with small incomes confined to certain sources such as wages, dividends, and interest. An arbitrary reduction in income is allowed in lieu of deductions. The tax need not be computed but can be readily determined by tables supplied with the return.

Miscellaneous Considerations. There is a widespread belief among informed critics that if the income tax is to assume a major role in the postwar tax system it must be given much stronger administration. At present, investigation is too largely confined to points where large returns can be had for the investment of effort. Policing the tax to ensure compliance may have great value in terms of morale even though it yields scant immediate

[31] *Proceedings of the National Tax Association Conference*, 1926, p. 185.

returns. The federal government is far indeed from the point where it could be said: "No source of information which would ensure full compliance with the tax laws is neglected."

There is much complaint, too, that the administration is onesided, seeking only to protect the revenue and neglecting the interest of the taxpayer when he is entitled to protection. The theory of American administration seems to be that a competent staff of administrators shall be pitted against an equally competent and much better paid staff of accountants and lawyers representing the taxpayer and that justice will somehow be achieved as a result of the contest. The British system invokes a much more neutral attitude on the part of both the officials and the taxpayer's representatives. Both are expected to protect the public's interest in fair play. Much would be gained for good government-taxpayer relations if the spirit of British administration might be cultivated in this country.

Administrative Machinery. Federal income tax administration has been characterized by a high degree of centralization both in the handling of returns and, until recently, in the administrative settlement of disputes over tax assessments. The controlling central agency has been the administrative and technical staff of the Bureau of Internal Revenue at Washington. Field agencies of the Bureau include 64 collectors and collection districts, each with a number of zone offices for the dissemination of information; a corps of regional supervisors for co-ordination of the work of the districts; the 38 divisions of revenue agents (auditors in the field); and the recently created ten field divisions of the technical staff. For judicial settlement of tax disputes, the Tax Court (formerly Board of Tax Appeals) has been created.

The collectors collect the taxes, audit and retain the "small" returns which show net incomes of less than $5,000, and check the larger returns for mathematical errors. All of these larger returns are then sent to Washington where the final decision is made as to which of them shall be accepted as they stand and which shall be submitted to the revenue agents for verification by office and field audit. If the result of such an audit is contested by the taxpayer, he is entitled to a hearing in the local revenue agent's office. The first administrative appeal from the final determination of the revenue agent-in-charge formerly had to be carried to Washington. The present innovations in federal machinery seek principally to decentralize facilities for conference and administrative appeal; final administrative determination of tax liability is now presumably in the hands of the division offices of the technical staff. First judicial appeal is normally to the Tax Court; the Court is an expert quasi-judicial body entirely independent of the Treasury, which greatly facilitates prompt settlement of voluminous litigation. Not all cases are submitted to it, however, for the taxpayer may and often does elect to pay the specified tax first and then sue for recovery in the district court or, less frequently, in the court of claims. Appeals from the decisions of any of these three bodies

are carried to the circuit courts and thence, if necessary, to the Supreme Court.

Even with the decentralization of machinery now in progress, the federal administration will be much more centralized than the British. Great Britain and North Ireland are divided into 725 districts, each under an inspector who has very substantial powers and who succeeds in making a final determination of the tax in the overwhelming majority of cases.

Income tax administration in most of the American states is highly centralized, though recently, as in the federal system, an attempt is being made in several states to decentralize it. Wisconsin has had the opposite experience. Starting with about 40 districts, consolidations have reduced the number to 4.

Centralized administration facilitates unity of procedure, expertness of personnel, and ease of supervision. Its weakness lies in its inadaptability to, and lack of familiarity with, varying local conditions. The absence of convenient local facilities is often a hardship for the taxpayer. To compel a large taxpayer in San Francisco to travel to Washington in order to confer about a disputed point in his income tax return is obviously an imposition. Undoubtedly some compromise between the extremes of centralization and decentralization is desirable, though just what degree of each will prove most satisfactory is still not entirely established.

It goes without saying that a merit system for the selection and promotion of personnel in the administration of income taxes is highly important. Income tax procedure is highly complicated and requires trained and skilled administrators. If the staff is chosen or turned out of office on political grounds, administration suffers badly. Only a few of the states have a merit system protected by statute or constitution, and not even all of those which have such systems are able to make them function successfully. The federal government has a statutory merit system which works quite successfully, but until very recently the collector's staffs were not subject to this system and the collector himself is still outside the system. Both state and federal personnel is weakened by the continual seepage of trained men into more remunerative private practice.

Although not much is known about state income tax administration, it can be said with assurance that it is frequently quite inadequately supported and feeble in spirit. It can also be said that the income tax, of all taxes, requires competent, alert, and vigorous administration. If the tax sometimes seems disappointing in its operation and its yield, the first clue to examine is not the law, but its administration.

PROBLEM

In 1944, Mr. Jones has net income from the following sources in the amounts specified:

Interest on federal World War Savings Bonds	$ 100.00
Interest on City of Los Angeles Bonds	100.00
Dividends from the Burlington Railroad	100.00
Gross income from grocery business	5,000.00

Mr. Jones has the following expenses:

Automobile expense and depreciation		$ 500.00
Addition to the store building		1,000.00
Fuel, light, and water for the store		200.00
Depreciation on store building		400.00
Dues to the Rotary Club		20.00
Subscription to magazines:		
Fortune	$10.00	
Retail Grocers' Review	3.00	13.00
Expenses of unsuccessful candidacy for Mayor		25.00
Property tax on his residence		200.00
Expenses of son at college		200.00

Mr. Jones is married and has a dependent son. If personal credits of $500 for himself and each dependent are allowed and if the tax rates are 10 percent on the first $2,000 of taxable income and 15 percent on the second $2,000 of taxable income, what tax will Mr. Jones have to pay?

CHAPTER VIII

Difficult Applications of the Income Tax to Capital Gains and Losses, Corporations, and Their Security Holders

The previous chapter introduced the income tax and treated some of its problems of definition and administration. The present chapter will be devoted principally to the application of the income tax to capital gains and losses, corporations, and their stockholders.

CAPITAL GAINS AND LOSSES[1]

Past and Present Treatment of Capital Gains and Losses in the Tax Laws

The treatment of capital gains and losses (usually gains or losses incidental to the sale of securities or real estate) is one of the most difficult issues in personal income taxation. The canons of simplicity and stability have been violated frequently, and often severely, in laws covering capital gains and losses. The main methods for the taxation of capital gains include treatment of such gains like other income with no deduction for losses, taxation with full allowance for losses, and classified taxation of gains with losses deductible only against gains of a similar class. The reduction of gains and losses by percentages dependent upon the length of time the assets have been held by the taxpayer, the application of maximum rates, and various provisions for the carry-over of losses not currently usable to offset gains, have provided additional refinements. These features have been used in various combinations during the past thirty years. The 1944 law classifies gains and losses as short-term when the assets to which they pertain have been held six months or less. Short-term gains are taxed like other income.

[1] This section is based in large part upon a manuscript by the author entitled "Postwar Taxation and Economic Progress," to be published by the McGraw-Hill Book Co., and sponsored by the Committee for Economic Development, 1945.

Long-term gains may be reduced to 50 percent of their amount in reckoning income subject to the regular tax, or they may be taxed separately at a maximum rate of 25 percent. The treatment of losses is parallel except that they (whether long-term or short-term) can be deducted from capital gains in full and from other income up to a maximum of $1,000. Moreover, a five-year carry-over of unused losses is permitted. The treatment of capital gains and losses for corporations is generally similar (including the provision for a 25 percent maximum rate on long-term gains) but there are some differences, such as the absence of the percentage reduction.

The British ignore both capital gains and losses in their income tax. In recent years, however, the definition of a capital gain or loss has been restricted to exclude profits arising from transactions of a trading and speculative nature. Profits arising from ordinary changes in investments remain outside the scope of the tax unless they constitute a regular source of income. The British practice involves arbitrariness and practical difficulty in drawing a line between taxable and nontaxable income. Moreover, the system is criticized on the score that it invites evasion; devices are available whereby dividends and interest can be converted into tax-free capital gains.

It would also be possible to tax capital gains and allow losses through an independent tax not integrated at all with the income tax.

Characteristics of Capital Gains

Capital gains provide a minor source of income in the economy and they are received by relatively few taxpayers. On the other hand, they are often a major source of income for particular individuals, and the total income derived from them is by no means negligible. Over the fifteen-year period from 1926 to 1940, the estimated net revenue from capital gains (with allowance for losses) constituted 15.2 percent of individual income tax receipts. Capital gains tend to be concentrated in the upper brackets of income but capital losses are more prominent in the lower brackets.

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

Realized capital gains and losses are not regularly recurrent, as is most other income. One may have a substantial gain or loss this year and never again in a lifetime. In the case of a group of people or that of an owner of many securities there is some degree of recurrence, but the pattern is far from regular.

Realized gains are frequently converted into new investments, whereas realized losses often result in new investment of a lesser value than the original; quite often neither is reflected in the recipient's scale or standard of living.

Realized capital gains and losses may be manipulated (to some extent) to suit the taxpaying interest of the recipients.

Issues in the Taxation of Capital Gains

Several outstanding issues in the taxation of capital gains and losses may now be discussed.

Are Capital Gains Income? This question was considered to some extent in the previous chapter. Recapitulating and expanding the argument there presented, one may observe first that capital gains and losses result from the sale of assets, not different in many respects from an ordinary trading profit. They are an important element in the distribution of economic power. They are closely related to other forms of income. Corporate saving, as previously noted, may be realized to the stockholder in the form of a capital gain. Recognition of the latter as income is an essential step in the eventual inclusion in the stockholder's tax base of what he gains through corporate investment. A discount on a bond is a substitute for interest to be paid. In the case of a corporation, the buying and selling of securities are often closely integrated with other business of the concern; and, even in the case of individuals, the difference between buying and selling as a business and doing so as an investment avocation is rather artificial. If depreciation and obsolescence of physical capital are (negative) income, the depreciation and appreciation of investment assets seem entitled to the same status. It may seem that a line should be drawn between short-term (speculative) and (long-term) investment gains, labeling the former income and the latter something else, but the distinction is not convincing.

Equity and the Taxation of Capital Gains. Is it equitable to tax capital gains like other income? The answer to this question is rather clearly and all but unanimously affirmative. Capital gains, like other income, represent taxpaying ability. With utilization of net income as a measure of taxpaying ability, it is essential to include all items of personal income in the base.

To be sure, capital gains are often, as the British would say, "casual income." This means that they are often quite irregular in their realization. But most income is casual to some degree. The main objection to taxing casual income is that, since it occurs irregularly, it is punished by the application of the higher rates in a progressive scale. We need some new techniques in our income tax to permit refunds or credits where the tax on annual income over a period of years exceeds what the tax would have been on average income.[2] The development and adoption of such techniques is a primary prerequisite for any reasonable and satisfactory solution to the problem of taxing capital gains.

If capital gains are to be taxed, the present system of permitting them to be wiped out by the death of the taxpayer is unjustifiable. Gains and losses accrued on assets transferred at death or by gift should be treated as realized by decedents and donors. (At present, the "basis" of assets received by an

[2] Discussed more fully in the next chapter.

heir is their value as of the date of death and not their cost to the donor.) At the present time, many capital gains are never realized; stocks may remain in the hands of one family for generations and the values that accumulate as a result of corporate reinvestment never appear in the personal income tax base. The same is not equally true of losses, for in their case the taxpayer stands to gain by an early realization.

Discouragement of Exchanges. Would the taxation of capital gains at full personal income tax rates greatly reduce the exchanges of investment capital and destroy the liquidity of such capital? Many have answered this question in the affirmative and have based thereon the conclusion that capital gains should be treated with care by the tax system. Why should a taxpayer make an exchange of investments if, by so doing, he must forfeit a substantial part of his income-earning assets to the government?

This appears to be the strongest and soundest argument for low-rate taxation of capital gains. But it is by no means conclusive. Account must be taken of the fact that at present it is not so much the tax on capital gains that discourages exchanges as it is the loopholes in the tax. If one is to be taxed on his gains eventually anyhow and a favorable opportunity for an exchange now presents itself, the transaction may appear desirable in spite of a tax on capital gains. It is true that postponement would leave more capital in the hands of the taxpayer. But he might also consider the embarrassment attending the combination of taxes at the time of death and the higher bracket rates (in spite of averaging) that might then apply.

There is a question as to how much the social interest is involved in the matter of liquidity of investments. It is not demonstrated that some restraint upon the willingness to exchange securities would be disastrous.

It has been claimed that the taxation of capital gains has a perverse effect upon the stock market. When times are good and the stock market is booming, taxpayers retain stocks which they might otherwise sell. This tends to create an artificial scarcity of stocks, which aggravates the boom. The opposite influence in times of depression tends to aggravate an already demoralized market. But, if some persons hesitate to sell stocks because of an anticipated tax, it is equally plausible to assume that others will be deterred from demanding stocks which promise a quick speculative profit. Were the owners to sell one kind of stock, they would probably use the funds derived from the sale to purchase and therefore increase the demands for other stocks. Thus the supply of and demand for stocks may not be greatly disturbed by a heavy tax on capital gains.

Capital Gains Taxation and Enterprise Incentives. Capital gains, along with dividends, are the principal return for risk-taking, and the latter is of great strategic importance in a dynamic economy. Moreover, new enterprises might obtain new capital were it not for the unwillingness of investors in established enterprises to exchange investments and thus realize capital gains and pay taxes.

On the other hand, there is no real difference between capital gains and dividends as incentives that would justify a special classification and especially favorable treatment for the former. Losses are undoubtedly an extremely important element in the psychology of incentives. A taxpayer's willingness to take risks will withstand high tax rates on his gains if he is assured parity treatment for his losses.

If, in "incentive taxation," it is reasonable to draw a distinction between business and wealth, principal concern should be for the former. The capital gains tax is more a levy on wealth than one on business. Like the death tax, it says in effect to the active businessman: "We will spare you to some extent while you are developing your business and employing your funds actively in the interest of society, but when you retire we shall have to insist on a settlement with the tax system."

Parity Treatment for Losses. Should capital losses be given a status in full parity with that of capital gains? The feature of our present practice especially resented by investors is the segregation of losses with the provision that they may be offset only against similar gains. Many taxpayers feel that the government is guilty of sharp practice in taxing their gains and ignoring their losses. Emil Schram, President of the New York Stock Exchange, relates the reaction of many investors as follows: [3] "I know that this is a sound venture and I know that it needs equity money, but I won't go into it because if it succeeds, I will have to give most of my gain to the Government, while if it fails, I will have to bear all of the losses myself." One-way rules usually cause resentment, and there is a strong presumption against them.

Segregation and limited deduction privileges for losses are logical defenses against the propensity of taxpayers to manipulate the realization of gains and losses. But taxation of gains and the allowance of losses "realized" at death, plus the development and application of averaging, would make such manipulation much less attractive and feasible.

Conclusion. In conclusion, the best answer to the problem of capital gains taxation seems to be that of treating capital gains like other income. If this were done, the tax rates on high incomes might be moderated. Fluctuating income should be given the benefit of an averaging feature added to the income tax system. The proposal should include the granting of parity treatment for losses, which in turn is conditioned by the proposal to tax gains and allow losses accrued to assets at the time of the owner's death.

[3] Testimony of Emil Schram, Hearings, Revenue Revision of 1942, Ways and Means Committee, House of Representatives, 77th Congress, 2nd Session, p. 923.

THE CORPORATE NET INCOME TAX

Introduction

The corporate net income tax as used in Great Britain is mainly a device for collection at the source. Stockholders are credited with the taxes collected from the corporation in their behalf. Where, as under our recent federal laws, the stockholder is allowed no credit for the corporate tax, the latter must be regarded as a business tax as such. Is this procedure warranted?

Arguments Concerning the Justification of a Corporate Income Tax

Application of the Ability Principle; Graduated Rates. The ability-to-pay principle is most readily applied to natural persons and, when it is employed to justify taxes on the corporate entity as such, many difficulties arise. Whether corporations have or do not have a soul has been frequently debated. Probably they would be the first to proclaim their capacity to suffer. But, in the last analysis, only natural persons pay taxes. The equity doctrine seems more logically applied to the corporation as an association of individual stockholders than to it as an entity in its own right.

The difficulty in the application of the ability principle to the corporate entity can be seen in the use of a graduated rate for the corporate tax.

Corporate net income as such tells us nothing about the rate of return on capital. A concern with a $50,000 income may have a 100 percent return upon investment, whereas one with a $1,000,000 income may be earning a mere one percent. That there is a necessary correlation between the size of corporate business and its profitableness has not been established. Looked at from the viewpoint of the owners, taxing a corporation on its net income affects them unequally because their equities vary in size. A $50,000 corporate income received by a corporation virtually owned by one stockholder represents more ability to pay per dollar of income than a $150,000 corporate income received by a corporation owned by 1,500 widows and orphans

The principal way in which the ability doctrine finds logical application in the taxation of the corporate entity is through recognition of the fact that corporate earnings represent the potential income of (in most cases) relatively well-to-do stockholders. Most dividends are received by those in relatively high brackets of income. But the application, to say the least, is highly rough and haphazard.

Benefit and Special Privilege. A case for a corporate income tax can be made by approaching the matter from the angle of benefits received, or, perhaps more accurately, the cost of the corporation to the government. Governmental services are a factor of production and it can be argued that business should pay for these services accordingly. However, it is not very logical to apply a cost doctrine only to corporations that make a net profit.

Moreover, if part of the cost tax is shifted to the consumers, the business tax takes on the aspect of a consumption tax.

Sometimes it is contended that corporations receive special benefits from government in such legal privileges as limited liability (by which is meant that stockholders are not liable for debts of corporations, as are partners for debts of partnerships) and that these special benefits justify a special corporate tax. However, these legal privileges are available to all for the asking, and, under free competition, their value should be nothing. It is true that competition is not that efficient, but business income taxes make no pretense of measuring the results of monopolistic competition.

Social Control. Some defense for the taxation of corporations can be made on the score that such taxation provides a desirable tool for social control. One such use (which does not, however, require a general corporate income tax) is attempted through the taxation of intercorporate dividends. Formerly, intercorporate dividends were entirely exempt from taxation. Now they are included in the base of the recipient corporation to the extent of 15 percent of their amount. This feature of the law is designed partly with the objective of discouraging holding companies. The holding company device probably has legitimate uses but it greatly complicates the financial structure of American business and makes for concentration of control. Probably adequate regulation would be a more suitable tool for controlling the abuses of intercorporate ownership. (The powers of the Security and Exchange Commission are largely confined to the public utility field.) But until such control is developed, these taxation devices probably will continue to fill a useful function.[4]

The corporate net income tax with graduated rates or a specific exemption can also be used to favor small corporations and unincorporated business.

Bond Interest and the Corporate Tax

There is also the question of whether bond interest should be a deductible expense if corporations are to be taxed under the net income tax. Legally, there is a difference between a bondholder and a stockholder in that the former is a creditor of the corporation whereas the latter is its proprietor. Actually, there is not very much difference between many stockholders, particularly those who have no voting power (or do not exercise it) and bondholders. If bond interest were not deductible, the tax burden upon corporations financed by stock and those financed in large part by bonds would be more equal. On the other hand, a tax on "operating income" (with no de-

[4] In present corporate tax procedure, corporations that have a high degree of overlapping ownership are permitted to file a consolidated return. This type of return facilitates administration and is defended on the ground that several very closely related companies really operate as one unit. On the other hand, it allows losses to be offset within the family of companies when they could not be thus utilized in the case of independent concerns. In compensation for this advantage, concerns using a consolidated return are required to pay an additional tax of 2 percent on their combined net income.

duction for interest) could force a business into bankruptcy. Inclusion of cost elements in the income base would make the tax easier to shift. Bonds are long-term contracts, and the change to a tax on operating income would involve grave problems of transition. Nevertheless, if the corporate tax, as such, is to be maintained, there is strong ground for shifting to operating income as the base.

A General Business Income Tax

Another issue is whether corporations should be singled out for special taxes when partnerships and individual enterpreneurs are not.[5] One difficulty here is that there is no clear definition of what constitutes a business. Is farming a business? Should the professions be included? If an arbitrary line must be drawn somewhere, the point between corporations and other businesses may be as reasonable as any. As a practical matter, little but confusion is accomplished by attempting to include businesses other than corporations in a business tax.

Conclusion

The taxation of business as such, like the taxation of most property under the property tax, finds little logical support except on opportunistic grounds. It does provide substantial revenue. Also, it can be added that ways and means must be found to prevent avoidance of personal taxes through the use of corporations as savings banks. This is the problem of taxing undistributed earnings, of which more will be said later. Here it can be added that our present unwillingness or inability to apply personal taxes to the impersonal corporation creates no end of confusion.

CASH DIVIDENDS

Introduction. The complications which beset any attempt at just taxation of income earned through the corporate institution become particularly apparent when the corporation, stockholders, and the various ways of disposing corporate income are all brought into the picture. The problems arising here vary with the disposition that is made of the corporate income; that is, whether it is distributed to shareholders in cash or its equivalent, stock dividends, or not distributed at all. Our attention will now be turned to these problems.

Cash Dividends and the Personal Income Tax. One of the questions of policy in taxing corporations and stockholders is the treatment of cash dividends under the individual net income tax. It is argued by some that, since

[5] This will be given further consideration in Chapter XI.

the corporation pays a tax on its earnings, the stockholder should not be subject to an additional tax (or at least not a full tax) on these same earnings when they are distributed to him as dividends. To tax these earnings twice, it is claimed, is discriminatory double taxation. The corporate tax is merely a device for collecting at the source and, once the tax is collected in this manner, it should absolve the stockholder from all or at least part of his personal responsibility. Moreover, to tax both the stockholder and the corporation is to discriminate in favor of the corporation which is partly financed through bonds, since the latter is not taxed on what it distributes to its bondholders.

On the other side of the argument, it is contended that the corporation is very definitely a legal entity separate and distinct from its stockholders; and this distinct-entity doctrine is often used to the advantage of the corporation, as, for example, in the matter of limited liability. Why should not this same doctrine now be applied to the disadvantage of the corporation? Furthermore, the corporation's tax may be regarded as a business tax and justified by the benefits business as such receives from the government. In that event, it is not illogical to include dividends in the measure of the personal tax paid by stockholders. To the layman, dividends are certain to appear like any other income and to afford the same ability to pay as any other income.

Moreover, in some cases, notably in the public utility field, corporations largely pass on their taxes to the consumer. In this case the stockholder escapes both the direct and indirect burden unless dividends are included in his taxable income. The same may be true of a preferred stockholder of any prosperous corporation; his dividends are not directly affected by the tax which the corporation pays. And finally, since the corporate tax treats all stockholders alike in the indirect burden it imposes upon them, it is only by taxing the individual that a suitable differentiation may be made in making the progressive rates applicable to them.

Present Treatment of Cash Dividends. The federal government formerly taxed cash dividends only under the surtax and exempted them from the normal tax. Since 1936 they have been subject to both taxes. Many of the states which tax corporations under the net income tax do not tax the recipient of dividends from those same corporations. In the case of dividends from corporations doing business both in and out of the state and subject to the state tax on only part of their income, various procedures are followed. Thus Wisconsin uses an arbitrary "50-50" rule; that is, if 50 percent or more of the corporation's income is earned in Wisconsin and subject to tax there, the dividends from such corporations are entirely exempt to the stockholders; but if less than 50 percent of the corporation's income is earned in the state and is taxable in the state, then the dividends received by Wisconsin stockholders are subject to the individual tax in full. This is a highly arbitrary rule, at best, but much simpler than the alternative of including

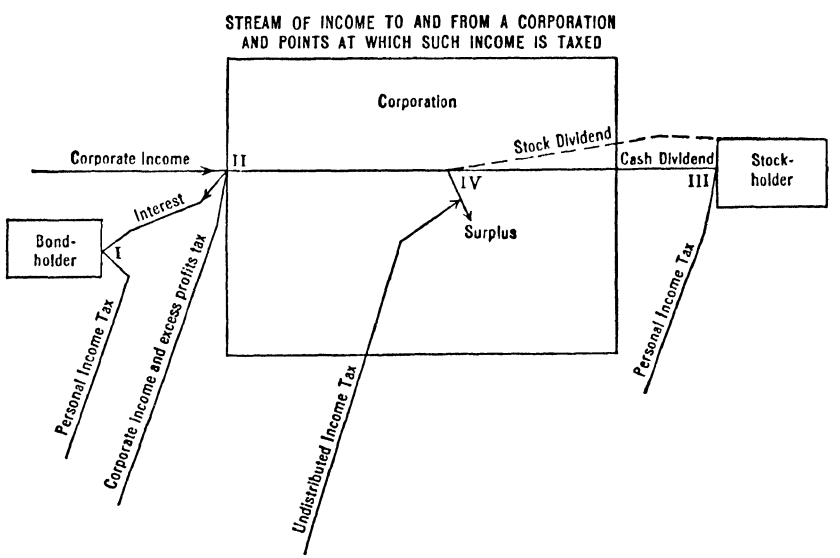
dividends in the taxable income of stockholders in inverse ratio to the proportion of income earned within the state by the corporation which distributes these dividends. Treatment of cash dividends throughout the states ranges from exemption (which may take the form of an exclusion, a deduction, or a credit) to additional taxation.

THE TAXATION OF STOCK DIVIDENDS

Introduction

Much more difficult than the taxation of cash dividends is the problem of taxing stock dividends. Figure 2 below presents a diagram showing the course of income earned by a corporation and the various points at which it may be taxed. It will be noticed that corporate receipts paid out to the

FIGURE 2



bondholder are not regarded as income to the corporation, but are taxed at point I to the bondholder as part of his individual income. Point II is where the net income of the corporation is subjected to the corporate net income tax and the excess profits tax. Once income has passed by point II, it may go through the corporation and be declared as cash dividends or it may stay in the corporation. If the former is the case, the income will be subject to a personal tax at point III. If the latter is true, then the undistributed corporate income (addition to surplus) may be taxed at point IV. The corporation may also declare a stock dividend but, as will be observed presently, this distribution is not ordinarily taxed to the stockholder.

The Nature of Stock Dividends

There are several kinds of dividends which may be declared by a corporation and received by a stockholder. The first is a cash dividend, which consists of a payment by check or cash. The second is a stock dividend, which consists of a payment in stock issued by the corporation. And the third is a "dividend-in-stock," which consists of a payment in the stock of some other corporation. Perhaps it will help to clarify the nature of these distributions if their effects are illustrated in accounting terms. Taking cash dividends first, assume that corporation A has recently been organized, that it has

Stage	*Corporation*	*Capital* *	*Capitalization* †	*Assets*	*Liabilities*
1.....	A	$1,000,000	$1,000,000	$1,000,000	$1,000,000
2.....	A	1,200,000	1,000,000	1,200,000	1,000,000 in stocks 200,000 in surplus or undivided profits
3.....	A	1,000,000	1,000,000	1,000,000	1,000,000 in stocks

* Income-earning assets of the company.

† Par value of outstanding stocks and bonds of the company.

raised $1,000,000 by the sale of capital stock, and that this sum has been invested in plant and equipment. This is Stage 1 above. Stage 2 is at the end of a year's operation, after $200,000 of undivided profits have been accumulated. Stage 3 is immediately after a declaration of a cash dividend. It is apparent that what takes place in the case of a cash dividend is a transfer to the stockholders of those assets of the corporation which were acquired as earnings. Now the corporation is just where it started; it has no surplus or undivided profits, having transferred them to the stockholders. But the profits so transferred are subject to the personal income tax as part of the stockholders' income.

The nature of stock dividends may be illustrated as follows:

Stage	*Corporation*	*Capital*	*Capitalization*	*Assets*	*Liabilities*
1.....	A	$1,000,000	$1,000,000	$1,000,000	$1,000,000
2.....	A	1,200,000	1,000,000	1,200,000	1,000,000 in stocks 200,000 in surplus or undivided profits
3.....	A	1,200,000	1,200,000	1,200,000	1,200,000 in stocks

Assume that corporation A, starting with $1,000,000 of capital (Stage 1), earns $200,000 dollars by the end of its first year of operation. This is depicted in accounting terms at Stage 2. Let us now assume that the earnings are reinvested in the corporation's plant and that stock dividends have been declared, each stockholder receiving his proportionate share of reinvested earnings in the form of new stocks. The result is shown in the illustration as Stage 3. It will be noted that the corporation has lost none of its capital, and also that the capitalization has been increased and that the surplus or undivided profits have been converted into additional stocks. Aside from the taxation of corporate income as such, unless there is some form of undistributed profits tax, these profits are ordinarily subject to no further tax[6]—quite in contrast to their fate had they been distributed in cash.

The nature of a dividend-in-stock may be illustrated as follows:

Stage	*Corporation*	*Capital*	*Capitalization*	*Assets*	*Liabilities*
1	A	$1,000,000	$1,000,000	$1,000,000	$1,000,000
2	A	1,200,000	1,000,000	1,200,000	1,000,000 in stocks 200,000 in surplus or undivided profits
3	A	1,000,000	1,000,000	1,000,000	1,000,000 in stocks

Assume that corporation A, after accumulating $200,000 of undivided profits, invested this money in the stocks of corporation *B*. These stocks are now a part of corporation A's capital and must be listed among its assets (Stage 2). At Stage 3 a dividend-in-stock is declared, after which the company is in the same position it would have been in had it never purchased corporation *B*'s stocks but had declared a cash dividend. And like the latter, this income (dividends-in-stock) is taxable in the hands of the stockholders.

Are Stock Dividends Income?

The question whether stock dividends may be regarded as income has come before the United States Supreme Court on several occasions and its answers have been mainly in the negative.[7] Its decisions, as well as the considerable supporting comments by students of the subject, are based mainly on the following grounds.

[6] Except as reflected in realized capital gains.

[7] Eisner v. Macomber, 252 U. S. 189 (1920). Although it is here held that stock dividends are not income and may not be taxed as such, they may afford the taxpayer a taxable capital gain if and when he sells his stock. The Supreme Court has since substantially qualified the doctrine enunciated in this case, as will be later explained.

The Stockholder Receives Nothing of Value. It is argued that when a stock dividend is declared the stockholder receives nothing of value. He obtains a piece of paper which is evidence of the fact that he now owns, let us say, two-sixteenths of the corporation instead of one-eighth. This argument may be plausibly answered by stating that it is not the mere act of declaring dividends which gives the stockholder advantage, but the accumulation of the profits over the months preceding the division. As a matter of fact, the mere declaration of a *cash* dividend gives the stockholder little if any advantage. The stockholder is "in" some cash, but he is "out" the expectation that he is about to be paid cash. Or to put it another way, what he gains personally, he is out in the decreased equity which the corporation has to divide. Why is a stock dividend not quite as much an advantage to the stockholder as a dividend-in-stock? [8] Both can be sold on the market for cash; and when either is sold it leaves the stockholder with the same equity in the corporation that he held when it started business.

A Stock Dividend Is Not Realized. A further contention is that an advantage must be *realized* to constitute income and that nothing has been realized in the case of a stock dividend declaration. Realization would seem to be a matter of having "a bird in the hand" instead of one "in the bush." There are contingencies which might intervene between the stock which is received as a stock dividend and the stockholder's enjoyment of his gain. But is this not true also in the case of a dividend-in-stock?

Realization of income is obviously a matter of degree. To illustrate, suppose a certain person buys an orchard and undertakes to raise apples. Let us assume that by the first of September a very good crop appears to be ready for harvest, but, for one reason or another, it is left on the trees for a while. According to the reasoning in Eisner v. Macomber, as long as the apples are still on the tree they do not constitute an income, since they are still subject to many contingencies such as storms, thieves, and the like. After the harvest is completed and the apples are stored in the owner's cellar, are they then income? No, perhaps not, because a great many "things may happen" to apples stored in cellars. Now suppose the owner takes part of the apples and trades them for a yearling calf. Has he finally received an income from his investment in the apple orchard? Perhaps not, according to the same reasoning, for quite as many "things may happen" to the calf as to the apples. If now the calf is sold and the seller receives a check in payment, the advantage is still not entirely secure. Checks are not always convertible into cash. But let us say that he has the cash and uses it to purchase groceries from which his wife prepares a meal for him. He eats the meal; is then "the bird" finally "in hand"? Not necessarily, for there are possibilities that the individual may suffer indigestion from the food and thus enjoy no final satisfaction from it.

[8] A dividend-in-stock has been held by the United States Supreme Court to be income.

Where along this line should we say that the individual's advantage is sufficiently realized to call it income? Probably most statutes and administration would draw the line at the point where the apples have been exchanged for the calf. The exchange may not make the seller's position more secure, but it does constitute a transaction which more or less closes one episode of production. It is the closing entry in the apple account, so to speak, after which the accountant may draw his double lines and begin over again. Could not the capitalization of corporate income into stocks also be regarded as a closing operation and hence a realization?

The above illustration is not submitted as a perfect analogy to the stock-dividend situation; it is intended to show: (1) that realization is a matter of degree; (2) that the degree required to make receipts income is an arbitrary matter; (3) that an operation which seems to close an account even though it does not make the receipts more secure is accepted as a realization; and (4) that stock dividends could be interpreted as such an operation.

A Stock Dividend Is Not Separated from Capital. It is also argued that there must be a separation from the corporation before the stockholder can realize an income. If the corporation and the stockholders are separate entities, how can the stockholder receive anything if nothing is severed from the corporation? In the case of a dividend-in-stock, it is clear that certain assets of the corporation are plucked off and handed to the taxpayer. In the case of a stock dividend, however, there is no plucking and the corporation loses nothing at all so far as its assets are concerned. The stock dividend constitutes a mere memorandum of the accumulated equity in the corporation which the stockholder's shares represent.

The Supreme Court could logically base a decision that stock dividends are not income on the ground that no separation from the corporation's capital takes place when such a dividend is declared. This at least is one aspect in which a stock dividend differs from a cash dividend or a dividend-in-stock. However, the Supreme Court itself has been unwilling to follow this logic. In the case of Koshland v. Helvering,[9] subsequent to that of Eisner v. Macomber, it decided that stock dividends declared in preferred stock to a common stockholder are income. Obviously, no more separation from a corporation's assets takes place when a surplus is capitalized and issued as preferred stock to common stockholders than when it is issued to them in the form of common stock.

Stock Dividends and the Assets of a Corporation. The final contention is that stock dividends are not income because the issuance of common stock to common stockholders does not change their proportionate claims upon the company. A stockholder who owned one-tenth of the corporation's stocks hitherto will now own two-twentieths. This does not hold, it is said, when preferred stock is declared to common stockholders, or presumably

[9] Koshland v. Helvering, 298 U. S. 441 (1936).

when common stock is issued to preferred stockholders. By the issuance of different types of claims to the existing security-holders, the company disturbs their relative proportionate shares in itself. The Supreme Court's latest decisions apparently rest upon this distinction between two classes of stock dividends. The distinction is a true one, but it does not seem very significant.

The problem so far considered has dealt only with the question: are stock dividends income? Another question, related, but by no means identical with the previous one is: should stock dividends be taxed?

Should Stock Dividends Be Taxed?

As has been observed, the Supreme Court of the United States has decided that stock dividends (with the qualifications previously indicated) are not income. This makes it impossible for the federal government to tax them, since the 16th Amendment opens the field of taxation without apportionment only to taxes imposed upon income. But the fact that the Court was divided in the Eisner v. Macomber case, and that a well-reasoned minority opinion was presented, indicates that the legal issue involved is a close one and might have been settled either way. Probably the Supreme Court should have left the matter for Congress to decide, not on the basis of fine legal distinctions but on the basis of national policy. Some of the state courts took this position and in consequence many of the state legislatures passed upon the issue, deciding eventually that it is better as a matter of policy not to tax stock dividends.

Even as a policy, the exemption of stock dividends poses a difficult question. It can be contended that stock dividends are a useful and legitimate instrument in corporate finance and that their use would be very limited were they subject to tax. (As a consequence of and immediately following the Eisner v. Macomber decision, there was a sudden increase in stock dividends.) Their usefulness consists in the fact that they enable the corporation to satisfy its stockholders without sacrificing any assets. The device considerably facilitates and encourages corporate saving, whether for better or for worse. And it aggravates the problem of inequality in the tax burden which must be borne by the stockholder if corporate income is distributed, compared with that which must be borne if it is reinvested. Even if stock dividends were eliminated, however, the problem of treating reinvested corporate earnings under the income tax would remain. This latter and larger problem will be considered later in this chapter.

THE EXCESS PROFITS TAX

Introduction. It would be possible to impose a corporate net income tax according to the ratio of income to capital rather than according to the

amount of income. Differentiation might take the form of either a graduated rate, or an exemption, or both. Where earnings up to a certain percentage on capital are exempt from taxation, the levy is usually referred to as an excess profits tax. This method of taxing a corporation is thought by some of its proponents to be the only true method of gauging and taxing the ability to pay of the corporation (if we can think of corporations as having ability to pay) and the only logical justification of a graduated rate.

Neither the federal government nor the states have ordinarily attempted to tax corporations according to the rate of return on capital. Under the original Wisconsin law, however, the tax was graduated according to the rate of return upon capital, which in turn was evaluated according to the local property tax assessment of the corporation's assets. This method of evaluation omitted intangible assets (exempt under the property tax) and was so palpably unfair and difficult to administer that the system was speedily abandoned in favor of the present more usual method of taxing corporate income.

The excess profits tax, as we usually think of it, is a business tax rather than a part of the income tax system. However, it figures in the picture of the income tax as applied to corporations and stockholders. For that reason a brief consideration will here be given to the nature and problems of this type of tax and the present federal application of it.

History and Explanation of Machinery of Operation. The excess profits tax in the United States has been used chiefly in times of emergency. During the First World War the federal government made use of it in two different versions. One was called a *war profits* tax and was based upon the excess of earnings during the war years over the average earnings of the same taxpayer during the three prewar years—1911, 1912, and 1913. The other was an *excess profits* tax and was based upon earnings in excess of what was considered to be a normal rate of return (8 percent in 1918) upon capital. The two taxes were alternative rather than supplementary; that is, the government collected whichever of the two was higher. The profits taxes were in addition to the corporate net income tax, although the former were allowed as a deduction in computing the latter. Under the 1917 law, the excess profits tax applied to unincorporated business and also to personal earnings in excess of $6,000, but, because of widespread dissatisfaction with these features, they were shortly abandoned.[10]

A so-called profits tax was inaugurated as a part of the federal government's depression tax program in 1934. However, this tax is usually and properly regarded as an administrative feature of a capital stock tax which accompanies it. The taxpayer declares a value on his capital stock and, if the figure is so low that subsequent earnings exceed a specified ratio to it, the excess earnings are subject to a tax. The tax is unimportant in its own right

[10] C. C. Plehn, "War Profits and Excess Profits Taxes," *American Economic Review*, Vol. X, No. 2, June 1920, pp. 283-298.

and will be discussed in more detail in Chapter XI in connection with the capital stock tax.

War profits taxes were reintroduced during the Second World War. The new version of the profits tax, following the model used in the First World War, calculated excess profits on alternative bases; one, the excess of present profits over those earned in prewar years, and the other, the excess over stipulated percentages of return upon invested capital. However, the taxpayer and not the government was allowed the choice of alternatives. This meant that a concern must earn both high profits and increased profits to be subject to the tax. The Coca-Cola Company fared easily because, although its profits were high, this had also been true in the prewar period. The United States Steel Corporation fared well for the opposite reason—its profits were substantially increased by the war but were still very moderate in relation to its large capital. The prewar years chosen for comparison were 1936 to 1939, inclusive, and the taxpayer was allowed 95 percent of its average earnings over this period as one alternative base. The percentage of invested capital used for the other base varied from 5 to 7 percent according to the amount of capital employed. Excess above the chosen base was taxed at 95 percent (1943 law) but normal tax, surtax, and excess profits tax combined might not exceed 80 percent of the surtax net income. A postwar credit was allowed to the extent of 10 percent of the excess profits tax. Other provisions allowed a two-year carry-over or carry-back of unused excess profits tax credit; provided for the exclusion of the profits tax base from the base of the corporate income tax; and sanctioned the use of borrowed capital and the interest on borrowed capital to the extent of 50 percent of their amounts in calculating invested capital and profits respectively.

The war excess profits tax is an example of the propensity of Congress to levy a tax at conspicuously high rates and with a relatively "easy" base. The rates are boosted to satisfy the public demand, and other terms of the tax are fitted to suit the taxpayer. As a matter of fact, war excess profits taxation has been far less effective than one would suppose from observing the tax schedule and also less effective than the circumstances demanded.

Included in the system of preventing excessive war profits was a program for renegotiating government contracts and of price control. The former allowed the government to survey the experience of war contractors after assignments had been completed and to revise the terms of contracts if the experience proved more favorable than expected. Although a difficult administrative task, this innovation proved very effective in preventing excessive profits at their source.

Consideration of the Excess Profits Tax as a War Measure. As a war measure the excess profits tax has many points in its favor. It is a safeguard against profiteering at a time when competitive checks on excessive earnings are weak. The state can quite plausibly claim an equity in the extraordinary profits created by its own outlay. A profits tax is a part of a control and

taxation program designed to prevent inflation. It is offensive to the national conscience to contemplate unjust enrichment growing out of the nation's misfortune. Profits taxes have proved very productive when revenue was badly needed.

On the other hand, a temporary tax on the margin of income (in excess of "normal profits") at very high rates offers a strong invitation to squander resources. The common illustration is that of advertising campaigns, largely at the expense of the government (because the income thus spent would otherwise be taken in taxes). Wartime patriotism can be counted on to check this tendency to waste but not to eliminate it. Profits taxes involve multitudinous points of subtle distinction and classification, and they are extremely difficult to administer. An exceedingly complicated law is necessary to cover the many conditions to which it must apply, and much even then must be left to administrative procedure. The problem of determining invested capital (what has been invested in the company's equipment) is one major difficulty among many. When recent legislation was introduced, there were cases still pending in the courts dealing with the determination of invested capital under the 1918 Act.[11]

A Peacetime Excess Profits Tax. The principal objective of a peacetime excess profits tax is to recapture monopoly gains. A major difficulty is to isolate such gains. In practice, to tax monopoly profits may mean that efficiency and risk profits will also be singled out for special taxation along with monopoly rewards. A return of 10 percent on invested capital may be excessive in the case of a concern with a steady income, small risk, and mediocre management, but is this true in the case of a company (perhaps a mining concern) with a highly fluctuating income, a high risk factor, and very superior management?

An excess profits tax is in no sense a regulatory and preventive measure like public utility rate control and the renegotiation of contracts. We cannot even be certain that the "recapture of monopoly profits" will be at the expense of the monopolist rather than the consumer.[12] *Preventive* measures for monopoly that might be further developed include the regulation of the corporate institution, business practices and combinations. In extreme cases monopoly may warrant price control or public ownership. Monopoly profits can be taxed in the hands of individuals as well as in those of corporations.

The monopoly problem in a highly developed economy is an extremely tough nut to crack, and no weapon for dealing with it should be lightly discarded. But the excess profits tax in its present state of development is a

[11] Testimony of Colin F. Stam, Joint Hearings Before the Committee on Ways and Means and the Committee on Finance, 76th Congress, 3rd Session, 1940, p. 102. See also Carl Shoup, "The Taxation of Excess Profits," *Political Science Quarterly*, Vol. 55, 1940, pp. 535-555; Vol. 56, 1941, pp. 84-106; 226-249; "Excess Profits Taxation," *Law and Contemporary Problems*, Vol. X, Winter, 1943, No. 1.

[12] See Chapter VI.

crude and undiscriminating "control." It seems unlikely that an attempt will or should be made to add an excess profits tax to the peacetime tax system.

THE TAXATION OF UNDISTRIBUTED PROFITS

The Problem. Mention has been made several times in this chapter of the problem of applying the tax system to undistributed corporate earnings. A combination of corporate income taxes and personal income taxes leaves a wide gap and an important discrimination. The gap is in the failure to apply the personal taxes to corporate savings, although the latter redound to the benefit and increase the economic power of individual stockholders. The discrimination lies in the fact that heavy taxes are levied on the income which passes through corporations but not upon that which is "plowed back."

According to Treasury estimates, during the decade ending in 1933, corporations reinvested on the average about 30 percent of their profits. During the late twenties, the figure was about 40 percent.[13] The most conspicuous example of corporate growth by reinvestment is that of the Ford Motor Company. One authority states that, according to the meager evidence available, the Ford Company paid out in dividends only 100 million dollars over a 23-year period, during which the profits for the corporation amounted to 924 million dollars.[14] Another study places the intangible invested capital of the company at 694 million dollars in 1926, of which all except $40,000 was provided by the reinvestment of profits.[15]

Impact of the Tax System on Undistributed Earnings. Attention has been called to the fact that capital gains may represent reinvested earnings and that such gains are taxed to the stockholder when realized. However, realization may be indefinitely postponed by retaining ownership of securities, and it is avoided entirely by the death of the taxpayer. Stock dividends represent capitalized reinvested earnings and these are taxable under certain conditions as previously discussed. Income withheld by a corporation from distribution *for the purpose of avoiding individual taxes* is subject to a special tax intended to be prohibitive. This provision has been in the statutes for many years but it is seldom applied because of the difficulty in proving intent to evade. There is no clear line between income withheld to evade and that retained to meet "the legitimate needs of the business." Certain personal holding companies, as will be explained later, are also taxed at special pro-

[13] *Revenue Act, 1936, Hearings*, p. 18, U. S. 74th Congress, 2nd Session, 1936, Senate Committee on Finance.

[14] Edward S. Mead, *Corporation Finance*, revised ed., D. Appleton-Century, New York, 1933, p. 343.

[15] L. Seltzer, *Financial History of the American Automobile Industry*, cited by J. E. Amos, *The Economics of Corporate Saving*, Illinois Studies in the Social Sciences, Vol. XXII, University of Illinois, Urbana, 1937, footnote, p. 67.

hibitive rates on the theory that they are obviously tax-dodging devices. Of course, corporate income and profits taxes apply to all corporate net income regardless of disposition, but they do not compensate at all for the fact that the personal tax applies only to distributed income.

The Undistributed Profits Tax of 1936. Much interest attended the federal government's first attempt in 1936 to tax undistributed earnings. The levy was an additional tax with rates graduated from 7 to 28 percent according to the proportion of income left undistributed. The tax was vigorously opposed and much resented by the business world. It was reduced in 1938 and repealed in 1939.

It was argued for the tax that it was a move in the direction of equity. It would either force the distribution of earnings, in which case they would be subject to the personal tax, or, if this did not happen, the compensatory corporate tax would apply. It was also argued that untaxed corporate reinvestment tends to aggravate oversaving. In addition, it was said that a small ring of insiders, the corporate management, often use undistributed profits to enhance their power and that the special tax would defeat this "tyranny of the board of directors."

Opponents of the undistributed profits tax contended that it undermined the will to build adequate reserves required for conservative corporate management; that it created undue hardship in obtaining corporate capital and thus discouraged investment; and that it was prejudicial to small and growing companies which find it especially difficult to recruit new capital upon the open market.

The experience with the undistributed profits tax of 1936 was not a happy one, but the very real problem which this experiment sought to solve remained after the levy was repealed.

Proposals Seeking a Solution of the Problem. From the theoretical standpoint, much the best solution of the problem of applying the tax system to undistributed earnings would be to disregard the corporate entity entirely and tax the stockholder on his pro-rata share of corporate income whether or not distributed. As applied to the general run of corporations, this procedure has no modern precedents and it encounters some substantial practical difficulties. In the case of corporations with several kinds of securities and complicated intercorporate holdings, it may not be easy to say how undistributed income would have been distributed had such been the decision. Every correction in corporate net income would mean an adjustment in the net income of all of its stockholders. The taxpayer is likely to regard income accrued to him through corporate saving as a bird in the bush rather than one in hand. There is some doubt that the Supreme Court would permit the taxation to the stockholder of what legally is the property of the corporation. It is quite possible that these difficulties, formidable as they are, will not prove conclusive and that this solution may eventually be found workable. Perhaps it could be applied to the very large number of small

corporations along with a high undistributed profits tax in the case of large companies.

As previously suggested, a more rigorous application of the tax system to capital gains would ensure the eventual application of the personal tax system to reinvested earnings. This system would fall short of equal treatment for reinvested earnings by virtue of the delay in the application of the tax. It would not allow the stockholder to cash in on his holdings and use them for consumption without the application of the personal tax, but it would allow him to accumulate large sums and much economic power before he became subject to the tax.

The British system of corporate taxation applies the standard low-bracket personal income tax rate to all corporate income. On the portion undistributed, the tax constitutes in effect an undistributed profits tax, and the system substantially reduces (but does not eliminate) the differential in burden upon what is and what is not distributed. Combined with an effective program of taxing capital gains, the system may represent the best available solution of the problem.

Proper treatment of undistributed income is sure to be a major item on the agenda of postwar finance.

CHAPTER IX

Other Income Tax Problems

PROPER ROLE OF EXEMPTIONS AND GRADUATION

Exemptions. There are several reasons for income tax exemptions and credits for dependents: (1) they protect a subsistence standard of living; (2) they provide a basis for differentiating among taxpayers according to need; (3) they avoid the administrative inconvenience of extending the personal tax to millions of small taxpayers; (4) they help to preserve the market for consumers' goods; and (5) they afford the political advantage of applying the direct tax system to relatively small numbers of taxpayers.

These reasons may be considered briefly in turn. The first—allowance of a subsistence standard—appeals quite properly to humanitarian impulses. But subsistence is a flexible standard depending on what a country can afford, what the economy produces, and the services a government provides its poorer citizens. Then, too, government is quite as much a necessity as any of the other elements of subsistence.

The second reason for exemption—differentiation—is undoubtedly valid, but it affords justification only of allowance for dependents. In judging credits for minor dependents, the effect on the birth rate may also warrant consideration.

The third ground for exemption—administrative convenience—probably is sufficient basis for some allowance. Much here depends upon the development of better techniques in administration.

As to the fourth reason, it is true that purchasing power can be protected by exemptions. However, where high exemptions lead to inadequate yields in the personal tax and the result is a shift from the personal tax to regressive substitutes, nothing is gained for purchasing power.

Finally, there is strong political opposition to low exemptions. Very frequently a congressman is more interested in the number of people affected by a direct tax than in any other aspect of the tax. A high level of self-discipline is required for the citizenry to finance itself mainly by a direct levy.

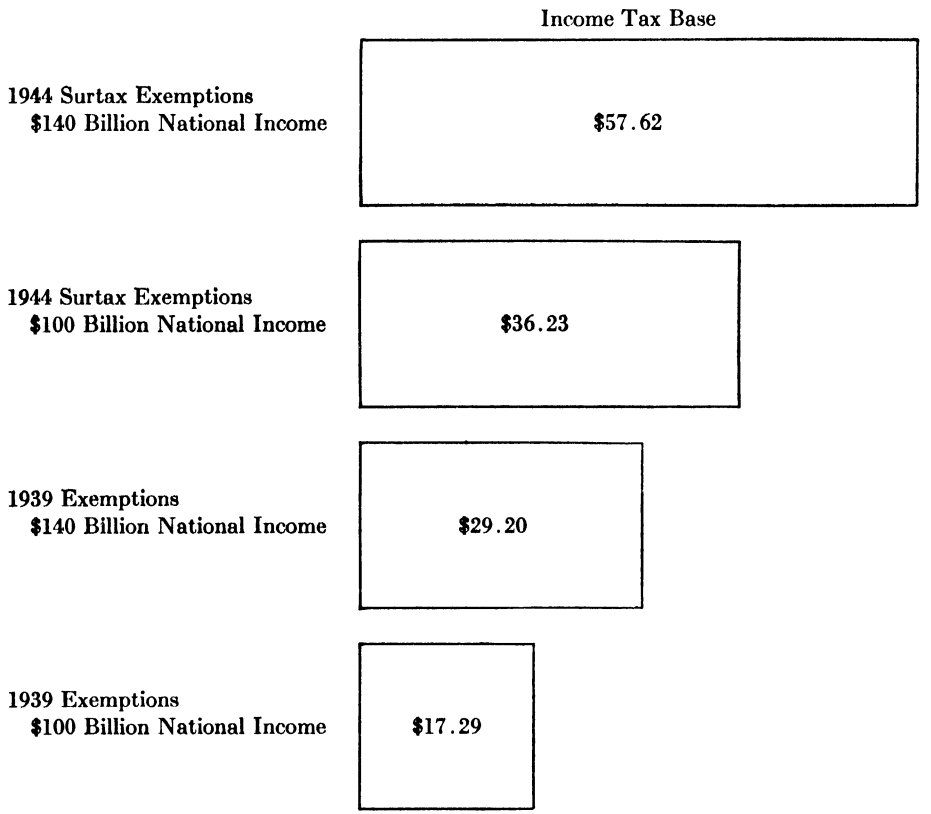
With income tax exemptions of $500 for the taxpayer and each of his dependents and a national income of 140 billion dollars, fully 60 percent of

the national income would be outside the tax base.[1] Income escaping the tax base would consist of: (1) the personal exemptions allowed those who pay no taxes; (2) the personal exemptions allowed taxpayers; (3) the deductions (such as those for other taxes and contributions); (4) exempt income

FIGURE 3

ESTIMATED INCOME TAX BASE UNDER VARIOUS ASSUMED CONDITIONS

(Figures in Billions)



(such as interest on certain government bonds); and (5) underreporting or administrative leakage.

Figure 3 shows the income tax base under various conditions of income and personal exemptions. It will be observed that, under the unfavorable conditions of prewar exemptions and a $100 billion national income, the

[1] The subsequent chart and some of the discussion in this section are from a manuscript by the author entitled "Postwar Taxation and Economic Progress," to be published by the McGraw-Hill Book Co. and sponsored by the Committee for Economic Development, 1945.

tax base would be about $17 billion—less than most estimates of federal postwar budgets.

It is easy to demonstrate that $1,000 for a married couple is insufficient to provide them with all the necessities, let alone the amenities, of life; but it is also easy to demonstrate that 40 percent of the national income is insufficient to support, without confiscatory rates, a government that goes in for all the services we expect from ours. Generally, income tax laws err on the side of excessive rather than inadequate exemptions.

The refinement of income for tax purposes might be compared with the process of extracting radium from ore; after the deductions and exemptions and other allowances are all disposed of, a scarcely visible base may remain to be taxed. The base is pure surplus, sure enough, but even if it were all confiscated it would not pay for the cost of "running the government."

States and municipalities that have been casting about for new sources of revenue and experimenting with dubious sales and gross income taxes might consider the possibility of developing a new species of tax—a net income tax without exemptions and with no deductions except for expenses involved in creating the income. This would provide a broad base upon which a low flat rate would provide very substantial revenue. This type of tax would have important advantages over the property tax—it would be truly proportional whereas the property tax in practice is regressive. The tax would not, like the present ones, reduce inequalities in income, but the leading role in accomplishing this purpose must be left to the federal government. The suggested differentiation in type of levy would counteract the objection that state and local income tax development constitutes double exploitation of a field already exhaustively tilled by the federal government.

Importance of the Standard Rate. Because the income structure is like a pyramid, with the bulk concentrated in the base, an adequate "standard" or first-bracket rate is very important for the revenue. The importance is enhanced by the fact that surtaxes are usually differentials based on the standard rate. Moreover the first bracket, to which the standard rate applies, is usually the most stable element in the income tax base. With national income of about 140 billion dollars and 1944 exemptions and brackets, about two-thirds of the income base would be in the first bracket of taxable income.

Place of Graduation. Enough income lies in the apex of the income pyramid so that the use of substantial graduation in the income tax can add materially to the revenue. More important is the fact that the graduated feature is a means of reducing inequalities regarded as undesirable in a democratic nation. Reduced inequalities are important for their own sake, but they also may be necessary to maintain a proper balance between saving and spending. As previously observed, the principal check on progression is the need for preserving incentives. It can also be said that rates should not be carried upward to the point where Congress is not willing to enforce them

effectively or apply them consistently. Whatever may be the effect of high rates upon other incentives, there can be no doubt that they provide a powerful incentive to avoid and evade.

METHODS OF EVADING OR AVOIDING THE FEDERAL INCOME TAX

Ethics of Avoidance. Evasion and avoidance differ in that the former involves a breach of law whereas the latter does not. Avoidance, though within the law, may raise some interesting questions of ethics. Is a wealthy man morally justified in paying large sums to the proverbial Philadelphia lawyer in order that he may discover loopholes in the income tax law? Perhaps most people should regard their income tax as a contribution which they are privileged to make toward the joint enterprises of mankind. Actually, they are more likely to regard the tax as a game between the taxpayer and the government, with the taxpayer's goal the payment of the least possible amount of taxes. The good will of the taxpayer is an important and much neglected asset in the administration of all taxes. But with an economic system and distribution of wealth based primarily upon power, it is perhaps a little academic to expect taxpayers to contribute more in taxes than the law requires.[2] It is thus "up to" the government to devise tax laws which are free from loopholes. This is not easy in a highly complicated economic order; certain time-honored institutions—notably, the corporation and the trust—aggravate the difficulty.

Methods of Avoidance Previously Discussed. Some of the more common guises of evasion and avoidance have already been mentioned. Except for the following three, which are treated quite extensively in other chapters, they will be discussed in more detail here.

1. Tax-exempt securities.[3] This is one of the most conspicuous and, in the author's opinion, one of the most "pernicious" loopholes in the existing law.
2. Capital gains on assets held until after the taxpayer's death.
3. Reinvestment of corporate earnings.

[2] In England, where civic responsibility is highly developed, the courts have repeatedly recognized this tendency to use all available legal means to reduce taxes. This was very aptly expressed when the Lord President of the Court of Session, Edinburgh, remarked that "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow—and quite rightly—to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue." (Ayrshire Pullman Motor Services and D. M. Ritchie v. C. I. R. (1929) 14 T. C. 754.) Quoted from Findlay G. Shirras, *Science of Public Finance*, Macmillan and Co., Ltd., London, 1936, Vol. I, p. 502.

[3] This loophole has been explained in Chap. VII and is discussed in more detail in Chaps. XIX and XX.

The Personal Holding Company and Multiple Trusts. By the incorporation of an entity between the taxpayer and the sources of his income, the taxpayer can delegate his investment functions to this impersonal intermediary and thus escape high surtaxes. To illustrate how this device works, suppose Mr. X, who owns most of the stock in the ABC operating company, exchanges it for stock in the IOU investment company. By this means Mr. X is able to invest his earnings without receiving any dividend upon which he would be liable to high surtaxes. Recently, intercorporate dividends have been made partially taxable. Previously the IOU investment company would not have been taxed at all.[4]

Recent federal statutes have attempted to plug the personal holding company loophole in several ways. When a company falls under a statutory definition of a personal holding company, its income is taxed at high rates. The law now provides that when a corporation has 50 percent or more of its stock owned directly or indirectly by not more than five persons and when 80 percent or more of its income is from investments, it is a "personal holding company" and is singled out for especially heavy taxation. Rents are included in the 80 percent, unless they constitute more than half of the total income of the company. The 1937 law also classed as a personal holding company the corporation receiving its income in large part from the services of one individual. Foreign personal holding companies are to be disregarded for income tax purposes; that is, their income shall be included in the accounts of the people who own them. In addition, since 1934, intercorporate dividends have been partially taxed.

It would seem that these new provisions of the federal law should prove

[4] The taxpayer may incorporate his personal holding company abroad as well as at home, and at one time the former procedure was far more advantageous in avoiding the federal law than the latter. By incorporating his securities in the Bahama Islands, Newfoundland, or other low or no-income-tax countries, he could escape the high personal surtaxes and be subject only to a relatively low flat rate on the income of the corporation. How prevalent and at the same time ludicrous this practice became within a comparatively short period was disclosed in the testimony of Treasury officials before the Joint Committee. Two shacks in the Bahama Islands were said to have housed the "home offices" of over 100 American-owned corporations representing many millions of American capital. It was with no little curiosity and amazement that the sixty-odd thousand inhabitants of the islands, mostly poverty-stricken Negroes, surveyed this rapid corporate development of their native land. (*Hearing, Tax Evasion and Avoidance*, pp. 162-191, U. S. 75th Congress, 1st Session, 1937, Joint Committee on Tax Evasion and Avoidance; also *Prevention of Tax Avoidance*, pp. 6-8, U. S. 73rd Congress, 2nd Session, 1933, Sub-committee of the Committee on Ways and Means.)

A variation of the personal holding company device is the incorporation not only of a person's investments, but also of his hobbies, such as his yacht, racing horses, and so on. The yacht may be incorporated along with certain investments, income from which may be used to pay the expenses of its upkeep. In turn, the yacht is rented out at a nominal sum to the taxpayer and at a heavy loss to the corporation. One case cited in the 1937 testimony was that of a wealthy woman who incorporated her country place and employed her husband as manager, thus supplying him with pocket money and claiming a deduction for the outlay. Still another variation of the same idea was that employed by an artist who incorporated his talents and received only such personal income as he chose to let pass through the corporation.

an effective stopper against evasion through the personal-holding-company device. Except for the undistributed corporate income tax, evasion through an investment corporation not so closely held as the personal holding company is still possible. And, because of the elaborate definitions and details which the new provisions carry, still other opportunities for loopholes may be found.

A taxpayer may create a trust for the benefit of his minor child, the income therefrom to accumulate within the trust until some future date. The income is not legally part of the father's income, for he has irrevocably parted with all legal claims to it. Yet the income does not legally belong to the child. Legally it is the trust's income, and the law has included trusts among those required to pay personal income taxes. But if it is legally possible to create one trust, then it is legally possible to create 100 trusts. Until 1937 this would have meant 100 personal exemptions from the income tax. It still involves splitting a large income 100 different ways for purposes of avoiding the high rates of the graduated income tax. Thus, a man receiving and saving $1,000,000 a year from investments may divide himself like an amoeba into 100 taxpayers, each receiving $10,000. Until the 1937 law, each one of the 100 taxpayers was allowed $1,000 personal credit (for family needs?) and, in addition, all of the taxable income was crowded into the lower brackets. The former of these features has been repealed, but the latter is still in the law. In 1937 the Treasury suggested eliminating this latter feature also and requiring all trusts (having a common donor and beneficiary) to be consolidated for tax purposes. Going further, it would seem no more than fair that income of all trusts created by a common donor for the benefit of his immediate family (husband, wife and dependent children) should be consolidated with the income on his own personal return.

Family Income. Probably no source of evasion of the federal income tax among wealthy taxpayers is more common than that of giving or otherwise disposing of property to members of one's family. This reduces the taxpayer's holdings and income, usually without any actual loss of control over or benefit from his property. Although the beneficiary may be taxed on the income from the gift,[5] the high rates of the graduated income tax will be avoided.

Under the property laws of certain states, it is impossible to tax even the husband's entire salary as a unit. In these states the wife has a vested interest in half of the husband's income. A husband receiving a $100,000 salary is assessed on only $50,000; the other $50,000 is assessed to his wife. This means that the higher rates on income above $50,000 do not apply to the income of either half of the family. Since this rule concerning rights to the husband's property is not universal among the states, taxpayers with the same income are subject to widely different taxes, depending on the state of their residence.

[5] And the gift itself may now be taxed under the gift tax; see Chap. X.

The privilege of filing separate returns by husband and wife has been defended on the ground that it is in accord with personal taxation and the ability-to-pay principle. It is plausibly argued that two people should not increase their liabilities to the government by the (fiscally) unimportant act of getting married. But, on the other hand, it seems reasonable to hold that the family is more significant than the individual in measuring ability to pay. Government agencies and others interested in the distribution of income have long recognized this principle; in measuring the welfare needs and the economic status of the people they usually employ the family and not the individual as the unit. In the case of the higher incomes, where income is significant mainly as a matter of economic power, the family unit appears quite as appropriate as at the lower levels. If measuring income on a family basis (as is done in Great Britain) is politically unacceptable, somewhat the same result could be obtained by taxing husband and wife in all cases on a per capita basis. This would mean that a couple with a $10,000 income would pay exactly twice as much as a single person with a $5,000 income.

IRREGULARITY OF INCOME

A and *B* may have the same net income over a five-year period, but *A* may have much more in some years than in others, while *B* may have an even flow from year to year. In such a case the income tax, with its annual income base, annual personal exemptions, and graduated rates, falls with considerably heavier weight upon *A* than upon *B*. This is not only inequitable; it is also bad for incentives. Often, fluctuating income is associated with risk-taking, which, in the interest of a dynamic economy, needs to be encouraged.

Causes of Irregularity of Income. Irregularity of personal income may be due to many causes. Some arises from the sporadic sale of capital assets, previously discussed. Some is due to irregular dividends, which in turn may be due to fluctuating company earnings or to changes in dividend policy by the corporation. Some is casual, as in the winning of a prize, and some may be due to the short tenure of one's income-earning powers, as in the case of an athlete. At lower income levels, irregularity may arise from unemployment, crop failure, or an adverse trend in the market.

In the case of business, the most serious form of irregularity from the standpoint of income taxation is the occurrence of losses. Had all American corporations filed a consolidated return so that losses could have been fully offset against gains, their net income would have been reduced by more than 45 percent from 1922 to 1939.[6] Losses are especially characteristic of new small companies, and they are much more pronounced among equipment goods industries than among those producing consumption goods.

[6] Calculation based on *Statistics of Income*, United States Treasury Department.

Tax Concessions Allowed to Fluctuating Income. A carry-over of business losses, never longer than two years, was allowed intermittently in the federal income tax law before the Second World War, but no carry-over at all was permitted during the thirties when losses were large and persistent. During the Second World War, a carry-over and a carry-back of two years was permitted, thus allowing for a certain amount of averaging over a five-year period. The British allow a six-year carry-over. Beginning with 1927, Wisconsin inaugurated a system of basing its income tax on a three-year moving average. The system proved moderately popular during the good and improving years of the late twenties, when the lag created by the averaging feature favored the taxpayers. But, with the beginning of the depression in 1929, the lag began to operate against the taxpayers. Many found themselves paying taxes on ability to pay that had been nonexistent for some time. As no reserve had been set aside for this purpose, those without any income in 1932 objected most vehemently to paying taxes upon what they had received (and perhaps spent) in 1929. For this and other reasons the system was abandoned in 1934, leaving a two-year carry-over of business losses as a memento.

Proposals for Further Averaging. There have been many ingenious recent proposals aimed at a more equitable treatment of irregular income. One suggests that, if over a five-year period the total taxes exceed by more than 5 or 10 percent the amount which would have been paid had the average income been the actual income, the government should allow the taxpayer a refund or credit for the difference.[7] This would avoid most of the difficulties encountered in previous experience with averaging. Principal difficulty would occur in the administrative load arising from multitudinous computations. In the case of the lower incomes, much of the benefit of averaging could be offered by provision for a carry-over of losses and unused personal exemptions. Averaging as such could then be confined to higher incomes. Contrary to the general view, a sampling of returns indicates that, with or without this classification, principal beneficiaries of averaging would be the low-income groups. The matter of improved techniques for treating fluctuating income is of great importance both in itself and because of the contribution it could make toward a sensible solution of the capital gains issue. In spite of the conceded difficulties, further efforts toward progress in this direction are badly needed.

DIFFERENTIATION OF INCOME

In the typical net income tax system in this country, incomes are distinguished and classified mainly according to size, but it is also possible to

[7] Henry C. Simons, *Personal Income Taxation*, pp. 154-155.

differentiate them according to source. Such differentiation might be on ethical grounds, holding some income to be more legitimate and deserved than other income. For example, the income from rackets might be singled out for especially severe treatment. A second basis of differentiating income is according to the effects upon future production that taxing it might have. The thought here is that income is a necessary reward to draw forth the factors of production and that these rewards should not be paid unless necessary and they should be kept at the minimum required. Thus it is alleged that the landlord is the recipient of rent for the services of land which he did not create and which would be forthcoming without such reward. Finally, differentiation may be based on the idea that income from property is more potent than income from services. This is the basis of the favors to "earned" as compared with "unearned" income found in many income tax laws, including the federal law during most of the period from 1924 to 1943. It is said that income from services is less able than that from investments because the former is dependent upon the short and uncertain tenure of the human faculties.[8]

In spite of some valid defenses for the differentiation of income according to source, its wide application in the income tax structure does not seem advisable. Ethical distinctions are too subjective to serve as the basis of income classifications, and distinctions on the basis of effects on production are almost as difficult. Land rent and inheritances can be subject to special taxation outside the income tax field. Differentiation and graduated rates based upon quantitative measurement are not easily combined. The correlation between "earned" income and the size of income is not perfect but it is sufficient to allow some recognition of the special claim of service incomes in the application of graduated rates.[9]

JURISDICTIONAL PROBLEMS AND TERRITORIAL MULTIPLE TAXATION

State Personal Income Taxes in the United States

What Income May the States Tax? One of the most difficult problems which states are called upon to face in the administration of a state income tax is the determination of what income can and should be taxed as belonging within the state's jurisdiction. As applied to individuals, the question is which income shall follow the domicile of the taxpayer and which the source or situs of the income. The Constitution and the United States

[8] J. A. Hobson, *Taxation in the New State*; R. H. Tawney, *The Acquisitive Society*, Harcourt, Brace & Howe, New York, 1920; John R. Commons, *Institutional Economics*, Macmillan, New York, 1934.

[9] Harold M. Groves, "Commons' Theory of Reasonable Value as Applied to Taxation," *Property Taxes*, Tax Policy League, New York, 1939, pp. 174-186.

Supreme Court allow the states a wide latitude in this matter. The Court has held that it is not illegal for the state in which the taxpayer is domiciled to tax all of his income wherever earned; nor is it unconstitutional for a state which has no jurisdiction over the taxpayer as such to tax all of the income earned within the state, whether from property, business, or salary. It is clear that a state may not tax the interest and dividends *received* by a nonresident from a corporation within the state, but there is legal precedent for sustaining a tax upon the dividends *paid out* by such corporation.

State Policies. When it comes to the matter of policy, state statutes differ considerably in their rules on jurisdiction. Wisconsin taxes only income "earned within the state," by which is meant that income from property or business follows the location of such property or business, and income from services and from intangibles follows the domicile of the taxpayer. Some states, e.g., Delaware, tax entirely on the domicile principle, taxing all income of individuals domiciled within the state regardless of where the income is earned. But many states, e.g., New York, tax residents on all their income wherever earned, and, in addition, nonresidents on the income (including service income) earned within the state. New York also provides an arrangement under which it agrees to credit the tax paid by a nonresident to his own state against the New York tax, provided the other state reciprocates.

Problem of Territorial Multiple Taxation. It will be observed that many chances for double taxation exist in the variety of state rules concerning jurisdiction. One residing in Delaware and owning property in Wisconsin is taxed twice on the income from such property. On the other hand, if the individual lives in Wisconsin and owns property in Delaware, he pays no tax at all upon the income from that property.

The Courts have been urged to set up strict rules of jurisdiction in the income tax field which would ensure that income can be taxed by one state and one state only. However, this raises the difficult question: If only one state is allowed to tax a certain income, should it be that of the taxpayer's domicile or that of the origin of the income? Faced with such problems, the present Supreme Court is likely to hold that these are matters for legislatures rather than the judiciary to decide. Credits to residents or nonresidents are sometimes allowed, but these also vary from state to state. Progress toward uniformity in legislation can be made by interstate negotiation, agreement, and reciprocal action. But, in these jurisdictional matters, state interests often conflict and each state is likely to follow its own advantage.

The multiple taxation problem in the operation of state income taxes is aggravated by the application of different rules as to the domicile of the taxpayer. Some states provide that, if the taxpayer spends 7 months or some other proportion of the year within their jurisdiction, this is sufficient to establish residence and personal jurisdiction over the taxpayer; others require

a more permanent domicile; and the location of permanent domicile itself may be disputed by two or more states.[10]

Procedure in Dividing Income of Interstate Corporations. When it comes to corporations, the problem of jurisdiction is quite as troublesome as in the case of individuals. Here the problem arises in the apportionment of the income of interstate corporations doing business within and without the state. Sometimes such corporations keep separate accounts of their business by states. There are judicial decisions which permit them to be taxed on such division unless it can be shown to be unreasonable. But ordinarily no division is attempted by the corporation, and the states are compelled to establish rules of procedure for making such division themselves.

One of the fairest systems of apportionment is that applied in Massachusetts, where the law lays down the general rule [11] that income of interstate corporations shall be apportioned according to the average of three ratios: relative tangible property, wages and salaries paid, and gross receipts (sales and rentals or royalties) within and without the state. The Wisconsin law is similar, also using three elements in its apportionment formula: tangible property, cost of manufacture, and sales. Thus, if a corporation has 70 percent of its tangible property in Wisconsin, 60 percent of its cost of manufacturing is incurred there, and 20 percent of its sales are made from Wisconsin offices, 50 percent of the entire net income is apportioned to Wisconsin and is taxable under its law. In practice, tax commissions find these formulas too general to be applicable to all interstate corporations and employ them as principles to be guided by rather than as hard and fast rules of measurement. The National Tax Association has recommended a standard formula which allows equal weight to three factors: tangible property, sales, and expenditures for wages and salaries.[12]

Territorial Multiple Taxation in Dividing Corporate Income. Application of the state income tax to corporate income creates serious problems of multiple taxation. If all states used the same standard for the division of corporate income, the problem would be unimportant. But the various states use different standards. Some, South Carolina, for example, use tangible property as the sole criterion; and others, Missouri, for instance, employ only sales as the basis for apportioning corporate income. This makes both complete exemption and complete double taxation possible. The former occurs in the case of a corporation that has all of its property in Missouri and makes all of its sales from a South Carolina office, while the latter occurs in the case of a corporation that has all its property in South Carolina and makes all of its sales from a Missouri office. On the whole, the courts have

[10] The problem of double domicile is discussed in Chap. X.

[11] The apportionment formula applies to certain business income only; income from securities, for instance, follows the domicile of the corporation.

[12] *Proceedings of the National Tax Association Conference*, 1933, p. 396; 1939, p. 190.

shown little disposition to tackle this problem by compelling a uniform procedure.

Territorial Manipulation of Income by Interstate Corporations. The courts have intervened to prevent the avoidance of the state corporate income tax by contracting away the income earned in one state to out-of-state subsidiaries. A Wisconsin corporation attempted to shift Wisconsin income beyond the jurisdiction of the state through the device of selling products manufactured in the state to an affiliated company outside of the state at a loss or no profit.[13] In another Wisconsin case the facts were reversed, that is, an out-of-state manufacturing company attempted to sell goods to a Wisconsin sales subsidiary at a price which would allow the sales company only a small and arbitrary profit.[14] In both of these cases the Tax Commission computed what it considered to be a fair profit for the Wisconsin corporations, and its authority to do so was sustained by the federal court.

Further Problems in Allocating Income. It should be apparent from what has been said that the origin of income is no simple matter to determine, and actually it is much more difficult than has been indicated. For example, the sales activity of a business is usually allocated to the state and municipality in which its sales office is located and *from* which it makes its sales. Waiving a number of very troublesome matters of definition in the application of this rule, the question arises as to whether or not the area in which the company's customers are located or from which it draws its labor supply (the area in which it does business in the broadest sense) may not have some claim to its income. Corporate income from intangible property (securities) is thought to belong to the state of the corporation's domicile. But it is not entirely settled whether this must be the state which issues the corporation its charter or may be the state in which it has its home office. Recent decisions of the Supreme Court seem to indicate that it may be taxable in both states.[15] In that case one may properly ask, why allow such an advantageous tax position to states like Delaware, whose sole connection with many corporations is its grant to them of the privilege of incorporation?

Jurisdictional Problems Among Nations

The problem of jurisdiction among nations is much the same as that among states; it is less acute in that the volume of international as compared with interstate transactions is less; but an additional factor of confusion occurs, namely, that of the citizenship of the taxpayer. Some progress in mitigating international multiple taxation has been made as a result of

[13] Palmolive Co. v. Conway, 43 Fed. (2d) 226 (1930).
[14] Buick Motor Co. v. Milwaukee, 48 Fed. (2d) 801 (1931).
[15] First Bank Stock Corp. v. Minnesota, 301 U. S. 234 (1937); Schuylkill Trust Co. v. Pennsylvania, 302 U. S. 506 (1938).

the efforts of the League of Nations and other organizations. Agreements between nations have also been useful in attacking the problem.[16]

PROBLEMS APPLICABLE TO STATE INCOME TAXES

Relation of the Income Tax to the Property Tax

All taxes in state tax systems are fitted more or less into the property tax framework, and the income tax is no exception. Historically, state income taxes have often been adopted as substitutes for part of the property tax and, even where this is not the case, the income tax is often judged by its impact combined with that of the property tax. Thus it is said that to tax both real estate and the income therefrom is unwarranted double taxation, especially if the income tax does not also duplicate but instead replaces the property tax on intangibles. Attempts to integrate the two taxes have included various property tax offsets, under which one tax or the other is allowed as a credit in meeting the other levy. But the offsets have not proved very satisfactory and have not been used widely. They involve the administration of two taxes to collect one and usually fail to improve the distribution of the tax load.[17] Massachusetts levies a classified income tax, under which income from certain intangibles is taxed at 6 percent; that from annuities, professions, business, employment, and trades at 1½ percent; and that from transactions in intangible personalty (less losses) at 3 percent. Vermont applies a rate of 4 percent on income from intangibles, as compared with the 2 percent it applies to other income. This appears to be a sounder approach to the problem of integrating the income and property taxes than the use of offsets. Classification, however, complicates the income tax law. It also precludes the use of a graduated rate, although Oregon, with an exceedingly complicated law, once attempted to apply a combination of a special tax on incomes from intangibles and a graduated tax on all income.

It is interesting to observe that the offsets seek to do just the reverse of what the federal law has provided in its concession to earned income. The earned income provisions seek to favor service incomes; the offsets seek to favor property incomes; the classified income taxes seek to favor both income from services and income from tangible property at the expense of income from intangible property. Perhaps some of these concessions are desirable, but they serve only to complicate the results when state and federal classifications contradict each other. Some states, such as New Hampshire and Ohio, apply the income tax only to income from intangibles. In these

[16] For an analysis of the problem of international multiple taxation in terms of principles, see E. R. A. Seligman, *Double Taxation and International Fiscal Cooperation*, Macmillan, New York, 1928.

[17] Herbert D. Simpson, "The Effects of a Property Tax Offset Under an Income Tax," *Proceedings of the National Tax Association Conference*, 1931, pp. 126-134.

states the income tax is entirely impersonal and is most logically conceived as a part of the property tax system. New Hampshire actually applies an average of the general property tax rates throughout the state to the income taxed.

Disposition of the Revenue

Income Tax as a Centrally Collected, Locally Shared Tax. Considerable dispute centers around the question of whether net income tax revenues are to be earmarked for state use or a part of them is to be returned to the communities where they are collected. The prevailing practice allows all revenue from the income tax to remain in the state treasury, with part or all frequently earmarked for state aids, particularly for education. The state-administered and locally shared system [18] is illustrated in Wisconsin, New York, and Massachusetts. Wisconsin now returns 60 percent of its income tax to the municipalities of origin, 50 percent going to towns, villages, and cities, and the remaining 10 percent to the counties. New York distributes 50 percent of its personal income tax receipts but on the basis of locally assessed property values. The New York system was expected to encourage the full value assessment of property but seems not to have been too successful in this objective. Massachusetts distributes all of its personal income tax receipts according to the latest state levy of taxes.

Two major difficulties arise in distributing income taxes according to origin, as in Wisconsin. One is that some municipalities receive more in revenue from this source than they need. The other is that origin, as previously explained, is difficult to determine, particularly at the municipal level. The income tax is largely an urban tax, and conflict between rural and urban communities is likely to develop over what should be done with the proceeds. The urban districts insist that taxes collected from income reported in their territory belongs to them and that the use of a large portion of the receipts to finance the state or for state aids is unfair. They call attention to the rapidly mounting urban expenditures and the necessity for high urban taxes on real estate to meet these expenditures. Subventions and subsidies, they say, result in the continuation of homes, farms, and superfluous governments where it would be better if they were abandoned. The rural and depleted districts reply that economic areas are larger than a particular city or county. The metropolis sells its goods and buys raw materials all over the state. Moreover, they claim that there is a common interest in many governmental services. For example, the metropolis is interested in rural education because, among other reasons, it draws heavily from the hinterland for its labor supply.

[18] Not to be confused with distribution in state aids. See Chap. XXIV.

Migration of Industry and Wealth

Fear of Driving Out Industry and Wealth. One of the main arguments with which proponents of state income taxes have always been confronted is that this type of taxation drives industry and wealth from the state which employs it and thus tends to destroy not only its own base but that of the property tax as well. It is a well-known fact that interstate boundary lines impose limits upon state control (as well as trade union control) of industry. This is one reason why the federal government is pressed to widen its field of activities. Even where state control and state taxation might in the long run prove beneficial to industry and wealth itself, the fear of "killing the goose that lays the golden egg," or in this case the fear of causing the goose to fly to some more congenial social climate, is likely to be an effective barrier to social legislation and taxation. Industry is constantly moving about for a variety of reasons, and it is a simple matter to make it appear that it is adjusting itself to relative tax or other government-imposed burdens.

State Income Taxes and Desirable Industrial Growth. It has never been demonstrated statistically or otherwise that the income tax within present limits has been prejudicial to the industrial growth of the states which have employed it. Such studies as have been made of the correlation between industrial progress and tax systems among the states have been inconclusive, but they have at least indicated that the income tax states have achieved their fair share of the country's wealth and industry.[19] The income tax may not be as bad a developmental tax policy as it is often made to appear. It imposes relatively light burdens upon infant industries—those which are building up and which have not yet been able to show large net incomes. It is true also that, important as taxes are in relation to net income, they are much less significant in relation to the cost of manufacturing. Taxes in general are not usually a major element in the decision of either a business or an individual seeking location to operate. Moreover, industrial growth may not always be a blessing, even though it is difficult to convince expansion-minded people of this. New needs for public expenditures arise along with the larger tax base. A happy balance between agriculture and industry may be preferable to a mushroom industrial growth. Parasitic industries, particularly, should be classed as a community liability.

Of very great importance, though not generally understood, is the fact that state taxes are a deductible expense in calculating federal income taxes. This means that the federal government collects less federal taxes from both corporations and individuals in states that have an income tax, and

[19] Geo. L. Leffler, *Wisconsin Industry and the Wisconsin Tax System*, Bul. No. 1, Wisconsin Bureau of Business and Economic Research, Madison, 1930.

Frank A. Hanna, *Wisconsin During the Depression*, Bul. No. 5, Wisconsin Bureau of Business and Economic Research, Madison, 1936.

Geo. A. Steiner, *The Tax System and Industrial Development*, Vol. XXXV, No. 58, Bureau of Business Research, University of Illinois, Urbana, 1938.

this helps reduce differential total burdens among the states. Where state taxes are deductible against federal and the reverse, a combination of an 80 percent federal and a 15 percent state rate is not a 95 percent total, as might be supposed, but a total of 80.7 percent.

Personal Exemptions in Terms of Taxes

Some state income tax laws now provide that personal exemptions shall be calculated in terms of tax rather than in terms of income. The more common and older rule was to grant the taxpayer a certain sum of untaxed income, possibly $800 if single or $1,600 if married, as an allowance for living expenses. This rule was objected to on the ground that the exemption was very much more valuable in dollars and cents to the taxpayer with a large than one with a small income. A taxpayer with a $500,000 income would have paid a tax on his exempt income, had it been subject to tax, at the highest or one of the highest bracket rates. One with less than $1,000 would have paid at the lowest bracket rate. Under the alternative system, exemptions are calculated in terms of tax at the lowest rates in the schedule. This makes the tax value of the exemption the same for all. Thus, assuming the first bracket includes $1,000 taxable at 1 percent and the second bracket, another $1,000, taxable at 1¼ percent, a single person would be allowed $8.00 off his tax instead of $800 off his income, and the married taxpayer would be credited with $17.50 against his tax instead of $1,600 off his income.

This new feature, when it was first inaugurated, was attacked on the grounds that it was unintelligible to the taxpayer and that it resulted in an increase in taxes, particularly for the taxpayer with many dependents. Moreover, the new system is subject to a theoretical objection. The exemption is properly regarded as an allowance for living expenses, and on this theory the true measure of ability to pay is the surplus remaining after living expenses are out rather than before. If this is true, the tax should be based on the surplus above living expenses, whereas the new feature bases it upon the income before living expenses have been deducted. The theoretical objection is sound, but, nevertheless, the new system is retained in Wisconsin, where it was first enacted, and has spread from there to several other states.

Special Limitations of State Income Taxes

Legal and Constitutional Difficulties. In many states (including some of the wealthiest and most populous) there are impressive legal and constitutional barriers to income taxation. For example, Illinois passed an income tax law in 1932, but it was declared unconstitutional by the state supreme court. In the opinion of the court, income is property and, according to the constitution of that state, all property must be assessed at a "just and uniform rate." There is, of course, the theoretical possibility of amending the

Illinois constitution, but an amendment, to carry, must receive in its favor a majority of the total number of votes cast at an election. Thus, failure to vote on an amendment is a vote against it. This and other restrictions make amendment to the fundamental law of Illinois extremely difficult. Similarly, in other states—among them Michigan and Indiana—the income tax has some very high constitutional barriers to hurdle.

Threatened Migration. An important factor retarding state income tax development is propaganda concerning its alleged effects upon industrial development. This problem has been discussed earlier in this chapter.

Productivity Likely To Be Low in the Agricultural States. It is reasonable, perhaps, to conceive of a state income tax strong enough to raise 20 or 25 percent of the revenue for state and local purposes in a state like Illinois. But what about a state like North Dakota, where there is very little corporate income to tax and where an individual with a $100,000 a year income is called a "financial baron"? North Dakota cannot expect to derive a substantial portion of its state and local revenues from its income tax unless it learns how to apply such a tax successfully to farmers and to people with small incomes.

The Debtor States. North Dakota's problem is much aggravated, too, by the fact that it is a debtor state and much of its income is paid over its borders to creditors outside the state. The property tax is collected where the roots of income lie, but the income tax more often goes to the state in which income is enjoyed. Income tax reformers would unintentionally aggravate this problem with the proposal that all income should be taxed in the state of the recipient's domicile. In this connection it is important to remember that debtor states also require revenue.

Instability of Yield. The income tax is notoriously a "fair weather tax" and its fluctuations in yield are likely to prove particularly embarrassing to states and municipalities, many of which can borrow for current expenses with considerable difficulty, if at all. To meet this situation, these units of government could build up a reserve in good years for use during lean periods. But this involves the political difficulty associated with changing administrations. Probably more promising are the possibilities of developing the kind of an income tax which would be less "cycle sensitive."

Should the States Tax Income? There are those who think that the income tax is an excellent source of revenue for the federal government but that the states should stay out of this field. Undoubtedly, central units of government have many advantages over their divisions and subdivisions in the administration and collection of income taxes. If the federal government, moreover, were to raise most of its revenue from its income tax, the place of that tax in the revenue system could be expanded without bringing the states into the field.

Under present circumstances the states are inevitably drawn into the income tax field. They and their subdivisions were spending, in normal times,

about two-thirds of the public dollar. The income tax is too important and meritorious a means of revenue to be ignored on so large a front. The states and their municipalities provide most of the prime essentials of government, including such personal services as education—which very properly might be supported by a personal tax on incomes. The alternatives to state income taxes are heavy federal aids to the states or distribution of part of the federal tax to the states from which it is collected. Both alternatives involve great difficulties and a generous surrender of sovereignty by the states. Finally, some of the states are more inclined to apply the ability-to-pay principle than others, and the state income tax gives them an opportunity to express this difference.

There are those who hold that the state income tax must be confined to an insignificant role because the national government has adopted a high schedule of rates. There is much validity in this contention. These people may be reminded, however, that all or nearly all taxes in the last analysis come out of income. The national income represents what there is to tax, and when it is exhausted there is nothing left for an income tax or any other kind of tax.

Recent decisions of the federal governments of Australia and Canada to "take over" their state and provincial income taxes during the war, returning a rough equivalent in funds, places the retention of state income taxes in the United States on the defensive. But the cause for such action here is considerably reduced by our system of allowing state income taxes as a deduction in calculating the federal tax and a similar provision for federal taxes in many of the states. It is not at all clear that the great task of financing the war would have been substantially simplified by such procedure. Considering the interest in maintaining independent sources of state revenue, such action could be recommended only as a last resort.

Two possible developments in state and municipal income taxes offer promising possibilities. The first is the use of the income tax as a supplemental levy based closely on the law of the central unit and administered by the latter for a cost fee. This would allow the local unit discretion as to rates. The second possibility is an independent levy with little, if any, allowance for exemptions and deductions (except for outlays in creating income) and with flat or mildly graduated rates. The latter type of tax might be more nearly proportional than progressive, but it could be made to yield large and relatively stable revenue and it would not involve problems of duplication with the federal system.

THE ROLE OF THE NET INCOME TAX IN THE TAX SYSTEM

Arguments in Favor of the Income Tax

It is a widely accepted proposition that on theoretical grounds alone the income tax should be the most important tax in our tax system. It represents the most rational means of taxation in a modern capitalistic state.

It is axiomatic that practically all taxes come out of somebody's income. The presumption is in favor of those which come out of income directly and in some relation to the size of the income.

The income tax comes nearest of all taxes to being a self-liquidating tax. Relatively speaking, it falls upon those who have the ability to pay *when* they have it. With reasonably efficient collection, tax delinquency among income taxpayers should be, and usually is, a nominal problem.

There was a time when most people thought equity in taxation requires distribution of taxes according to benefits received from the government. More and more people have by now come to regard ability to pay as the proper standard of equity in taxation. These people usually regard income as by all odds the best single measure of ability to pay.

The net income tax, more than most taxes, tends to "stay put" (is not shifted) and thus permits a fairly accurate calculation of its ultimate burden.

Whether or not levied for that specific purpose, income taxes, particularly where progressive, tend to reduce the inequalities in the distribution of wealth and, by so doing, to enlarge the market for mass production and to reduce the evils of concentrated wealth and power.

Criticisms and Limitations of the Net Income Tax

On the other side, the income tax is criticized as an unstable producer of revenue. This is particularly important for states and municipalities. In the case of the federal tax some instability may be a virtue rather than a drawback. A large yield during prosperous times would have a deflationary effect, and the shrinkage during hard times would avoid draining purchasing power, privately needed, into the Treasury. However, a cyclical budget (balanced over a period of years) requires considerable Congressional discipline. It is very likely true that we must learn to live with a large amount of revenue instability. In the case of the states, where fiscal powers are more limited, possibly a reserve might be built up in good times for use in bad times.

The income tax requires high-grade administration and encounters grave problems of evasion and avoidance. Its productivity is frequently limited by a narrow base, dictated by political resistance to direct taxes. Excessive grad-

uation and confiscatory rates may be injurious to the economic incentives required to keep a private economy functioning at a high level.

To a large degree, progress in taxation takes the form of perfecting the techniques and enlarging the scope of the net income tax.

SUMMARY OF INCOME TAX CHAPTERS

Although there had been considerable experimentation with the net income tax in the United States in earlier years, the era of continual and important application of the tax by the federal government dates from the adoption of the 16th Amendment in 1913 and, by the states, from the discovery of a successful technique of administration in 1911.

The income tax base is arrived at by refining gross income, or, more specifically, by subtracting certain items classed as income not taxed, deductions, and credits. This base may be subject to a general tax called a normal tax, in which case a surtax is also applied at graduated rates to the brackets or sectors of income. The federal law applies to corporations as well as to individuals, and much the same procedure is applied to both. State income taxes, in operation in about two-thirds of the states, follow the federal pattern with considerable variation, including higher exemptions and lower rates.

In choosing a concept of income for the tax base, many difficulties are encountered. For example, there is considerable academic support for the view that savings are a postponement of enjoyment and should not be counted as income. There is also support for the exclusion of capital gains and losses from the reckoning of income. On the other hand, viewing income as the economic power of the taxpayers, both savings and capital gains and losses should be included.

Many techniques have been evolved to facilitate the administration of the net income tax. Collection at the source is one of these; it has been used in Europe for many years and was introduced in the United States as a withholding tax on wages and salaries during the Second World War. This method of collection has many advantages, particularly in the timeliness of payment and convenience for the taxpayer, but it is difficult to adapt to the differentiation found in many income tax laws. Among other techniques used in the United States are information at the source, auditing, penalties, and self-reporting. Federal administration in the United States has been highly centralized but is becoming less so. State administrations generally suffer from bad personnel management.

A moot point in American income tax policy is the treatment of capital gains and losses. This income, if so it may be called, has special characteristics, including its irregularity, long and indefinite periodicity, and amenability to manipulation. Possible alternatives of tax policy include the British

procedure of largely ignoring these receipts, treating them like other income, giving them a special classification with special treatment, and taxing them under a levy entirely separate from the income tax. The problem is complicated by the fact that gains accrued on assets passing at death are wiped out for income tax purposes. Treatment like other income, with some qualifications, is recommended.

Probably the most troublesome problem in income tax policy concerns the treatment of corporations, corporate income, cash dividends, stock dividends, and particularly undistributed profits. Business income may be taxed at a flat or graduated rate, with or without the inclusion of income from nonincorporated business and with or without account of the ratio of income to capital. Stock dividends have been held by the United States Supreme Court not to be income, but the Court's decision is vulnerable on many points and has been substantially modified by the Court itself. The excess profits tax is based on the rate of earnings in relation to capital or, during a war, on the ratio of wartime to prewar earnings. Strong justification for such taxation during a war is afforded by the weakness of competitive controls. During peacetime such taxation would aim principally at recapturing monopoly profits, but in practice it would probably also involve special taxation of rewards for efficient management and risk-taking.

Undistributed corporate income was specially taxed under the federal income tax law of 1936, but this law was repealed in 1939. The legislation was defended mainly on the ground that reinvestment of earnings avoids a personal tax and therefore creates inequities; it was criticized on several grounds, including the contention that small and struggling corporations should have access to their earnings for new capital. Many proposals for the treatment of undistributed earnings are being made, including the assessment to individuals of their pro-rata shares in retained profits and the British system of applying the standard low-bracket personal tax rate to such income.

A broad base, adequate standard rate, and substantial graduation are important for the stability and sufficiency of income tax yield, and the first two conditions are often ignored because of their political unpopularity. Other problems of income tax policy include the differentiation of earned and unearned income and more equitable treatment for irregular income. The latter may take the form of carry-overs or of averaging. The income tax affords many troublesome "loopholes," including among the most prominent the personal holding company and the division of income among members of the taxpayer's family.

The income tax presents many problems of multiple taxation. In the personal income tax this involves the question of which jurisdiction may claim the right to tax; whether it is where the recipient of income is domiciled or where he "earns" the income. In the case of interstate corporations, the income must be apportioned among the states in which the corporation is doing business. This is a difficult task.

State income taxation also encounters certain special problems, such as the relation of the income tax to the property tax (including offsets), the distribution of revenues, and the migration of industry and wealth. It is argued by some that the states should be excluded from the net income tax field, but this seems inadvisable. Some experimentation with a new type of income tax which would be more easily integrated with the federal and raise more and steadier revenue seems warranted.

The net income tax, in spite of its many difficulties and limitations, is usually accepted as the most rational method of securing revenue in a capitalistic yet democratic state.

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CHAPTER X

Death and Gift Taxes

FORMS OF DEATH TAXES

Death taxes assume two major forms, one called the estate tax and the other, the inheritance tax. The term "estate tax" is used to describe a levy upon the entire estate left by the decedent, whereas the term "inheritance tax" is applied to a levy upon the separate shares of the estate transferred to the beneficiaries. Ordinarily, estate taxes provide for a single uniform exemption, although they may also allow specific exemptions according to number of dependents and relationship to decedent (similar to those provided in income taxes). In either case, if the rates are graduated, the brackets apply to the net estate as a whole. Inheritance taxes, on the other hand, usually carry an elaborate classification of heirs and provide a specific exemption and a special scale of rates for each class. Graduation in such laws is based upon two factors: the size of the share and the degree of relationship between the heir and the decedent. Table 9 presents a typical schedule of rates, exemptions, and classification by heirs and size of inheritance, as embodied in the California law (1942).

Estate Tax versus the Inheritance Tax. The estate tax is simpler and more productive than the inheritance tax. It avoids entirely the exceedingly complicated task of determining the value of shares where the transfer involves life estates, contingencies, and remainders.[1] The inheritance tax, on the other hand, gives special weight to the ability to pay of the heir, although if his circumstances apart from the inheritance are not taken into account, the measure of his ability to pay is incomplete. Inheritance tax rates are often deceptive; they may appear very high in the top brackets, yet the average effective rate of the tax on all transfers may be very low. The overwhelming majority of estates are left to near relatives, which means that most of them would fall under Class A in the schedule presented above. An analysis of

[1] A life estate is a grant of limited enjoyment of an estate during the life of the heir. A contingent estate is one in which enjoyment is conditioned upon the occurrence of some event which may or may not take place. A remainder is the underlying right to property which accompanies the grant of one or more life estates.

TABLE 9

Rates of the California Inheritance Tax—1942

Relationship of Beneficiary to Deceased	*Exemption*	*Rates Applicable to the Fraction of the Inheritance in Excess of Exemption from—*						
		0 to $25,000	*$25,000 to $50,000*	*$50,000 to $100,000*	*$100,000 to $200,000*	*$200,000 to $300,000*	*$300,000 to $500,000*	*$500,000 and up*
Class A								
Wife *	$25,000	2%	3%	4%	7%	9%	9%	10%
Minor child	12,000	2	3	4	7	9	9	10
Husband,* other child, parents, grandparents, grandchildren	5,000	2	3	4	7	9	9	10
Class B								
Brother, sister, or descendant of either; son-in-law; daughter-in-law	2,000	5	7	10	12	12	14	15
Class C								
Uncle, aunt, or descendant of either	500	6	9	12	12	12	15	15
Class D								
All others †	50	7	10	12	12	12	15	16

Source: Adapted from Reports to the Joint Committee on Internal Revenue Taxation, *Federal and State Death Taxes*, Government Printing Office, Washington, 1933, p. 87, and *Tax Systems*, 1942, p. 301.

* One-half of the community property is also exempt.

† Does not include charitable bequests; these are entirely exempt.

inheritance tax transfers in Wisconsin in 1927 and 1928 showed an average effective rate of 3.1 percent.[2] The Wisconsin rates were somewhat more severe than those of the California tax now in effect.

Refinements of the Inheritance Tax. The inheritance tax is generally thought to be a refinement on the estate tax. Some further modifications have recently been suggested, and at least one has also been tried. Of the suggestions, the best known is that of Rignano, the Italian economist, who proposed differentiating between what the deceased has added to his estate and what he himself had inherited and now passes on.[3] A variation of this scheme has been offered by two British economists, Dr. Hugh Dalton and Dr. H. D. Henderson. Their proposals provide in effect that the state should

[2] *Report of the Wisconsin Tax Commission*, Madison, 1928, p. 208.

[3] Eugenio Rignano, *The Social Significance of the Inheritance Tax* (trans. by W. J. Shultz), Alfred A. Knopf, New York, 1924, Part I, Chap. I.

take title to part of the decedent's estate and, as a sort of public trustee, pay the income from it to the beneficiaries during their lifetimes. After that the state is to have all enjoyment of the property.[4] Another proposal is to vary the inheritance tax rates according to the wealth of the heirs at the time of the transfer. This was experimented with by Germany and Italy for a short time between 1919 and 1923, but the results were unsatisfactory because of the administrative difficulties involved in valuing the prior wealth of the heirs.[5] It is quite possible that the inheritance tax can be further refined without introducing prohibitory administrative difficulties. However, it may be better to proceed in this field on the supposition that death taxes fall upon the decedent, and thus confine them to levies on the estate only. Either an estate tax or an inheritance tax might be refined to take some account of the time elapsing between successive transfers.

THE HISTORY OF DEATH TAXES

One of the earliest recorded taxes is the inheritance tax, which dates all the way back to antiquity.[6] In the Middle Ages the inheritance tax appeared as one of the institutions of the feudal system. As has been observed in Chapter I, under this system the ultimate title to all land was vested in the sovereign, and inheritance could take place more or less only at his sufferance. Property was usually allowed to pass freely from father to son, but there was no clearly recognized right other than that of the ruler to give or take title. In case the deceased left no direct heirs, the property was supposed to escheat to the crown, although relatives might acquire good title if they paid the crown a "relief." This "relief" was what might be considered the feudal equivalent of the modern inheritance tax. In some countries, notably, France, Spain, and Portugal, direct lines of descent can be traced

[4] Josiah Wedgwood, *The Economics of Inheritance*, George Routledge and Sons, Ltd., London, 1929, pp. 258-262.

[5] W. J. Shultz, *The Taxation of Inheritance*, Houghton Mifflin Co., Boston, 1926, pp. 87-95, 309-311.

[6] Some students of the subject place the origin of this tax in Egypt where, as far back as seven centuries before the Christian era, there was a 10 percent levy on transfers of property at death. It was only at a later period of Egyptian history, however, that the tax became truly a death duty. As in all feudal societies, the full title of property in Egypt rested in the ruler, and the tax was considered as a redemption fee on the passing of property from the dead to the living. But the best-known application of the inheritance tax in ancient times was the *vicesima hereditatium*, which Emperor Augustus forced his Senate to accept. This was a 5-percent duty upon inheritances and bequests, and was levied for the purpose of raising funds for pensions and "bonuses" for the army. At first it applied only to citizen residents of Rome, but then it was gradually extended to apply to all citizens, which by 212 A.D. meant all the free inhabitants of the Empire. The tax was based on the shares received by the beneficiaries, some of whom at times were exempted entirely, depending on their relationship to the deceased. (W. J. Shultz, *The Taxation of Inheritance*, Chap. I; also Max West, *The Inheritance Tax*, Columbia University Studies in History, Vol. IV, No. 2, 1893, pp. 11-15.)

between these medieval feudal obligations and their modern inheritance taxes. Even when there is no apparent connection between the two exactions, the medieval principle of escheat is sometimes relied upon to justify the modern tax. It was the principal basis upon which the state and federal courts in the United States sustained the legality of the state inheritance tax.[7]

Great Britain is recognized as the country in which death taxes have reached their highest development—at least from the standpoint of their relative place in the revenue system. In prewar years the British collected about 10 percent of their tax revenue (national and local) from this source, compared with about 5 percent in the United States. British death taxes in modern form date back to 1894. The British system consists of several taxes: the legacy and succession duties (like our state inheritance taxes) and an estate tax. The latter, which is by far the more important for the revenue, carries an exemption of £100 ($400) compared with our federal estate tax exemption of $60,000.[8]

Although the federal government of the United States had used death taxes as emergency measures in previous periods, it was not until 1916, under the pressure of revenue needs for the First World War, that an estate tax became a permanent addition to the federal revenue system. The early tax was very mild compared with present-day standards. It carried an exemption of $50,000 and rates ranging from 1 to 10 percent. In 1944, rates ranged from 3 to 77 percent, the latter upon portions of taxable estates above $10,000,000.

State inheritance taxes date back to the Pennsylvania law of 1826, and there were some probate duties in even earlier periods. Early laws were characterized by weak administrations, proportional rates, and limited application (to collateral heirs and, in some cases, personal property only). The New York law of 1885 was carefully drawn and well administered, although it still applied only to collateral heirs and was a proportional tax. Direct heirs were included in 1891, but it was the earlier law which served as a model for the other states—that is, until Wisconsin enacted its progressive inheritance tax in 1903. The Wisconsin law was hailed as the first

[7] W. J. Shultz, *The Taxation of Inheritance*, pp. 7-10. Two court cases discussing this principle are: Magoun v. Illinois Trust and Savings Bank, 170 U. S. 283 (1898); United States v. Perkins, 163 U. S. 625 (1896).

[8] The British tax appeared in embryo as early as 1694, when a stamp tax was imposed on probates and letters of administration. Ever since then some form of inheritance tax has been a part of the British revenue system. During the course of time, even in its earlier years, many attempts were made to modify the tax, but it was not until 1894 that any real achievement could be registered in this direction. The duty then adopted carried progressive rates ranging from 2 to 8 percent and took the form of an estate tax. There were at this time two other death taxes in effect, the legacy and succession duties, both of which were based upon separate transfers to heirs, the former applying to personalty and the latter to real property. Both of these were continued, with some modifications, and the three together have since come to form an important part of the British revenue system. Some form of death duty is now an accepted part of the revenue system of all or nearly all countries.

scientific inheritance tax act. In addition to the elimination of the objectionable features mentioned above, its rates were graduated both according to the amount of the transfer and the degree of relationship between the heir and the deceased. And the act broke precedent by including real estate along with personal property, even in its application to direct heirs.[9]

The state inheritance tax has gained much ground both extensively and intensively during the last four decades. The enactment of the federal credit in 1924 and 1926 had a particularly stimulating and unifying effect. The credit provision of the federal law permits payment of part of the federal estate tax with state death tax receipts and thus alleviates some of the burden that might result from paying both state and federal taxes on the same estate. At present only Nevada fails to take advantage of this credit, and several states levy a tax which is just sufficient to cover it. Most of the other states, including those with some other form of death taxes, have also enacted special legislation (usually a minimum estate tax) which ensures them full advantage of this provision of the federal law.

The predominant form of death tax among the states is that on inheritance, the estate tax being found in only 12 of the states, some of which also have an inheritance tax. The California schedule given in Table 8 is fairly typical of most state inheritance taxes; that is, they are graduated according to both size of legacy and kinship between the decedent and the beneficiaries. Exemptions, although not usually as large as that allowed by the federal law, are fairly generous. One state, New Hampshire, taxes only the shares going to the collateral heirs.[10]

RELATION OF FEDERAL AND STATE DEATH TAXES

Whether the federal government, the states, or both should use the death tax field as a source of revenue has been a matter of some dispute. Some early attempts to inaugurate a federal estate tax in peacetime (as in 1909) were strongly opposed by state officials. One of the strongest opponents was the National Tax Association, an imposing organization mainly of scholars and state tax administrators.[11] Sixteen years later this organization was still opposed to a federal death tax, and in 1925, in cooperation with a Special National Conference on Inheritance Taxation, it went on record for the repeal of the federal estate tax in order to leave this source of revenue to the states.[12] Another prominent representative of the opposition was Mr. Mellon who, while Secretary of Treasury, appeared before the Ways and

[9] Solomon Huebner, "The Inheritance Tax in the American Commonwealths," *Quarterly Journal of Economics*, Vol. XVIII, Aug. 1904, pp. 529-550; Max West, *The Inheritance Tax*, pp. 97-155; W. J. Shultz, *The Taxation of Inheritance*, pp. 98-135.

[10] *Tax Systems*, 1942, pp. 301-303.

[11] W. J. Shultz, *The Taxation of Inheritance*, pp. 155-156.

[12] *Bulletin of the National Tax Association*, Vol. XI, No. 3, Dec. 1925, p. 70.

Means Committee of the House of Representatives and presented the view that "by tradition, legal theory, and revenue necessity" the death tax belongs to the states.[13] He stated that his conclusion was not based on opposition to death taxes, but on the theory that some taxes, of which the estate tax is one, can be more properly levied by the states than by the federal government.

Federal versus State Death Taxes

The legal-theory argument referred to is based upon the proposition that the state has the ultimate title to land and other property. It is under state law that property at the time of death passes from the deceased to the heir, and it is to the state that the property escheats in case there is no heir. Possibly these facts give the state easier access to information concerning estates than is available to the federal government, but this hardly seems a weighty objection to the latter remaining in the death tax field.

Revenue Necessity. As to revenue necessity, it probably is true that the states have less financial resources and relatively more need for revenue than the federal government. But certainly a plausible case could be made for the reverse of this proposition, particularly since the recent federal deficits.

Relinquishment and Low Rates. Although the proponents of federal abandonment of the death tax field to the states profess no opposition to death taxes as such, the fact remains that, were the federal government to step out of the picture, state competition would reduce death taxes to a bare minimum. States are sorely tempted to bid for wealthy residents, particularly for the aged ones, by setting up very lenient death taxes or by entirely eliminating such taxes. Any state which would refuse to enter this competition would be pressed to do so for fear of losing "the goose that lays the golden eggs." Florida in 1924 adopted a constitutional amendment expressly ruling out all inheritance taxation. This was done with the avowed purpose of inducing the wealthy to establish residence there. The state is said to have thought it good business to tax the wealth which might be brought within its borders before the owners died rather than after. Not to be outdone, Nevada repealed its inheritance tax law in 1925.

The Difficulty of Localizing Inheritances. Another argument in favor of retaining the federal tax is that it makes for a more equitable distribution of death tax revenues and the benefits resulting therefrom. Were the federal government to withdraw from the field, certain states would secure an undue advantage in their share of revenue from this source. Some states, like New York, would procure a relatively large revenue from the tax, whereas others, like North Dakota and Montana, would derive but scant benefit from it. Huge fortunes in particular have frequently been derived from business

[13] *Hearings, Revenue Revision, 1927-28*, p. 13, U. S. 69th and 70th Congress, House of Representatives, Committee on Ways and Means.

profits which may have come from trade over an area far beyond the limits of any one state. For example, when a wealthy manufacturer of tobacco died not long ago, it was felt that, since his large estate had been built by contributions from tobacco farmers and consumers in many parts of the country, it should not be earmarked for one state just because he happened to have resided there. Similarly, a person might make a fortune harvesting the natural resources of a particular state and move to another shortly before his death. Through the use of death tax revenues by the federal government for central purposes, or for distribution in aids to the states, a broader benefit could be derived from the tax.

Multiple Taxation. There is still another argument for the retention of the federal death tax. It is contended that the use of the tax by the states must encounter the confusion and inequities of multiple taxation. The possibilities of multiple taxation in the death tax field are great and increasing.

Federal Credit—the Eighty-Percent-Credit Clause

The federal government has devised and adopted a compromise solution of this issue of federal versus state death taxation. The compromise is called the federal credit and provides that, within limits, the taxpayer may pay his federal estate tax with state inheritance tax receipts. The limit is 80 percent of the federal tax computed according to the 1926 schedule of rates. The effect of the credit is to deprive a state which has no death tax of any revenue from this source, although its residents must pay quite as much tax as though they lived in a state which imposed such a tax. Suppose, for example, that the federal tax on a particular estate is $100,000 and that the state death taxes are $80,000. The estate would pay only a total of $100,000, 80 percent of which would go to the state. If the decedent had moved his domicile to a tax-free state shortly before his death, the estate would still have to pay $100,000, the only difference being that all of the money would be paid to the federal government.

Effect of Federal Credit upon State Legislation. Florida carried the federal credit law to the United States Supreme Court, contending that it was unconstitutional because it was not uniform in its effect and was an undue interference by the federal government with the freedom of the states in their choice of a revenue system. The Supreme Court, however, in a unanimous decision sustained the law.[14]

When the credit was adopted, some states with death tax laws hastened to advertise their advantage over the noninheritance-tax states as domiciles for wealthy taxpayers. With total death tax burdens no higher than those of the noninheritance-tax states, they could retain a large part of the revenue instead of sending it all to Washington and would thus need less from other taxes. This was too much for the State of Florida. By a substantial majority

[14] Florida v. Mellon, 273 U. S. 12 (1927).

it voted in 1930 to amend its constitution, repealing the prohibition of death taxes in that state. The amendment permitted an estate tax—but only for as long as the federal credit might be in force and only to the extent necessary to absorb the full credit allowed against the federal tax. Several other states have also enacted minimum estate tax laws in addition to their regular inheritance tax. The minimum estate tax ensures them the full benefit of the federal credit.

The federal credit has proved a useful instrument in the co-ordination of federal and state death taxes. But it now needs to be modernized and kept up to date. The present attachment of the credit to the now antiquated 1926 law is unfortunate. Also there is good reason to extend the crediting program to cover state and federal gift taxes.[15]

CASE FOR AND AGAINST DEATH TAXES

Arguments in Favor of Death Taxes

Inheritance Is an Indication of Ability to Pay. Some form of tax upon transfers at death is now a part of the tax system of every important modern country. Its proponents often couple it with the net income tax as being the clearest application of the ability-to-pay principle. But this is far from self-evident. There is the question, for example, of whose ability to pay is being aimed at, that of the heir, the decedent, or both. If it is the heir's ability which is being singled out, death taxes must fall short of their purpose because they take no account of the economic status of the recipient. One hundred thousand dollars received by one who already has a "tidy" fortune and a handsome income is one thing, and the same sum received by an individual without means is another. If it is the decedent's ability to pay which is aimed at, the objection may be raised that the incidence of the tax can hardly reach a dead person. This objection is not entirely tenable because the decedent probably anticipated the tax before his death and laid his plans accordingly. He may have insured his fortune against the death taxes, in which case these taxes assume the form of an annual property or income tax with deferred collection.[16] As a deferred annual tax on the fortune, however, the death taxes are open to the criticisms that they are irregular because of the uncertainty of the time of death and because they discriminate against the estate which is subject to transfer at short intervals. Probably the strongest case for the contention that death taxes apply the ability principle is that the legacy by itself gives the heir some measure of ability to pay, and that the decedent's fortune, which bears witness to its

[15] Committee on Intergovernmental Fiscal Relations, Treasury Department, *Federal, State, and Local Government Fiscal Relations*, pp. 14-16.

[16] During his life the insured pays an annual sum to the insurance company which in turn pays a certain amount to his estate at death.

owner's ability to pay during his lifetime, can be most strategically taxed at the time of the latter's death when readjustment, appraisal, and liquidation ordinarily occur.

Of course, the timing of the death taxes may not always seem opportune to the heir, particularly if the heir is the surviving widow. As a result of her husband's death, she may have been deprived of her main source of support. She may have difficult adjustments to make, including a financial one. It may seem to her that the government is choosing a most inopportune time to add to her cup of woe by imposing an inheritance tax. Often, too, she may have been a partner in the amassing of the estate now left to her. These special circumstances have been widely recognized in inheritance tax laws by the grant of especially large exemptions in case of property left to a widow.

At the other extreme among the beneficiaries is the collateral heir, or, in other words, one who is not a close relative. His ability to pay arises from being the recipient of a windfall. He finds himself suddenly possessed of wealth which he probably did not expect and which he is quite accustomed to do without. His receipt of an inheritance appears to be a very strategic occasion for the government to obtain a "contribution" to its treasury.[17]

Inheritance Is "Unearned" Income. From the standpoint of the heir, the important fact in inheritance taxation is not so much the receipt of wealth as its source. To him the inheritance constitutes an unearned income. He seldom has rendered an equivalent to either society or the decedent which would ethically justify a future claim on his part upon the productivity of society. It may be necessary to allow the decedent some freedom in the disposition of his estate in order to induce him to produce and save—a point which will be considered presently—but, as far as the heir is concerned, his receipt may be classed under the heading of privilege.[18] From the decedent's standpoint, it may be argued that society is every man's partner in business, so to speak, and the imposition of a tax at death is really nothing more than the partner's collection of his proper share from the dissolved partnership.

Death Taxes and Equality of Opportunity. Another justification for the inheritance tax is that it serves to create equality of opportunity. This species of equality, sometimes referred to as "cradle equality," is not infrequently accepted as desirable by the most "rugged" of individualists. The idea is that we should all start at the same tape line and be allowed to go as fast

[17] The importance of expectation in the psychology of sacrifice was described by Jeremy Bentham as follows: The heir would suffer no hardship, "for hardship depends on disappointment; disappointment upon expectation . . ." and if the law of succession leaves him nothing, he will not expect anything. (*The Works of Jeremy Bentham*, William Tait, Edinburgh, Vol. II, 1843, p. 589.)

[18] It has been suggested in an earlier chapter that privilege is an element in ability-to-pay. It would be argued, consequently, that the unearned character of the heir's receipts lends support to the proposition previously discussed, that death taxes are an application of the ability-to-pay principle.

and as far as our talents will carry us. Actually, of course, many are privileged to begin the race with a long financial lead, whereas others are burdened with the handicap of poverty. To the extent that death taxes tend to equalize the competition, they serve as a means whereby each generation is partially freed of the inequalities of the past. As an example of what is meant by this, take the case of the Du Pont family and Alexis I. Du Pont, who, at the time of his death, had a fortune of about $30,000,000. Some years later it was estimated that, of his forty-odd heirs, each was worth more than Alexis himself, who was the wealthiest of the family at the time of his death.[19] It is possible that the Du Ponts are an extraordinary family, but it is also plausible to conclude that their economic success has been partially due to the long running start which they were fortunate enough to receive from their elders.

Inheritance is generally accepted as an established feature of our economic society, but that it is a necessary part of our institution of private property and the capitalistic system, at least in its unrestricted form, has often been questioned. That there is nothing immutable about the institution is suggested by the fact that the forms, laws, and customs of which it is comprised differ very substantially both in time and space. No modern state, for instance, would give such a free hand to private owners that they could prescribe for generations ahead without limit how their property should be used. Jeremy Bentham and John Stuart Mill, among others, went so far as to question the usefulness of the institution in most cases, the former advocating its abolition for all except direct heirs and the latter proposing a severe limitation on the sum which any one individual should be allowed to inherit.[20]

Death Taxes and a Wider Distribution of Wealth. Some would justify death taxes on the theory that they tend to correct a bad distribution of wealth. This assumes, of course, that the present distribution is bad—a not uncontroversial assumption. Some aspects of this problem have been discussed in Chapter II. It may be approached not only from the angle of equity, in which case the student asks himself what a fair distribution of wealth is, but also from the pragmatic angle which takes into consideration the adequacy of saving and spending, the wastefulness of possible extravagance and idleness on the part of heirs, and the social consequences of concentrated wealth and power. Among the social consequences which will need to be considered is the control of such institutions as the schools,

[19] Silas Bent in *The New York Times*, May 11, 1924.

[20] "The inequalities of property which arise from unequal industry, frugality, perseverance, talents, and to a certain extent even opportunities, are inseparable from the principle of private property, and if we accept the principle, we must bear with these consequences of it; but I see nothing objectionable in fixing a limit to what anyone may acquire by the mere favor of others, without any exercise of his faculties, and in requiring that if he desires any further accession of fortune he shall work for it." J. S. Mill, *Political Economy* (Ashley, ed.), Book II, Chap. II, p. 232.

churches, newspapers, radio, and cinema. Needless to say, a consideration of all these matters would carry us far afield. But it may be observed in passing that death taxes are an ever-ready weapon for an attack on concentrated wealth and power.

Other Arguments for Death Taxes. Death taxes are relatively easy to assess and collect. Moreover, once levied, they probably cannot be shifted. They reach earnings from such securities and salaries as are exempt from the income tax,[21] and other property or income which may have avoided taxation during the owner's lifetime.[22]

Arguments Against Death Taxes

Death Taxes and the Incentive to Save. An argument against death taxes is that they are a direct attack upon the nation's capital, or potential capital, and that they thus reduce the productivity of our economic system. "We are now selling our seed grain," said one critic, referring to death taxes, "and will have nothing to sow when next spring comes." When the estate tax was introduced into the British revenue system in 1894, it was accomplished with much head-shaking on the part of capitalists, bankers, financiers, and economists, to whom it appeared as a tax on capital and a scandalous waste of the inheritance of the nation.[23] There are several respects in which an inheritance tax may be viewed as having a deleterious effect upon a nation's capital. The first is that the freedom to dispose of one's property is a necessary incentive to the accumulation of capital. Without this, it is argued that, after they have accumulated a certain amount of wealth, men will spend their time and money in idleness, waste, and riotous living.

It is extremely doubtful that the privilege of disposition at death is as effective a stimulus as this argument asserts. More correctly this incentive might be regarded as only one among many. Some people work and save because of the creative interest such activities offer them. They enjoy building a fortune just as a boy enjoys building "a house." Others work and save because of the power and prestige they may acquire. Still others work and save because it has become a habit. It is easy to recall numerous instances of old men continuing their work, not because of necessity but because they cannot retire to an inactive life. Some save automatically because it is impossible for them to spend their income. The difference between frugality and extravagance for many amounts to only a small percentage of their total income. Moreover, there are some very wealthy people who frankly state

[21] It is judicially well established that tax-exempt securities are not immune from death taxes. See, for instance, Plummer v. Coler, 178 U. S. 115 (1900).

[22] Early state inheritance taxes in some cases were confined to personal property and were based mainly upon the idea that much of such property escaped taxation during the owner's lifetime.

[23] Henry Higgs, "Death Duties or Life Duties," *Quarterly Review*, Vol. CCLV, 1930, p. 108.

that, in their opinion, their children would be better off were they not to inherit fortunes but were to start the way their parents did.[24]

Death Taxes Consume Capital. Does a heavy inheritance tax dissipate a nation's capital in a more direct sense than the one above considered? By capital is here meant "the tool fund" of society; that is, the income which has been set aside for investment in machinery, buildings, and other productive assets plus those already in existence. Of course, death taxes do not actually gather machinery and buildings into the national treasury. But people who inherit machinery and buildings may have to sell part or all on the market in order to secure cash to pay the government. The cash thus obtained may have come out of the buyer's income. In this sense all taxes in the last analysis come out of somebody's income. But does not the death tax in this case come out of *potential* capital? Would not the income, or at any rate the wealth which is diverted into the public treasury, have been otherwise available for new construction of productive equipment? The answer is yes, but the same answer would go for the income tax or the property tax. All taxes come out of potential saving except when they strike individuals who, because of poverty, habit, or personal nature, must or will curtail saving and maintain spending because of the tax. It is true that taxes upon the wealthy tend to curtail saving more than taxes upon the poor, since the latter by necessity spend most of their income. This seems to be the only valid point in the assertion that the inheritance tax is an attack upon capital.

The inheritance tax need not differ from the income tax in its effect upon saving. This can be shown very easily by a mathematical illustration. Let us assume that the government needs to collect $6,000,000 in taxes and that all of this must be collected from 12 fortunes, each of which provides its owner with a $1,000,000 income and each of which represents $100,000,000 of past savings. Let us further assume that each of these millionaires spends $100,000 a year for living expenses. If all of the revenue for the government were raised through an income tax, it would require a 50 percent tax. Personal expenditures and taxes combined would consume $7,200,000 of the total $12,000,000 income, leaving $4,800,000 to be added to capital as savings. Now, suppose that one of the fortunes has been transferred as a result of death and that the government raises all of its revenue by a 6 percent

[24] Andrew Carnegie, for example, in writing on the subject of "Wealth," expressed this view as follows: "Why should men leave great fortunes to their children? If this is done from affection, is it not misguided affection? . . . It is not well for the children that they should be so burdened . . . great sums bequeathed often work more for the injury than for the good of the recipients." *North American Review*, Vol. CXLVIII, No. 391, June 1889, p. 658.

It has been argued by some that death taxes actually stimulate the propensity to save, since people are required to save an additional amount in order to provide the same security for their dependents that they would have sought had there been no tax. The argument is valid, if at all, only for the ranges of wealth where the provision of security is a marginal matter.

inheritance tax on this fortune. On the assumption that there need be no income tax levy, the saving out of the $12,000,000 income would amount to $10,800,000. However, $6,000,000 of the latter would be used to purchase the equipment which must be sold by the estate of the deceased owner, leaving $4,800,000 available, as before, as a net addition to capital or saving.

The above illustration ignores the fact that in practice the income tax reaches many more people than the death taxes. The latter are concentrated to a large extent upon the wealthy. Although there are many people who enjoy fair-sized incomes, it is a well-known fact that at death relatively few people leave even a moderate-sized estate. Property is more concentrated than income. The income tax collected from a spendthrift, or one who is in no position to save, comes directly out of consumption. Spendthrifts are not taxed under the inheritance tax. Take the case of three people, each with a $4,000 income. *A* lives from hand to mouth. His income tax means reduced consumption for him. He pays no inheritance tax when he dies. *B* is very prudent and will provide his dependents with a certain standard of security regardless of taxes. Both his income tax and his anticipated death taxes will come out of his consumption or his scale of living. Since he saves in anticipation of death taxes, it may seem that, until the occasion arises to pay them, savings are positively augmented by the existence of the death tax. This is true individually, but not collectively, since *B*'s extra savings are needed to buy the capital of someone else whose estate is now paying its death taxes. *C* is moderately prudent, but he has a rigid scale of living. Each year he saves all and only what he earns above $3,500, which means that either income or death taxes will all come out of his savings. By virtue of the fact that the income tax, as contrasted with the death tax, reaches many like *A* who have no inclination to save, it tends to reduce accumulation less than the death taxes. On the other hand, death taxes are less likely than income taxes to discourage the propensity to save because they do not weaken the saving habits of the taxpayers. This is true because of their remoteness and the lesser interest which one naturally has in what happens after death. On the whole, it could probably be said that death taxes discourage capital accumulation somewhat more than income taxes, dollar for dollar, but the difference between the two in this respect is not a great one. Death taxes, because of their remoteness, are probably much less inimical to the enterprise incentives than income taxes.

Capital Conserved by Certain Public Expenditures. Notwithstanding an impression to the contrary, the government does not raise money only to drop it into the bottom of the sea. It may, like any private investor, spend it for buildings, machinery, and the like, in which case a tax that comes out of saving does not deplete capital but merely transfers it from a private to a public use. To emphasize this fact, Denmark does not include death duties in ordinary revenues but designates receipts from these taxes as capital

receipts.[25] Capital is increased equally whether the government builds a road, a school, and an apartment house or the private investor builds a railroad, a theater, and a hotel. The total annual government investment in durable goods amounts to not only as much as but usually far more than death tax revenues.

Can There Be Too Much Saving? The present controversy as to whether saving is overdone in our modern era has been referred to several times. It has been observed that high income and death taxes have thus far created no apparent shortage of capital goods.[26] On the contrary, there is quite a general alarm lest the entrance of the federal government into the old age insurance business under the Social Security Act become a "deflationary influence"; that is, result in too much saving. Large numbers of people are more concerned about the market for the products turned out by the economic system than about the adequacy of the equipment with which to meet the demand for both durable and consumption goods.

It remains true, however, that the requirement of capital does set an upper limit to certain forms of taxation, including death taxes, in our present economic system. It is conceivable that the institution of inheritance could be abolished entirely without destroying private property, private capital, and the capitalistic system. But the proposition is doubtful, to say the least. It is much more likely that confiscatory death taxes, combined with confiscatory taxes upon income above the necessities of life, would put an end sooner or later to private property in productive equipment.

Death Taxes Undermine Their Own Base. It is also argued against death taxes that they tend to defeat themselves. The productivity of these taxes depends on the existence of large fortunes, the very foundation of which these high levies would destroy. It is true that if the rates are too steeply graduated they might have this result, especially in an old and highly developed country where the opportunities for a comparatively rapid acquisition of wealth are limited. Actually, however, as previously noted, it has never been shown that death duties have had this effect in Great Britain, where death taxes have had their longest and highest development.[27] On the other hand, there can be no doubt that fortunes would accumulate more rapidly without these taxes. But this is not to say that large fortunes disappear under the attack of a severe schedule of death taxes. Were this to occur when there were a great need for revenue, it would be necessary, of course, either to raise the rates in the lower brackets of the inheritance tax or to seek revenue from other sources.

Death Taxes and the Break-up of Effective Productive Units. Closely akin to the above criticism of death taxes is the corollary that, insofar as they

[25] J. Wilner Sundelson, *Budgetary Methods in National and State Governments*, Special Report No. 14, New York State Tax Commission, Albany, 1938, p. 210.

[26] See Chap. XXVIII.

[27] But see L. H. Parker, "The Time Element in Estate Tax Valuation," *Proceedings of the National Tax Association Conference*, 1937, pp. 219-225.

result in the breaking-up of large estates, they may destroy an effective combination of business capital and direction. This argument had greater merit back in the days when most property consisted mainly of land and the constant division of landed estates resulted in too small a working unit. The institution of primogeniture was defended on the ground that it prevents the undue division of estates. But today, when business is owned through share capital, a change of ownership may not greatly affect management.

In general, the death tax would probably interfere less with the perpetuation of closely held family businesses than might be expected. The estate tax need not be settled in a moment of time. It can be anticipated by gifts and can be paid on the installment plan over a period of ten years after death. This permits the payment of sizable estate taxes out of income without resort to a sale of stock. The son or business associate who is expected to follow in the dynastic control will have many advantages which will enable him to acquire a strong hold upon the business before the founder passes on.

Not infrequently the social interest would be best served were the heir to start a business of his own as his father did. Dynastic industries may be as often opposed to the social interest as not. It is by no means certain that either the ability or the inspiration of the deceased will be passed on with the fortune. In 1930, John T. Flynn made a study of the outstanding business leaders in the United States in 1840. He found that ninety years later not a single descendant of the men on the 1840 list would qualify as among the nation's outstanding business leaders.[28]

Death Taxes and Liquidation. Besides the amount of the tax itself, death taxes may impose an additional burden upon the taxpayer, especially if the rates are steep. The necessity of sudden liquidation may break the market for the securities which make up the estate, causing heavy losses. However, certain procedures are available which temper the harshness of even very heavy death taxes. One of them is life insurance. It affords the taxpayer an opportunity of having some liquid assets at the time of transfer at death. Another is installment payments, under which the government may give the administrator of the estate and the heirs several years—perhaps even ten years—to work out their problem.[29] Through these two devices a substantial tax may be paid out of the income of an estate, and forced liquidation involving great sacrifices may be avoided. However, it remains true that death taxes may encourage the investment of large estates in liquid assets and thus discourage risk-taking. Valuation procedure which would recognize losses in the disposition of assets would help to eliminate this effect.

[28] John T. Flynn, "Dwindling Dynasties," *North American Review*, Vol. 230, 1930, p. 649.

[29] The federal government allows the Commissioner to extend the time of payment not to exceed ten years. State laws are seldom so generous. On the contrary, many of them provide heavy penalties if the tax is not paid within a fairly short time.

Death Taxes Undermine Philanthropy. In the arguments against death taxes the point is also made that only through the preservation and enlargement of private estates may we expect the institution of large-scale private philanthropy to continue. Gifts for educational and charitable purposes have been very large in the United States, probably larger than anywhere else. But just what proportion of big estates is devoted to philanthropic purposes has not, to this writer's knowledge, been disclosed. Studies abroad indicate a very low percentage.[30]

Private philanthropy undoubtedly performs some highly useful services. But at this point an interesting question arises as to whether private individuals give away their money more intelligently than governments could dispose of it. Moreover, in certain fields private philanthropy is objected to because it makes those who should be disinterested in their criticism of political, social, and economic conditions subservient to their benefactors.[31]

SPECIAL FEATURES OF DEATH TAXES IN PRACTICE

Rapid Succession, Life and Contingent Estates. In some death tax statutes provision is made for rapid successive transfers. The problem here arises from the fact that several rapid transfers constitute a misfortune to an estate. Illustrations may be given of automobile accidents in which great-grandfather, grandfather, and father all die in the course of one day. This may involve three separate transfers and three separate taxes within a few hours. To prevent an excessive burden on the estate, statutes commonly provide that a second transfer within five years, or some other period, will be exempt from tax. Such provision is found in the federal statutes as well as in those of quite a number of states. Time is one of the essential dimensions of a death tax and one that is largely neglected. There is much to be said for a provision that would adjust the tax according to the time elapsing between successive transfers of estates or according to the age differential of the deceased and the heir.[32]

Life estates, and particularly contingent estates (such as occur when a will provides that A shall have the income from certain property only so long as she remains single), are exceedingly difficult to evaluate under the inheritance tax. Value may be based on expectancy of life in the case of life estates, but in the case of contingencies it is sometimes necessary to postpone final adjustments among individuals until the contingency occurs.

Valuation of Property. It is customary to use net assets as the base of the tax. Deductions for debts (excepting state and federal taxes) and expenses of

[30] Josiah Wedgwood, *The Economics of Inheritance*, pp. 82-91.
[31] See Chapter XXIII.
[32] William Vickrey, "An Integrated Successions Tax," *Taxes*, Aug. 1944, pp. 368-374

closing the estate are permitted. Where an estate is partly outside a state, the exemptions and debts are usually prorated or the tax is calculated on the entire base, excluding the exemptions and debts, and the tax itself is prorated.[33] Value is usually taken as of the time of death, except in a few states where either the date of transfer or appraisal is determining. In recent years there has been some agitation for postponing the date of valuation for at least a year after the owner's death. The reason for this has been the numerous cases of hardship that have resulted from the application of the tax during the precipitous stock market decline of the early thirties.[34] Since 1935, valuation for the federal estate tax may be made as of the date one year after the decedent's death, but the estate so valued must take in all property included therein on the date of death. Property included in the gross estate distributed within one year after the decedent's death is valued as of the date of such distribution. Subsequent shrinkage in property values, once they have been appraised, does not affect tax liability; in fact, in some states not even assignment by the heir can free him of the tax, even though assignee may be an educational or charitable institution.

Disposition and Administration of Death Taxes. It has been pointed out that death taxes play a comparatively insignificant role among the tax revenues of most states. This perhaps accounts, at least in part, for the little pressure put upon the central authorities to distribute these taxes to the municipalities or to earmark them for special expenditures. Unlike the income tax, which is earmarked in most states (largely for education, property tax relief, or some aspect of public welfare), the inheritance tax is usually left in the general fund. Only a minority of states distribute any of their death tax collections and, of these, only one or two distribute all or a major part. The tax is particularly ill-adapted to distribution according to origin because the revenue it may provide for small units is highly irregular and quite unpredictable. In addition, the determination of origin is likely to involve arbitrariness and inequity.

The administration of the tax varies in the different states. The diversity extends to the state agency responsible, the local agencies involved, and the division of authority between the two. Most of the states now designate the chief tax body to serve as the state agency, but the state comptroller, attorney general, treasurer, special inheritance tax commissioner, and auditor are also used in this capacity by one or more states. A recent study of state death tax administration concludes: [35] "At present it is probably true that among

[33] This latter method successfully adapts the progressive rate schedule to the taxation of segments of an estate.

[34] Reports to the Joint Committee on Internal Revenue Taxation, *Federal and State Death Taxes*, pp. 254-255. Glen R. Treanor, and Roy G. Blakey, *Inheritance Taxes*, The League of Minnesota Municipalities, Minneapolis, 1935, p. 45.

[35] Walter W. Heller and C. Lowell Harriss, "The Administration of State Death Taxes," *Iowa Law Review*, Vol. 26, No. 3, Mar. 1941, pp. 628-673.

major state taxes none is more poorly administered than the death tax, whether judged by principles of organization, by equity in application. or by available quantitative measures."

PROBLEMS OF MULTIPLE TAXATION

Introduction. The problems of jurisdiction and multiple taxation in the death tax field are very difficult, and recently, because of a sharp turn in the Supreme Court's position, they have become sharply aggravated. A hypothetical illustration will show the possibilities of conflicting jurisdictional claims. Assume that Mr. Smith dies a resident of New York and leaves all his property to his son, Mr. Smith, Junior, of Philadelphia, Pennsylvania. The property consists of a house and lot in Toledo, Ohio, and several shares of stock in the XYZ Company, which stock at the time of the death is kept in a safety deposit box in Boston, Massachusetts. The XYZ Company is incorporated in New Jersey, owns property, manufactures and sells goods in Michigan, Indiana and Illinois, and has customers for its product in every state in the Union and several foreign countries. The question now is which states could and should tax what under the inheritance tax.

The possible claims of the states may be summarized as follows: New York might lay claim to part or all of the estate on the ground that the deceased was domiciled there; Pennsylvania might assert its right to tax the estate because it is the domicile of the heir; Ohio might claim the right to tax the house and lot on the ground that they are located there; Massachusetts might lay claim to the securities on similar ground; New Jersey might claim the securities as the domicile (or at all events the state of incorporation) of the company whose securities are involved; Michigan, Indiana, and Illinois might each claim part of the securities according to the relative value of the corporation's property located within each state because they are the territories in which the corporation's physical assets are located; finally, all states might make some claim on the ground that the corporation is doing business in their territory by selling to their inhabitants as customers.

Supreme Court and Multiple Taxation. Not all of these claims were ever good, and others have been outlawed by the United States Supreme Court, though of these latter some have recently been re-admitted to validity. The "states at large" have never had a sound legal claim; the corporation legally does business only in the states "from" which it sells and not "to" which it sells. Logically it would seem that the state of Pennsylvania has a good claim since the ability to pay is perhaps as much the heir's as the decedent's. However, nowhere in this country, and rarely abroad, has the state of the heir's domicile asserted any claim.[36] The estate is administered in the state where

[36] W. J. Schultz, *The Taxation of Inheritance*, pp. 239-240. This is strong evidence of the fact that death taxes are usually conceived as being taxes upon the decedent.

the decedent was domiciled at the time of his death and which has been assumed to have exclusive rights, as far as such rights are based on domicile.

One of the most troublesome problems has been that of taxing intangible property under death taxes. Prior to 1932 there was authority for states to assess, under the inheritance tax, stocks and bonds kept within their borders even though the decedent was domiciled elsewhere. In that year, however, the Supreme Court became concerned over the possibilities of double taxation, once by the state of the domicile of the decedent and once by the state in which the securities might be kept. Therefore it laid down the principle that, for inheritance tax purposes, intangibles follow the domicile of the owner.[37] For a number of years the Court asserted quite vigorously the unconstitutionality of the multiple taxation of intangibles. In 1939 the Court began to take a different view. In two companion cases [38] the Court held that both the state of the domicile and the state in which the intangibles are deposited could tax the transfer. It maintained that, when a taxpayer avails himself of the benefit and protection of the laws of another state, he must pay for that protection.

Michigan, Indiana, and Illinois have a remote theoretical claim, but, on the doctrine that the corporation and the stockholder are separate entities, the deceased possessed nothing over which these states have any jurisdiction. This is true because the legal title to all the corporate property is in the corporation and not the stockholder. Judicial opinion on this matter has not been unanimous; in a Wisconsin case [39] a minority opinion held that the corporation might, through its relationship as agent for its stockholders, bring the latter under the jurisdiction of the states in which the corporation did business. The dissent also laid stress on the fact that the corporation is only a legal fiction and that stockholders could acquire a right to physical property by merely dissolving the corporation. At one time many states taxed nonresidents upon their shares of stock in corporations owning property in these states; this is no longer permissible under the decisions of the United States Supreme Court.[40]

New Jersey has a strong claim on legal grounds because, having created the corporation, it could presumably impose such conditions of incorporation as it sees fit. Until 1932 it was quite common for the state of incorporation to tax nonresidents upon the full value of their shares in the corporation. During that year the Supreme Court ruled out all rights of the states to tax merely because they had incorporated the company in which the decedent held shares.[41] This remained the law until 1942, when the Supreme Court

[37] First National Bank of Boston v. Maine, 284 U. S. 312 (1932).
[38] Curry v. McCanless, 307 U. S. 357 (1939); Graves v. Elliott, 307 U. S. 383 (1939).
[39] Estate of Shepard, 184 Wis. 88 (1924).
[40] Rhode Island Hospital Trust Co. v. Doughton, 270 U. S. 69 (1926). See also Philip Nichols, *Taxation in Massachusetts*, pp. 97-100.
[41] First National Bank of Boston v. Maine, 284 U. S. 312 (1932).

again made it possible for states of incorporation to reassert their claims.[42] Thus at present, intangibles transferred under an inheritance tax may be assessed in the state of the domicile of the deceased, in the state where they are deposited, and in the state of incorporation.

The state of Ohio has a well-recognized claim to tax the transfer of the real estate located within its borders.[43] Were there tangible personal property involved, it would follow the same rule.[44]

The present trend in Supreme Court opinion is toward the view that to rule out one plausible state jurisdictional claim in favor of another is arbitrary and beyond the prerogative of the Court. The dissenting view stresses the inequities and complications of multiple taxation as a practical matter. The conclusion apparently is that legislatures must shoulder some of the difficulties that courts have hitherto carried for them.

EVASION AND AVOIDANCE

Hiding

Some transfers of personal property take place without ever being revealed to the death tax administrators. Cash, jewelry, and unregistered bonds lend themselves to this direct form of evasion. However, escape of this sort is not easily accomplished under alert and competent administration. If the administrator works in an income tax state, he may have access to the income tax records from which he can detect transfers of income-earning property. In addition, practically all states require that the death tax administrator be given first access to safety deposit boxes after the renter's death. The administrator usually has the power of placing the executor of the estate, or even the relatives of the deceased, under oath and taking testimony. Thus the sources of information are fairly adequate. It is true that some very small estates are probably missed entirely, particularly if there is nothing but a small life insurance policy and some personal property involved. An estate of this kind may not go through any court at all. But even in cases like this it is possible for the administrative agency to require notice from insurance companies of all insurance payments. The latter could furnish a means for checking, quite effectively, evasion of insurance. The total amount of such evasion is probably not very large.

Migration

Another means of avoiding or reducing death taxes is to run away from them. It probably is much easier for an individual taxpayer to change his

[42] State Tax Commission v. Utah v. Aldrich, 316 U. S. 174 (1942).
[43] Dana v. Treasurer and Receiver General, 227 Mass. 562 (1917).
[44] Frick v. Pennsylvania, 268 U. S. 473 (1925).

residence than it is for an industry to change its place of business. However, a change of domicile may be no small matter even for the individual, involving, as it often does, the severing of some long-established ties.

Problem of Domicile. It is perfectly legal for an individual to change his domicile in order to avoid taxation, or for any other reason. Considerable uncertainty arises, however, as to when a domicile is actually changed. Certainly, much more is required than a mere statement to the effect that one's domicile has been changed. It is clear in the law that every person has a domicile, and only one; it is usually the place of his birth, unless he later changes it. To change it, he must have had the intent to establish "a permanent abode" elsewhere and have made some overt act in the direction of moving there.

The main element in domicile is intent, and intent may be proved or disproved by a wide range of evidence. One of the most celebrated domicile cases in inheritance taxation is that of Dr. John T. Dorrance.[45] Until 1925 Dr. Dorrance was admittedly domiciled in Camden, New Jersey, where he lived with his family on a modest country estate. In the course of time, as sole owner of the stock of the Campbell Soup Company, also of Camden, he became very wealthy and as a result he decided to move to an environment more in keeping with his station in life. In 1925 he moved to the suburbs of Philadelphia, where he purchased a sumptuous estate of 150 acres at a cost of over $1,000,000. Meanwhile he also retained ownership of the New Jersey home, which he gave over for use to his mother and sister. Occasionally, however, he visited and slept there, although most of the time he stayed with his family in Philadelphia.

The evidence concerning this case disclosed the fact that ten servants had been employed in New Jersey before and only two after the removal; more than 25 were regularly employed about the house and grounds in Philadelphia. The cost of running the New Jersey establishment decreased from $20,000 in 1924 to $6,500 in 1929, in which year expenses at the Pennsylvania establishment aggregated $90,000. The Dorrances entertained exclusively in Pennsylvania, and the children attended school and church there. On the other hand, Dr. Dorrance voted, paid taxes, and held a vestrymanship in New Jersey. He drew his will according to New Jersey laws, and it was disclosed that he had been assured by legal advisors that he would not have to surrender his New Jersey domicile by acquiring his Pennsylvania home.

The Pennsylvania supreme court, in sustaining the inheritance tax of that state upon the Dorrance estate, reaffirmed the oft-enunciated principle of domicile: "A man's home is where he makes it, not where he would like to have it." Physical characteristics; time he spends in it; things he does therein; the persons and things therein; his mental attitude toward the place; the

[45] The following description of the Dorrance Case is adapted from 81 *U. of Pa. Law Review*, 177 (1932).

elements of his other dwelling places, if any—all have a bearing on the question. On the other hand, the New Jersey courts held that, "Where a person domiciled at one place moves to a new abode, his domicile will not be changed if he intends not to abandon the old home but to return to it, even though the particular time of such intended return be not definitely fixed."

The Dorrance case is interesting, not only because of the light it throws upon the problem of domicile but also because of the conflicting claims of two states. Both New Jersey and Pennsylvania claimed Dr. Dorrance, and both assessed and collected death taxes on his estate. In the former, the tax amounted to approximately $12,000,000, and in the latter, $14,000,000. An appeal to the United States Supreme Court failed to bring relief, as the Court refused to take jurisdiction. There is some doubt about the power of federal courts and Congress to force rules as to domicile upon the states. There seems little doubt, however, that eventually these federal agencies will have to work out a technique for arbitrating cases like that of the Dorrance estate.[46]

A domicile once acquired continues until it is actually abandoned and until a new domicile is actually acquired. Thus, a resident of Iowa was held to be still domiciled in Iowa when he died en route to the land of his birth where he expected to remain indefinitely.[47] It was not enough to abandon his old domicile, which he did; he also had to acquire a new domicile, which he did not do since he died en route. There is a conflict of authority, however, in cases of this kind.

Of course, as previously explained, much of the incentive to migrate in order to escape the inheritance tax was eliminated by the "eighty percent credit" amendment to the federal estate tax.

Gifts

By far the most common method of evading death taxes is through gifts of property before death. Gifts are usually classified into four types: (1) gifts in contemplation of death; (2) gifts to take effect at death; (3) gifts *causa mortis* or "death bed" gifts; and (4) gifts *inter vivos* (between living persons). A gift in contemplation of death is included by most death tax statutes as a part of the death tax base. But there is much confusion and argument con-

[46] The cases here discussed are: Dorrance's Estate, 309 Pa. 151 (1932); In re Dorrance, 115 N. J. Eq. 268 (1934); Dorrance v. Pennsylvania, 287 U. S. 660 (1932). See also an opinion holding that the Constitution does not require "uniformity in the decisions of the courts of different states as to the place of domicil, where the exertion of state power is dependent upon domicil within its boundaries." Worcester County Trust Co. v. Riley, 302 U. S. 292 (1937). However, see also, Texas v. State of Florida, 306 U. S. 398 (1939). A committee of the National Tax Association has given the problem prolonged consideration. (See *Proceedings*, 1936-1940.)

[47] In re Estate of Jones, 192 Iowa 78 (1921).

cerning whether or not a gift is in contemplation of death or *inter vivos*.[48] A gift *causa mortis* needs no further discussion; it is in the nature of a distribution at death by a sort of oral will and is clearly included in the base taxable under death taxes.

Gifts in Contemplation of Death. Contemplation of death is obviously a matter of degree. It is agreed that it does not include "that expectation of death generally entertained by every person." [49] Everyone expects to die, of course, and is always influenced by the thought that he cannot take his wealth along to the grave. To hold otherwise would rule out gifts *inter vivos* altogether. The courts generally take the view that mere old age is not sufficient in itself to establish contemplation of death. It seems plausible to hold that contemplation of death increases at least proportionately as one gets older. But there is no general agreement as to when one is old, and the argument that much of the great work of the world has been done by men over seventy is likely to meet with a warm reception by a court many of whose members are about that age. The usual ground for proving contemplation of death is illness.

Conclusive Presumption of Contemplation of Death Unconstitutional. As the result of court decisions concerning age, the State of Wisconsin in 1915 enacted a statute providing that gifts of a material part of the donor's property in the nature of a final distribution made at any time during a six-year period prior to death were *conclusively presumed* to be in contemplation of death. The constitutionality of this measure was several times upheld by Wisconsin courts, but, upon appeal to the United States Supreme Court in the case of Schlesinger v. State of Wisconsin,[50] the statute was overruled as contrary to the Fourteenth Amendment. The Court held that the conclusive presumption covers cases where gifts in fact *inter vivos* would be presumed in contemplation of death, and that this would constitute unreasonable classification and therefore deprivation of property without due process of law. The state, said the Court, cannot enforce an arbitrary tax in order to facilitate the collection of a lawful one.[51]

Prima Facie Presumption of Contemplation of Death Constitutional. Following the Court's ruling on the six-year presumption clause, Wisconsin

[48] More will be said later about gifts to take effect at death.

[49] U. S. v. Wells, 283 U. S. 102 (1931); State v. Pabst, 139 Wis. 561 (1909); In re Case's Estate, 191 Wash. 6 (1937).

[50] Schlesinger v. State of Wisconsin, 270 U. S. 230 (1926).

[51] A minority opinion by three justices cited precedents in which somewhat arbitrary provisions to facilitate administration of statutes had been sustained, and held that the precedent should be followed here. The minority added that if the period of conclusive presumption had been six months instead of six years, it would have seemed quite clearly a reasonable administrative measure, and that "reasonable men might regard six years as not too remote." That the decision did not turn upon the length of the presumption period, however, was demonstrated when six years later the court overruled a clause in the federal statute which provided a conclusive presumption period of two years instead of six. (Heiner v. Donnan, 285 U. S. 312 (1932).)

enacted legislation providing a two-year period before death in which gifts would be *presumed—though not conclusively*—to be in contemplation of death; that is, in cases of this kind the burden of proving non-contemplation would rest with the estate. At present, most state inheritance tax laws are buttressed with similar provisions to prevent this kind of avoidance. The courts have generally held this phrasing of the law valid.[52] The presumption is a considerable factor in establishing contemplation notwithstanding that it "can not stand against ascertained and proven facts showing the contrary to be true." [53]

Gifts to Take Effect at Death—Trusts. The problem of gifts as a means of avoiding the inheritance tax is very much complicated by the existence of trusts. The trust is a device by which a person or corporation is vested with title to certain property that he or it is to manage for the benefit of another person. Usually there are at least three parties to a trust: [54] the settlor, or the one who creates the trust; the trustee, or the one who administers it; and the beneficiary, the one for whose benefit it is created. Trusts may be established for various purposes; a familiar type is exemplified when a donor wishes a relative to have a certain income and, uncertain of the latter's ability to handle "money matters," leaves the administration of property from which the income is to be derived to a trust company or some other third party. Under this arrangement the latter obtains the legal title to the property, subject to certain conditions enumerated in the trust contract, while the beneficiary is accorded merely an equitable title to or interest in it.

Classification of Trusts. Trusts may be revocable or irrevocable; that is, the settlor may or may not reserve the right to change his mind and take back the property from the trustee. For example, *A* may create a trust for the benefit of *B*, but with the proviso that if the latter proves unworthy the trust will be revoked. This is a case of a revocable trust. In an irrevocable trust there are no such strings attached, *A* having decided "for better or for worse" to permit the trust to stand.

Trusts may be created in such a way that the benefit, or the income therefrom, goes immediately to the beneficiary, or they may be created so that

[52] Will of Harnischfeger, 208 Wisconsin 317 (1932); In re Button's Estate, 190 Wash. 333 (1937). In the former case a donor had made substantial gifts within two years of his death. He was in his seventies at the time he made the gifts but was in good health and spirits. It was argued for the state that the donor had made "an extensive re-arrangement of his affairs" at the time of the gifts and that this was done "to put his house in order" for death. The rearrangement consisted, among other things, of retirement from active business, drawing a new will, and creating a foundation for the benefit of his employees. The Court accepted this as sufficient evidence of contemplation of death.

[53] United States v. Wells, 283 U. S. 102 (1931).

[54] There is some dispute as to whether a donor may appoint himself as trustee of a trust estate. There are court decisions which indicate that he may. See M. N. Friedland, "Irrevocable Trusts: Observations and Comments," *Tax Magazine*, Vol. XVI, No. 6, June 1938, pp. 326-328.

the benefit or income goes immediately to the settlor, and to the beneficiary only at the settlor's death.

Judicial Opinion Concerning "at Death" Gifts.[55] Death tax laws generally include a clause which makes "gifts to take effect at death" subject to tax as part of the estate. Just what constitutes gifts to take effect at death has been in some dispute, but, in general, revocability of the trust agreement or the reservation of a life estate to the settlor is sufficient to establish such status.

Even though a gift in trust may not be taxable as a "gift to take effect at death," it may still be taxable as a gift "in contemplation of death" if the fact of contemplation is established, or, under the presumption clause, the fact of non-contemplation is not established. It is sometimes said that the entire dispute may in due time be relegated into history as the policy of taxing gifts *per se* becomes universal. However, this conclusion overlooks the fact that, even with a gift tax, an important advantage may still be gained by the taxpayer if he can establish that a transfer is a gift rather than a bequest. The advantage arises from the fact that the gift tax often carries a separate exemption and separate graduation. Occasionally, in addition, it may involve a lower rate schedule. The discussion above concerns only the inheritance and estate taxes, both of which differ from a gift tax in that the latter applies only to gifts *inter vivos*.

Use of Trusts and Powers of Appointment to "Skip" Taxes. Probably the most important source of evasion in the estate tax field is the use of trusts and powers of appointment to skip one or more generations in handing down property. One way in which this is done is to give one or more succeeding generations a life estate with the remainder to a still later generation of heirs. The power of appointment adds a refinement in allowing the life tenant some discretion in naming his successors. Legally the creation of a life estate with a remainder constitutes one transfer, and the passage from life tenant to the remainderman is not taxable. Powers of appointment do not make such transfers taxable as long as the powers are specific rather than general and are further limited to a choice within the direct line of descent.

As far back as 1926, when estate tax exemptions were quite high and the rates relatively low, it was estimated that a full one-quarter of inherited property was being transferred by way of life estates with remainders.[56] In 1944, with estate and gift taxes higher, the use of property settlements of various kinds—trusts, life estate-remainder, and powers of appointment—was apparently the common practice in most estates of $60,000 or more. Probably one-half of inherited property was transferred to skip at least one

[55] Of necessity, only the barest outline of the subject is given here. Students who are interested in the problem will find an excellent discussion of it in an article by Prof. Henry Rottschaefer, "Taxation of Transfers Taking Effect at Grantor's Death," 26 *Iowa Law Review* 514 (1941).

[56] William J. Shultz, *The Taxation of Inheritance*, p. 231.

death tax. The full fiscal effect of this practice will be felt more when the initial life tenants die and property worth millions of dollars will pass untaxed to later life tenants or remaindermen.

The remedy for evasion of the estate tax by use of the life-estate-remainder device is to make a transfer from the life tenant to the remainderman taxable. Precedent for such provision can be found in Great Britain. An equally fundamental remedy would be to adjust the estate tax to the differential in age of the donor and heir. A thirty- or forty-year differential would be regarded as standard. An age differential of zero might be sufficient ground for completely disregarding the transfer for death tax purposes. An age differential between zero and thirty or forty might allow a fractional weighting. For example, a ten-year differential would support an exemption of two-thirds or three-fourths of the estate. A differential of more than thirty or forty years would result in a weighting of more than 100 percent or an increase in the base over the amount actually transferred.

TAXATION OF GIFTS *INTER VIVOS*

Contemplation of death is extremely difficult to establish. The evidence involves the state of the donor's mind at the time of the giving, a condition which is not easy to determine or prove. To make matters worse for the state, the family physician, who may be presumed to know something about the health of the deceased at the time the latter made the gifts, is usually "privileged" to withhold testimony. Friends and neighbors of the deceased and the heirs are frequently brought in to testify to such habits and characteristics of the deceased as that he chewed tobacco, drank strong whiskey, went swimming late in the fall, went on long fishing and hunting trips, and talked of living ten years or longer. These are evidences which are hard to controvert by strangers, and as a result the impression often prevails among those concerned in the administration of these laws that the inheritance and estate taxes strike mainly the estates of those who die unexpectedly and who have not had sufficient time to put their "house in order." And, of course, the difficulty of administering the inheritance and estate taxes has not been made any easier by the court decisions which ruled out the conclusive presumption statutes.

Justice Stone, in a dissenting opinion in a case declaring a conclusive presumption clause unconstitutional, stated that up to 1932 the courts had decided 102 cases dealing with whether or not gifts had been in contemplation of death. In only 20 cases, involving $4,200,000, was the government successful in its efforts. In 78 cases, involving gifts of $120,000,000, it was unsuccessful, and there is no evidence that it has done much better since.[57]

[57] Heiner v. Donnan, 285 U. S. 312 (1932).

Gift Taxes in Practice. It has been mainly for this reason, to prevent a wide loophole in the enforcement of the death taxes, that there has developed in recent years a demand for a gift tax—a tax which would reach those gifts that could not be proved to be in contemplation of death. The federal government and 11 states now have gift taxes, all of recent origin.[58] The federal gift tax at present carries rates three-fourths as high as those of the federal estate tax and the law in general parallels that of the estate tax. Both the base of the tax and the exemptions are cumulative; that is, each new gift is added on to previous ones for purposes of applying the proper bracket rate and determining when total gifts exceed the statutory exemption. State laws resemble the federal, though they parallel their own inheritance or estate taxes rather than the federal estate tax.[59] These gift taxes are supplementary to death taxes and do not duplicate them; if a gift is taxed as a gift, it will not be included as a part of an estate or inheritance, and vice versa.

Occasionally some difficulty arises in distinguishing gifts from ordinary support by a relative. The exemptions afford the taxpayer some defense against the taxation of such transfers. Moreover, they can usually be excluded by administration. It is not the purpose of the gift tax to tax "support" or "token" gifts. The tax is aimed at substantial transfers which are attempts to pass on property from one generation to another. There can be no reasonable doubt that a gift tax as a means of blocking a detour around the death taxes has a legitimate and permanent place in a modern revenue system.

Although the passage of gift tax legislation was a step in the right direction, it failed to recognize that gifts during life are not essentially different from gifts at death. Under existing law with two transfer taxes, the estate-owner is free to use either or both, according to his particular advantage. It is quite convenient for him to make use of the exemptions and lower brackets of both and thereby escape the upper brackets of either. Thus the progressivity and revenue-raising capacity of both taxes are defeated. Both levies should be replaced by a single, cumulative transfer tax. A discount might be applied to a tax collected from a gift, the factor being gauged by the life expectancy of the donor.

Philanthropic Gifts. Congressional policy in allowing tax concessions for various kinds of gifts to charitable, educational, and religious institutions has been very liberal. One theory supporting this policy is that, if tax-favored institutions were not to perform certain services, the state would be obliged to undertake them. A gift to charity at the margin of a very large income or estate is mainly financed by the federal government. However, the crea-

[58] The first federal gift tax was enacted in 1924 but was repealed in 1926. The present tax was enacted in the Revenue Act of 1932 and has since been in effect. It has been modified several times through amendments.

[59] In six of the states having gift taxes, both the exemptions and the rates are the same as under the inheritance taxes. They are California, Colorado, North Carolina, Oklahoma Virginia, and Wisconsin (*Tax Systems*, 1942, p. 304).

tion of a charitable trust does not always divest the heirs of the deceased from control of the property so distributed. For example, Andrew Mellon left an estate of approximately 100 million dollars almost entirely to the A. W. Mellon Educational and Charitable Trust. The charitable deduction granted to the estate practically wiped out an estate tax of about 67 million dollars, and the property continues in the control of those nominated by Mr. Mellon: namely, his son, son-in-law, and attorney.[60] The element of control in modern economic life is often of greater strategic value than bare legal title. Very probably there should be some top limit to the deductibility of charitable gifts for the estate tax as there is now in the case of the income tax.

OTHER NET WORTH TAXES

It is perhaps logical to mention in a chapter on death taxes that there are certain alternative ways and times for the taxation of the net wealth or fortune of individuals. One is the net worth tax, which is like the estate tax, except that it falls at regular intervals of time rather than at death. This type of tax meets an important objection to the death taxes, namely, that their imposition is irregular. But the time chosen to levy death taxes has certain strategic advantages mentioned earlier in this chapter. Closely akin to the net worth tax is the capital levy. This tax is usually conceived as a graduated net worth tax but one which is levied only in time of emergency.[61]

SUMMARY

Death taxes are usually levied in either one of two forms, as inheritance taxes or as estate taxes. The former are based on the individual shares transferred to the heirs, and the latter on the undivided estate. The estate tax is simpler and more productive; the inheritance tax is usually thought to be more equitable in that it has some correlation with the ability to pay of the heir. Other refinements to improve this correlation have been suggested and occasionally tried.

Death taxes have a long history behind them. In their modern form they have probably been used with the greatest fiscal success in Great Britain. As in the case of the income tax, United States experience with death taxes is rather recent. Use of the estate tax as a continuous feature of the federal tax system dates only from 1916.

[60] Erwin Griswold, *Cases and Materials on Federal Taxation*, Foundation Press, Chicago, 1940, p. 263; Randolph E. Paul, *Federal Estate and Gift Taxation*, Little, Brown & Co., Boston, 1942, Vol. I, p. 689.

[61] Both the net worth tax and the capital levy would likely meet with constitutional objections if used by the federal government—unless levied on the basis of apportionment among the states according to population.

Some dispute has persisted over the question of which unit of government has the better claim to death taxes, the federal or the state. At one time there was very substantial support for the proposition that the federal government should surrender this source to the states. This was objected to on the ground, among others, that interstate competition would reduce death taxes to negligible proportions. The issue was compromised by the adoption of a federal credit under which a considerable portion of federal taxes can be paid with state inheritance tax receipts.

Death taxes are supported mainly on the ground that they are in accord with ability to pay and have a salutary effect on the distribution of wealth and income. In opposition to this argument, however, is the contention that they consume the capital fund of the nation which uses them. There are many angles of approach to this argument. Probably most taxes are to some extent at the expense of potential saving. Because of their concentration upon relatively wealthy and thrifty people, death taxes do probably reduce saving more than other taxes. That adequate saving is jeopardized by death taxes is, however, very doubtful. Moreover, estate taxes are probably less injurious to enterprise incentives than is the income tax.

Certain features of death taxes in practice create considerable difficulty. Among these are the unequal and occasionally very short interval between transfers and the selection of a time to evaluate the assets of an estate, especially when market values are on the decline.

Multiple taxation was at one time a very serious problem in the application of state death taxes, and the recent trend of United States Supreme Court opinion has greatly enlarged the problem. The Court has recently espoused the view that where there is a plausible ground for tax jurisdiction the Court will not declare the exercise of the taxing power unconstitutional.

Evasion and avoidance of death taxes take place principally through migration, gifts, and the creation of limited interests in estates so as to skip taxable transfers. Migration raises interesting and difficult questions of what constitutes domicile. Gifts in contemplation of death and to take effect at death have long been taxable as part of estates and inheritances. However, it is difficult to establish just what gifts *are* in contemplation of death. The Supreme Court ruled invalid the conclusive presumption that gifts made within a certain period before death are in contemplation. Gift taxes have been enacted to prevent evasion and avoidance of death taxes by large gifts. Integration of both gift and death taxes has not yet developed but is overdue. Another major source of evading the estate tax is by the use of life estates and powers of appointment. This results in skipping a generation or more in successive transfers. The remedy here is to tax the transfer from the life tenant to the remainderman or to include the age differential between deceased and heir as one of the dimensions of the tax. Some bold thinking and courageous reform are required to give the estate tax the place in the revenue system which it deserves.

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CHAPTER XI

Taxes upon Business

TAXES ON BUSINESS IN GENERAL

Introduction

The subject of business taxation falls quite distinctly into two divisions. The first concerns the nature and justification of special taxes upon business in general; the second deals with the application of general or special taxes to particular business. Of the latter, attention here will be confined to taxes upon public utilities, banks, insurance companies, and chain stores. In addition, mention will also be made of the application of general taxes to business.

Directly or indirectly, many general taxes not so aimed nevertheless fall in part upon business. The general property tax must be paid on factories, store buildings, and goods in the process of manufacture or on hand for sale. The income from unincorporated business and the interest and dividends from incorporated business are taxed under the personal income tax. The income tax may also apply to corporations, as such, in the form of either a corporate net income tax or an excess profits tax. The gross income tax includes business among the taxpayers; and a retail sales tax, although thought to rest ultimately upon the consumer, is paid in the first instance by merchants. Using the broadest possible concept of business (as all economic activity), it could be said that all income arises from business. If the frequent assertion that all taxes come out of income is also accepted, the conclusion is inevitable that all taxes are business taxes.

Justification of Business Taxes. Many students of taxation have suggested that in addition to the general taxes paid by business some special business tax should be imposed. This subject was discussed in connection with the corporate income tax but a brief recapitulation may be in order here. The theoretical justification for a business tax is perhaps strongest when viewed from the point of benefits and costs. Business activity in a modern community is greatly facilitated by the orderliness, security, and general enlighten-

ment prevailing, all of which are attributable in large part to government. Many of the problems which the government faces nowadays arise from the way modern business is conducted.

Whether the ability-to-pay concept can be applied to business is a matter of dispute. Certainly, business has what many have accepted as one attribute of ability to pay—namely, the power to meet tax bills.

Business taxes have much to recommend them on practical as well as theoretical grounds. For example, they afford a means whereby revenue from the same source may be shared between the jurisdictions of origin and domicile. The district in which the business is carried on may be allowed the business tax, and the district in which the employees and investors are domiciled may receive the personal taxes. Moreover, business taxes can be made to yield substantial revenue. Perhaps this is fortunate because, both politically and psychologically, it may be inexpedient to load all the burdens of government on personal income and general property.

Nonfiscal Objectives. Mention should be made of the possible nonfiscal objectives in the taxation of business. One of these is the discouragement of "big business" through the imposition of a tax graduated according to the size of the business. The difficulty in such a program was previously suggested; namely, that the unit for optimum operating efficiency varies in different lines of business. What might be a desirable size for a business unit in the manufacture of furniture might be too small for the manufacture of steel. The chain store tax, in part, aims at controlling the size of certain mercantile businesses. The excess profits tax may have the nonfiscal objective of recapturing monopoly profits. Certain features of the income tax, such as the taxation of intercorporate dividends, have been supported on the ground that they tend to prevent undue intricacy in the financial structure of business.

Incidence of Business Taxes. One of the more troublesome matters in business taxation is incidence. If the objective of such taxation is to impose a tax burden upon business itself, then it can be accomplished only through the imposition of a business tax which cannot be shifted forward to the consumer or backward to other producers. The consensus would probably agree that, except for the net income tax (and there is considerable difference of opinion even here), almost all business taxes are usually shiftable. Thus what is first thought to be a business tax may turn out, with further analysis, to be a tax upon the consumer. But were net income accepted as a proper measure for the imposition of a business tax, the large unprofitable concern, which absorbs as much benefit or causes as much expense to the government as the profitable one, would pay no business tax.

Personal v. Business Taxes. The British impose few taxes upon business as such. Their tax system features the personal income tax as its mainstay. The corporate income tax is regarded and is consistently treated as a device

for collecting at the source.[1] The British system has much to recommend it; but there is a somewhat different problem in a country where the income tax is largely federal and where states need more revenue than they care to squeeze out of the general property tax. Perhaps it simmers down mainly to the relative merits of business, general property, and retail sales taxes, all of which are paid in considerable part by the consumer. At least it can be said for the business tax that it diversifies the tax system and attempts to measure the responsibilities of business to government, not only on the basis of capital employed (under the general property tax) but also on some other bases which will be discussed shortly.

General Problems of Business Taxation

Should Unincorporated Business Be Included? If special taxes are to be imposed on business, should they cover all firms or only corporate business? If all, then a question arises as to the definition of a business.

The Model Plan of the National Tax Association approves the view that business taxes should extend to all forms of business, unincorporated as well as incorporated, but the predominant practice is to confine such taxes to corporations. There is some plausible support for special classification and treatment of corporations. As a class, corporations are identified with big business, which creates difficult problems for the government. Corporations and their stockholders are separate legal entities and are often physically as well as legally separated. This is not usually true of partnerships and individual entrepreneurs. A business tax on the corporation enables the community in which it is located to collect something for the support of public activities made necessary by its presence. The government grants certain privileges to corporations, particularly the privilege of limited liability, and sometimes this is cited as an argument for special taxation. But the argument can be answered that, insofar as this privilege is open to all, free competition should make it valueless. Immunity from personal taxation is a more important privilege, which, however, probably should be abolished rather than taxed.

If the recommendation of the National Tax Association to tax all business, incorporated and unincorporated, were accepted, where should the line be drawn to indicate what constitutes business? Is farming a business? Is owning real estate and charging rent a business? Is practicing law a business? Is working for a salary a business? If the answer to all of these questions is "no," then the question may be put: Why tax the corner grocer on his way of making a livelihood and not any of these others? The question is not easy to answer. Perhaps everyone should be taxed once in his productive capacity

[1] Recently the British have imposed a 5 percent corporate income tax which is in all respects a business tax; however, it is considered an emergency measure only.

and once in his consumptive capacity. This idea, however, has never made much progress outside of textbooks.

New York now imposes a business tax of 4 percent on the net income of unincorporated business, but its application is quite limited. Businesses earning less than $5,000 net or receiving more than 80 percent of their income from personal services are excluded. Under the heading of professional services, substantial engineering, law, and accounting firms employing large staffs of employees and having payrolls as high as $500,000 are exempt. Consequently, the law extends the business tax into new territory only to a limited degree.[2] Professor Shultz indicates that under prewar conditions only 7,000 firms were liable to the tax, though the number has since increased to around 40,000.[3] Connecticut applies a business gross income tax to several classes of unincorporated business, thus supplementing a net income tax on incorporated business. These taxes undoubtedly lessen the tax advantage of some firms competing with corporations.

Methods of Business Taxation. Perhaps because of the reluctance of most tax students to accept the view that there are three legs to the "tax stool," property, income, and business, the methods employed in taxing business have proceeded on a wide but somewhat haphazard front. Whereas property and income taxes are usually based on only one measure, value in the case of the former and income in the latter, the bases of business taxes often include a great number of different measures, such as net income, property, capital stock issued, gross income, and so on. The business tax system is further complicated because some of the taxes levied on business are peculiar to business activity whereas others are laid on business along with other taxpayers; some of these taxes tend to remain on business while others are shifted; some are confined to corporations while others include unincorporated businesses as well; and some are imposed upon business in general while others are confined to specific types of business.

Although no attempt is made here to list all methods of business taxation, it is believed that those applying to business in general fall more or less into the classifications listed below. The taxes on specific types of business will be discussed later.

A	B
1. Sales taxes	1. Occupational taxes
2. Property taxes	2. Incorporation fees
3. Excess profits taxes	3. Capital stock taxes
4. Corporate net income tax	4. Corporate excess taxes
5. Gross income taxes	

[2] Paul Studenski, "New York's Experience with a Tax on Unincorporated Business," *How Shall Business Be Taxed?*, Tax Policy League, New York, 1937, pp. 86-87.

[3] W. J. Shultz, *American Public Finance* (2nd ed.), p. 482; Letter from New York State Tax Commission, Albany, 1945.

The taxes listed under A above were mentioned at the beginning of this chapter and were described as taxes more or less general in character but including business in their scope. They are discussed in more detail in other chapters of this book. Here it may be recalled from the chapter on income taxes that the corporate net income tax is both a device for collection at the source and a business tax, and that the excess profits tax, although a business tax and applicable mainly to corporations, also has a place in the income-tax picture. Gross income and sales taxes will be discussed as consumption taxes, but they deserve some additional consideration as business taxes.

The Gross Income Tax and Retail Sales Tax. The gross income tax differs from the net income tax in that the former ordinarily allows no deduction for business expenses or cost of goods sold. In some states, as in Indiana and West Virginia, the gross income tax is a general tax applying not only to what is usually considered business but to service and investment income as well. In other states it is more strictly a business tax (sometimes called a gross receipts tax). This is true in Arizona and Washington.

A strong case can be made for volume of business (gross income) as the basis of a business tax, either as a substitute for part of the property tax on business or as a supplement to it. Under such a tax the government in effect says to the taypayer: "You have come amongst us and have exploited our market; you have trafficked as much as your competitor; whether you have used your opportunity as well as he is not our concern. It is the gross volume of your trade which both represents your opportunity and causes our expense. Upon that you must pay." [4]

However, the use of gross income as the base of a business tax results in the accumulation of taxes according to the number of transactions involved in the preparation of a commodity before it reaches the consumer. The number and amount of taxes the consumer has to pay depends upon this fortuitous circumstance. To illustrate, the manufacturer sells goods to the jobber at a price of $1,000,000; the jobber sells them to a wholesaler at a price of $1,050,000; and the latter passes them on to several other middlemen, each one adding a moderate mark-up until they are ultimately sold to the final consumer at a price of $1,500,000. A gross income tax would include in its base the sum of all of these exchange values. A retail sales tax based on the final exchange avoids this overlapping and in this respect is a sounder form of business taxation. The same result could be had by applying the tax to "value added" by manufacturer and merchant rather than to gross sales. "Value added" would differ from gross income as a base in that cost of goods sold would be a deductible expense.

The gross income tax as a state tax on business also encounters difficulties of interstate competition. The retailer can bear a fairly high tax because he has little outside competition with which to contend. The manufacturer

[4] T. S. Adams, "The Taxation of Business," *Proceedings of the National Tax Association Conference*, 1917, p. 189.

must be dealt with tenderly since he competes with others not paying the same taxes.

The retail sales tax may also be conceived as a business tax. It is a means of charging the consumer (along with other business costs) for the services which government renders to business. However, it ignores the objective of taxing business as such (rather than the consumer) and throws the entire risk of incidence upon the merchant. Moreover, at their best, retail sales can be regarded as only a rough index of governmental service to business.

Occupational Taxes. In some states, particularly in the South, a great variety of special charges are imposed upon business. In 1942, Alabama had over 130 such separate occupation taxes on the state statutes. Some of those included were: special taxes on barber shops, dealers in coffins, dealers in dice, junk dealers, and persons engaged in the practice of medicine. Some of these levies were payable to the local units rather than the state.[5] The Brookings Institute for Government Research described the occupation tax system of Alabama as follows: [6]

> In describing the system as a whole the best that can be done is to say that it is a conglomeration of heterogeneous taxes imposed for different purposes, on different bases, under many forms of rate schedules, and with many types of administrative machinery. It is a good example of the effects of log rolling and unplanned development over a period of 60 years. All kinds of government charges are jumbled together without distinction. There are fees, licenses, permits, property taxes, sales taxes, severance taxes, personal taxes, motor vehicle taxes, and many different forms of business taxes.

The outstanding characteristic of these occupation taxes is their arbitrariness. A few of them are based upon some rough measure of the volume of business, but most of them are based upon no reasonable principle whatever. One student lists no less than 13 important elements that are used either singly or in combination to form the base or measure for these taxes. Eleven of these are of external or objective character. They are: (1) the occupation itself; (2) the population of the community in which it operates; (3) the kind or size of product produced or sold (as boat-builders upon the tonnage of boats contracted for); (4) the number of units of some essential equipment (as knitting mills on the number of knitting machines); (5) the room or producing capacity of building or factory; (6) the number of employees; (7) the kind or size of equipment; (8) the length of time or number of local jurisdictions in which business is carried on (as advertising agencies according to the number of counties in which they have billboards); (9) volume of actual

[5] Chapter 20, Tit. 51, Code of Alabama, 1940; see Tax Research Foundation, *Tax Systems*, 1942, p. 7.

[6] Institute for Government Research, *Taxation of the State Government of Alabama*, Brookings Institution, Washington, 1932, Vol. IV, Part III, p. 315.

production (as cotton compresses on bales compressed per annum); (10) the amount of fee or price charged (as athletic clubs on admission charges); and (11) the amount of invested capital.[7]

The French have had a business license tax system similar to that prevailing in the South and from which the latter was probably copied.[8] The French penchant for gauging by some external index the fundamental factors in taxation—ability and benefit—can be seen in this system. The latter assumes that there is a correlation between the external factors and ability or benefits. Thus, under this system the obligation of business to government is more likely to be measured by the number of persons employed or the floor space occupied than by the gross or net income. In practice the system lends itself beautifully to political pressure. Moreover, it is frequently regressive and penalizes the "little fellow."

Incorporation Fees. These are charges incidental to the acquisition of a corporation charter and are ordinarily nonrecurrent and of small fiscal importance. They are usually based on (and sometimes graduated according to) the par value of the stock or the number of shares issued or authorized. A complementary tax may be imposed upon foreign corporations as a condition on their doing business in a state.

Capital Stock Taxes. A capital stock tax is a business tax applicable to corporations and proportioned in some way according to the capital represented by stock and employed in the business. Based, as it frequently is, upon the value of assets, it has some resemblance to a special property tax. But the alleged justification of the tax is the privilege of engaging in business as a limited liability concern.

The methods of measuring this privilege are numerous and sometimes very arbitrary. The federal government bases its tax upon declared value and supports this procedure with a so-called excess profits tax[9] based on the same figure. If the taxpayer declares a low figure, he will be caught under the supplementary excess profits tax; if he declares a high figure, he will pay an unnecessary amount of capital stock tax. Formerly the declaration had to stand for three years and involved some very capricious results especially inimical to the small taxpayer, whose source of advice in playing this game was least adequate. The declaration is still a matter of expediency, and need relate to no existing facts. The present base is a function of income, and the feature in effect is neither an excess profits tax nor a capital stock tax except in name.

During and after the First World War, the federal government tried out the use of a capital stock tax based on the value of the assets of corporations.

[7] Roscoe Arant, "Business Taxation in the Southern States," *Tax Magazine*, Vol. XVI, No. 7, July 1938, p. 463.

[8] *Ibid.*

[9] Not to be confused with the war excess profits tax, see Chap. VIII.

But this program involved very grave administrative difficulties and it was abandoned in 1926.[10]

In addition to this basis, capital stock taxes may be imposed upon the market value of stocks or upon the par value of either the issued or authorized issue of securities. In the case of no-par stock the tax may be based on the number of shares. Bonds as well as stocks might be included in the measure, but this is rarely done. Obviously, capital stock alone, without regard to bonds or other indebtedness, gives a distorted picture of the capital of a corporation. Par value or authorized value may have little or no relation to actual capital. Market value, although better, is open to many objections as a criterion of value. For instance, it offers no means whereby the value of an interstate corporation could be apportioned among the various states for tax purposes without going to the actual value of the assets. But the value of corporate assets is extremely difficult to determine.

Logically, a state might seem restricted to taxing only the stock represented by the proportionate assets of the corporation lying within its borders. However, it is apparently within a state's legal power to tax (at least under the "franchise tax") all the securities of a corporation which it incorporates. The state of Delaware, notorious for its lax incorporation laws, enjoys the benefit of this laxity by imposing a capital stock tax on all stocks authorized by the corporations it incorporates. Thus, in effect, the state imposes a tax on the assets of a corporation even though those assets may all be located west of the Mississippi River. Delaware imposes a light tax so as not to discourage its incorporation business, but the base of the tax is large and the state receives a substantial portion of its revenue from this source. Probably it is legal for a state to tax a foreign corporation only upon some fair apportionment of capital stock employed within and without the state. This involves the difficult problem of making a fair apportionment.

About two-thirds of the states employ some form of capital stock tax but with a great variety of bases, procedures, and methods of apportionment. The law of Michigan may be taken as an example. The rate in that state is 2.5 mills, with a maximum tax of $50,000 and a minimum of $10 on any one corporation. On interstate corporations it is based upon the portion of the value of paid-up stock and surplus represented by assets in the state.[11] In some instances, especially on small and relatively unprofitable corporations, it represents a greater burden than would the usual net income tax. Why a top limit should be provided in such a tax is not at all clear to the outside observer.

[10] See C. A. Drake, "The Federal Capital Stock Tax," *Proceedings of the National Tax Association*, 1922, p. 224; Harley L. Lutz, *Public Finance*, 2nd edition, D. Appleton & Co., New York, 1929, p. 500. For a presentation of the problems and practices of capital stock taxation in state taxation see National Industrial Conference Board, *State and Local Taxation of Business Corporations*, New York, 1930.

[11] Tax Systems, 1942, p. 124.

It is probably fair to conclude that capital stock taxes in practice are only a little less arbitrary than occupational taxes. But, although they are only a rough indication of the size of the corporation, they represent one means of obtaining revenue from it. The cannon of taxation to which they answer best is probably that of "getting the most feathers with the least squawking."

The Corporate Excess Tax. The corporate excess tax is really a feature of the property tax, but it is usually associated with business taxes and may be discussed along with them. Corporate excess is the value of a corporation above that of its tangible assets and may be determined by placing a value upon the business as a whole, another value upon its tangible assets, and then deducting the latter from the former. The original method of assessment by local assessors has lost ground in favor of assessment by state officials. In a few of the states, corporate excess is taxed at special rates rather than as general property. In Illinois it is taxed not where the physical property of a corporation is located but where the corporation maintains its central office.

By 1912, sixteen states had adopted this measure, but since that time it has diminished in favor, chiefly because of administrative difficulties. By 1944, only eight states retained this levy, and one of these, Indiana, apparently did not enforce it. The tax has its highest development probably in Massachusetts, where it is administered by the state tax commissioner and contributes substantially to the revenue.

Although the corporate excess tax is a companion piece to the property tax, it serves also to tap the same values as those reached by the capital stock tax. The corporate excess tax applies only to the intangible values of a corporation, so that tangibles and intangibles shall be taxed at the same rate as real estate, whereas the other (the capital stock tax) reaches both tangible and intangible values represented by the corporation's stock. Thus, though the tax base of values taxed by the capital stock levies is much broader than that reached by the tax on corporate excess, the rates are usually much lower.

The principal limitation of corporate excess taxation is in administration. If no real valuation of corporate assets is made, the tax is arbitrary like the capital stock tax, and, if such valuation is made, the task of doing the job creditably is formidable.

Toward a Better System of Business Taxation. Business taxes in the United States are characterized by much arbitrariness, complexity, and lack of co-ordination. Students of the subject have sought to remedy these conditions and have made a number of proposals to that end. One of these takes the form of a single co-ordinated business tax [12] which would include a number

[12] Committee on State and Local Taxation, "Second Report on a Plan of a Model System of State and Local Taxation," *Proceedings of the National Tax Association Conference*, 1933, pp. 353-427.

of alternative bases, with the tax imposed upon the base producing the highest tax.

Among the alternative levies suggested are, first, a flat minimum tax, something like a poll tax, to cover the cost of administration or to exact a small charge for the privilege of corporate existence. The minimum charge might also be conceived as an administrative device to avoid the difficulty of applying other taxes to very small businesses. In the case of small and inactive businesses this would probably be the only business tax paid. The second alternative tax suggested is one based on net income; this tax would catch the more profitable businesses. The third proposal is a tax on gross income, which would hit the large but unprofitable businesses and the nonprofit cooperatives. Rates would be adjusted so that normally the average business would pay the net income tax as the highest of the three alternative levies. But even the nonprofitable business would have some taxes to pay and, in time of depression when the government is in need of more funds, the gross income tax alternative could be relied upon to ensure greater stability to public revenues. The Model Plan recommended no distinction between incorporated and unincorporated business in the application of this tax. However, some classification, differentiation, and exemption would not be incompatible with the plan.

The least that can be said for a co-ordinated and rational system of business taxes, such as the one described above, is that it would be a great improvement on the present practice.

TAXES ON SPECIAL BUSINESS: PUBLIC UTILITIES

General Level of Utility Taxes

One of the first questions to present itself in the taxation of public utilities is that of the relative tax burden which should be imposed upon them as compared with other property and business. Some have taken the position that utilities should be entirely exempt from taxation on the ground that utility taxes are sales taxes in disguise and fall upon the consumer of utility services. On the other hand, it may be argued that utilities should pay taxes at a higher rate than that prevailing for business in general on the ground that utilities are monopolies and, therefore, special taxes should be levied upon them to recapture their monopoly profits. A position midway between these extremes would call for equality of taxation with other property and business.

It is true that public utility taxes are paid in large measure by the consumers of utility services. By decision of the United States Supreme Court, all taxes, including income and profit taxes, may be counted as business expenses in the determination of the "reasonable return" upon the fair capital

value which is used as a basis for setting rates.[13] Justice Brandeis qualified his opinion with the suggestion that the privilege to count taxes as business expenses might be weighed in the determination of what constitutes a reasonable return. However, it is doubtful whether this qualification has had any practical bearing upon rates.

The theory that utility taxes are paid in the last analysis by the consumer needs to be qualified in two respects; first, where the utility's price is set by what the traffic will bear rather than by public authority, the rule does not necessarily hold; and, second, it may take considerable time for a change in utility taxes to work itself into utility rates. There is some chance that taxes will never be reflected in rates. The wheels of utility regulation grind slowly and imperfectly.[14]

Returning to the problem of the general level of utility taxes, it may be said that, even though the taxes are borne by the consumers of utility services, these consumers are not identical with the general public and therefore they should pay for the special services they receive. There are many other important taxes which are probably passed on in the main to the consumer without the latter putting in a claim for exemption on that account.

The proposition that monopoly profits may be recaptured through especially heavy taxation of utilities may, of course, be countered with the fact that utility rates are now subject to state regulation and therefore there should be no monopoly profits in the business. It may be doubted that state regulation has been sufficiently effective to have eliminated all excessive or monopoly profits from the utility business, but, even conceding this, it may still be urged that the public should seek to strengthen its regulation rather than impose discriminatory taxes. On the whole, the middle ground that utilities should pay taxes at the same level with other businesses seems most tenable.

The history of public utility taxation has frequently been divided into three periods: one of subsidy, lasting to about the end of the nineteenth century; one of neutral treatment, lasting from then to the depression of the thirties; and one of special burdens, from the thirties on to the present. Whether the present tax system discriminates against public utilities may be questioned, but, in general, this historical division is a useful way to describe the trend.

[13] Galveston Electric Co. v. City of Galveston, 258 U. S. 388 (1922); also Georgia Railway and Power Co. v. Railroad Commission of Georgia, 262 U. S. 625 (1923).

[14] As a matter of fact, the view that public utility taxes are to be borne by consumers was somewhat modified by the rate-making authorities in carrying out the price-freezing policies of the government during the Second World War. Rates were not, as a general rule, adjusted upward to meet the greatly increased burden of income and profits taxation. Probably in most cases, however, income after taxes was at least sufficient to constitute a fair rate of return.

The Ad Valorem System of Taxing Railroads

The Ad Valorem System and Local Assessment. A substantial number of states attempt to apply the property tax, frequently called the ad valorem system, to public utilities including railroads. Invariably, this involves difficult problems of administration. It is obvious that the usual methods of assessment, at least in the case of railroads, are quite inadequate. It is impossible to evaluate a railroad properly in the enormous numbers of segments which local assessment involves. Local assessment means valuation by hundreds of untrained and unqualified local assessors. It offers no solution for evaluating and taxing rolling stock. Nearly all railroad property is still locally assessed in a number of states, but the trend is decidedly toward state assessment by a tax commission or similar agency. The problems of ad valorem taxation of railroads and many other utilities are so difficult that not only state assessment is required but also a well-staffed and efficient agency to perform the task.

The Ad Valorem System and State Assessment and Taxation

The procedure employed for the assessment of railroads in the ad valorem states has, to some extent, become universalized. The procedure described below is that used in Wisconsin, except as variations in other states are noted.

1. *The Unit Rule.* A railroad is assessed according to the "unit rule," that is, as an organism or system more or less independent of the value of its parts. The reasons for this procedure have already been suggested. It is thought that each part of the railroad has value only insofar as the whole has value. Piecemeal valuation of a railroad is like piecemeal valuation of a horse. What is the value of the left hind leg of a horse? The answer depends, of course, on all the other limbs and organs of the horse. Moreover, in the case of the railroad, the whole may not be equal to the sum of all its parts. The railroad may have an additional positive or negative intangible value as a result of many factors which add to or detract from its present and future earning power. This may be taken into account by assessment under the unit rule.

2. *Evidence of Value.* What evidence of value should be weighed in making an ad valorem assessment of a railroad? Usually, the general property tax statute lays down the rule that property shall be assessed at market value—what it would bring in a free exchange. But railroads are not bought and sold every day as are many other kinds of property. Thus, in place of this the following are generally accepted as evidence of value.

The Value of the Outstanding Securities. Some indication of the market value of a railroad may be ascertained by observing how its stocks and bonds are selling. Though railroads may not be bought and sold every day, fractional

equities in them are constantly being exchanged. From these exchanges, security values may be ascertained and totaled. Since unit rule assessment seeks only the value of the operating property, it is necessary to subtract from the total value of securities the value of nonoperating property of the railroad. Nonoperating property, such as idle real estate, timberland, mines, and hotels, is assessed by the local assessor like other property of a similar nature. But another complication arises in that the XYZ railroad may own some of the securities of the ABC railroad. Since the ABC railroad is independently assessed, this influence, wherever it appears, must be discounted.[15] More universal as a limitation on the usefulness of stock and bond values in ad valorem assessment is the fact that such values fluctuate more or less violently as a result of speculative trends in the security market. People may sell or buy stocks not because of their own estimate of the future earning power of the company these securities represent, but rather on the expectation of "what average opinion expects the average opinion to be." [16] The stock of one large Wisconsin corporation during the panicky market of the depression of the thirties dropped below the worth of the company measured by its liquid assets; that is, the company had cash enough in its treasury to buy up all its capital stock at the market value.

Capitalized Income. The value of most property depends considerably on what income it may be expected to yield, and the expectations must be gauged to a large extent by what the property is yielding and has yielded in the past. This reasoning also applies to railroads. The past record should be a representative one and, for that reason, should cover a longer period than one year. If there has been a general business depression in the past years, that fact should be taken into account in extending the period to be considered, in the rate of capitalization, or in the interpretation of the final results. In choosing a rate of capitalization, weight should be given to the interest which the business must pay in order to float new securities and draw new capital into the industry. Some attention may also be given to the average rate of return upon values in other lines of business, making due allowance, of course, for the element of risk. Another factor that should enter the calculation is management, which may affect income considerably and obscure the productive capacity of the property as such.

Physical Value. Capitalized income as a test of value breaks down when a company incurs an operating loss over a period of years. "Junk value" might be thought to represent a minimum beyond which the value of railway

[15] Moreover, special situations arise where security values are obviously a poor measure of the value of the company they represent. Such a case occurs where the company being appraised has its securities guaranteed as to interest or principal by another company. Frequently, nonoperating assets have an influence upon security values that is not easily isolated. The dividend policy of a company also affects its security values (see C. M. Chapman, "Use of Railway Statistics and Accounts in Determining Taxable Valuations," *Proceedings of the National Tax Association Conference*, 1937, pp, 242-251).

[16] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, Harcourt, Brace and Co., New York, 1936, p. 156.

property cannot fall, but this is contested on the ground that public authority does not allow railways freely to abandon the railway business. Some value may be supported by the fact that a prospective buyer might see in the property some prospects of income under reorganization and better management. Many other taxpayers, such as farmers, grocers, and manufacturers, continue to pay some property taxes even though they have encountered persistent deficits. It may be doubted that even railroads which have experienced chronic depression would surrender their properties to the government for nothing or less than nothing. One of the accepted evidences of value, particularly in circumstances of this kind, is physical value.

For major railroads the Interstate Commerce Commission has spent much time and effort making physical appraisals and maintaining cost of reproduction figures. These data, with some modifications, can be used as the third index of value in assessing railroads.

3. *Determination of Value.* Given the principal evidences of value suggested in the above discussion, there still remains the question of what weight to ascribe to each in order to arrive at a single figure. A well-equipped state tax commission has the services of trained statisticians and accountants for gathering information on public utilities assessed by the commission. Preceding the annual assessment, the statistical division presents the commission with full information concerning all of the above measures of value, as well as many other additional facts, such as gross income, ratio of previous year's taxes to gross income, salaries of officers, dividend record, previous assessments, and other data which may be useful to the commission in making an assessment. The commission then "goes into a huddle" and, on the basis of the information presented, comes out with a "preliminary assessment" of the railroad. The preliminary assessment is the basis for hearings at which taxpayers or others may endeavor to show that the preliminary assessment is in error. The commission then deliberates a second time and produces the final assessment.

The "huddle" system of assessing railroads may be objected to because it is not scientific. In the opinion of experts there is no specific formula that could be generally applied to different properties in reaching a value that would do equal justice to all of them. A correct formula for one year might be incorrect when applied to the same property a year hence.

It has been said that judgment, not formulas, "arrived at after skilled and careful consideration of all relevant data, facts, and relationships, is the base upon which the finding as to unit value of any complex property must rest. Let us not expect the impossible by assuming that a simple or even involved formula can be written and handed to a group of calculating machine operators to grind out satisfactory final answers as to value." [17]

[17] A. G. Mott, "Weight To Be Given Physical Appraisals in Determining Unit Value Assessments for Railroads," *Proceedings of National Tax Association Conference*, 1937. p. 241.

4. *Apportionment.* In the case of utilities which extend into more than one state, there is the problem of determining what value to ascribe to the various parts of the system lying in the different states. It is well established by legal opinion that apportionment must be on some fair basis which will show approximately the true proportion of the railroad or other utility in a given state. The Wisconsin rule of apportionment for railroads is an average of six ratios.[18] These ratios are as follows:

a. Total track mileage.
b. Traffic units—ton miles of freight and passenger miles.
c. Locomotive and car mileage.
d. Physical property.
e. Gross income.
f. Net income.

Illinois has developed a further factor: tons of traffic originating and terminating within the state. It is a factor favorable to the terminal as contrasted with the so-called "bridge" states.

The ratios consist of the proportion of these quantities within and without the state. The commission, however, is not obliged to follow an unweighted and inflexible average of all these items.[19]

Undoubtedly many states have been guilty, consciously or unconsciously, of arriving at railway values for tax purposes to which they are not legitimately entitled. The courts have not proved an adequate defense against this form of multiple taxation. A plausible case on this ground can be made for a federal system of railroad assessment and apportionment, but such a development has never been very seriously considered.

5. *Determination of Rate.* Once an assessment has been completed, the next problem is to determine what tax rate to apply to the value obtained. In Wisconsin the rule is to apply the "average state rate." This is arrived at by dividing the total property taxes of the state (including all its subdivisions) by the "equalized" value of all the property subject to assessment. It is important to use "equalized" rather than assessed value in determining the rate because it is presumed that the railroads are assessed at full value; they could legitimately protest a rate built up on assessed values for other property. These assessed values might be considerably under true value; and a tax rate calculated on the basis of assessed values would be higher than one

[18] These factors of apportionment have been approved by the National Tax Association.

[19] The use of track mileage as the sole basis of apportionment was declared contrary to the 14th Amendment in the North Dakota case of Wallace v. Hines, 253 U. S. 66 (1920). This single standard takes no account of density of traffic, the location of terminal property, and as a sole criterion would result in "importation" of value by certain states. The net income figure has always been suspect, both because it cannot be arrived at without arbitrary accounting procedure and because it sometimes shows a negative figure for particular states. An interesting discussion of the use and misuse of apportionment factors can be found in the *Proceedings of the National Tax Association Conference*, 1937, pp. 251-301.

based on equalized values. Here the importance of tax commission calculation of "equalized values" is again illustrated.

In many states, the value of railroad property is allocated back to each taxing district wherein railroad property is located, to be included on the local tax rolls and taxed as other property in the district. In Iowa the value is apportioned to the various political subdivisions through which a railroad operates on the basis of a uniform value per mile of main track, regardless of the amount and value of other railroad property within each political subdivision.

6. *Disposition of Revenues.* When the railroad taxes are collected by the state, there is a problem as to what disposition should be made of the revenues therefrom. In Wisconsin all goes into the state treasury with the exception of taxes collected on "docks, piers, wharves, and elevators" assessed as a part of the operating system of a railway. In Michigan the railroad tax is distributed to school districts in accordance with school population. The practice followed by these two states avoids some difficult problems of local apportionment, but it is objectionable to municipalities with valuable terminal property or repair shops within their jurisdictions. Most states attempt to apportion railroad taxes (or property) to the counties or even smaller units of government. In such cases, in addition to the problem of equity involved in the method of apportionment itself, there is the question of why districts which have no railroad property but contribute traffic to the railroads should be excluded from the enjoyment of railroad taxes. For the railroads the apportionment of property values to subdivisions of the state involves a very considerable additional burden of detailed accounting and reporting. In a few instances the boundary lines of school districts have been manipulated or gerrymandered to include a bit of railroad so as to help pay school taxes. On the whole, there is little doubt that railroad taxes are best suited for state revenue and that apportionment is a survival of the era when railroads were locally assessed.

Variety of Procedure Among the States. In practice the application of the property tax to railroads presents considerable variety of procedures among the states. Despite the wide recognition of its undesirability, exclusive local assessment of ad valorem taxes is still found in a number of states, and others divide the assessment function between local and central agencies. Thus in Texas all utility property is locally assessed except the "intangibles" and rolling stock of railroads. This time-honored custom is protected by the Texas constitution. Nebraska has a system of central assessment but permits cities and villages to make independent assessments of all railroad property within their boundaries. In Illinois, one railroad, the Illinois Central, is taxed on gross earnings; all others are under the ad valorem system, though assessment is somewhat divided between central and local agencies.

Taxing Railroads Under the Gross Earnings Tax

A considerable number of states make no attempt to tax railroads under the property tax but apply in lieu thereof a gross earnings tax.[20] In Minnesota, for example, the railroad tax consists of a 5 percent levy on gross operating revenue which is assessed by the tax department. The system avoids the necessity of annual valuation and is generally conceded to be considerably simpler than the ad valorem system. It does not avoid, however, the problem of apportionment, which is much the same under both systems.

Ad Valorem v. Gross Earnings Taxation of Railroads

The relative merits of these two methods of railroad taxation have been debated at quite some length. The proponents of the gross earnings tax base much of their case on the administrative difficulties involved in the ad valorem system. "If the going value of public utility enterprises is determined by a capitalization of net income, the tax commission or other assessing body is put to the laborious task of determining net income only to have the figure so obtained capitalized by a ratio determined by arbitrary rule-of-thumb methods. . . . In practice the ad valorem assessment of public service enterprises generally resolves itself into a bargaining between the assessing body and the legal representatives of the taxed enterprise, the latter defending themselves against what they consider unreasonable valuations by the threat of litigation." [21]

On the positive side, it is argued that the gross earnings tax is simpler and involves less arbitrariness in administration than the ad valorem tax. Moreover, by using income as the base, the tax applies to some extent the ability-to-pay principle.

Proponents of the ad valorem system contend that it is not incompatible with good administration. Valuation is a feature of the general property tax and is nowhere determined by formula without the exercise of judgment. If actual sales of railroad property are infrequent, the same is true of many other kinds of property, particularly manufacturing property. It is true that judgments of value differ. A group of ten appraisers will usually show a considerable range of opinion in evaluating even as ordinary a property as a residence or a herd of cattle. The general property tax is not condemned on that account. It seems probable that a tax commission with a good personnel could assess railroads at least as efficiently as most other property is assessed.

There is much objection because no definite formula is used under the ad valorem system for arriving at the market value of a railroad.[22] No defi-

[20] The gross earnings tax is used most exclusively in Minnesota, Connecticut, and Maine Many states use it in part. (*Tax Systems*, 1942, pp. 263-275.)

[21] W. J. Shultz, *American Public Finance and Taxation* (1st ed.), p. 514.

[22] See Roy G. Blakey and Associates, *Taxation in Minnesota*, Chap. XI.

nite formula is used in arriving at the market value of anything, least of all perhaps by an actual buyer. Values are a matter of judgment in which many factors must be weighed. On what formula has Minnesota determined its gross earnings tax of 5 percent?

Ad valorem assessment of railroads is at its worst when applied to properties persistently showing little or no operating income. It must be admitted that the valuation of such properties involves a large element of guesswork and that the legal validity of most any assessment under these circumstances is somewhat doubtful. The gross earnings tax at least provides a clearly legal basis for collecting a substantial contribution for government from such utilities. The difficulty, however, is at least almost as great in the application of the property tax to manufacturing property. Perhaps the conclusion must be that the property tax should stand or fall as a whole and that utility property should not be split off for special treatment.

The proponents of the ad valorem system are not without ammunition for counterattack. They observe, first of all, that in states where the gross receipts tax is used, an attempt is made to adjust the rates on gross receipts so that companies as a whole will pay about the same amount as they would were they under the general property tax. This weakens the alleged advantage of the gross earnings tax as to simplicity of administration. States using the gross earnings tax must check periodically to see that rates are adequate. In doing so, they usually make an ad valorem assessment of the utility to compare the taxes under the gross earnings system with what they would be under the ad valorem system. This seems to indicate that the ad valorem system furnishes the standard of equity even in states using the other system; it also shows that these states, too, must resort to "arbitrary methods" in order to test their own system.

Much experience appears to indicate that in practice the gross earnings tax frequently results in lighter taxes on public service corporations than the ad valorem system. Gross earnings taxes are inflexible in practice, and changes in rates show a substantial lag behind those which fluctuate automatically with the rates of other property in the state. Changes in rates of the gross earnings tax must be ratified by both houses of the legislature and be approved by the governor before they become effective.[28]

It has been said that the gross earnings tax "tempers the wind to the shorn lamb"; that is, the companies are favored when in distress. However, the farmers and grocers have no favors when in distress. Why should the railroads? From the standpoint of public revenues, receipts from the ad valorem tax fluctuate from year to year much less than do those from the gross earnings tax.

[28] In Minnesota they must also be submitted to a referendum vote of the people. The 5 percent rate on the gross earnings of railroads adopted in 1913 should be raised about 50 percent, it is estimated, in order to put railroad taxes on a level with those on other property (*ibid.*, p. 341).

It is apparent that both of these systems of taxing railways are open to important objections. Probably it is proper to conclude that the ad valorem system at its best is more equitable and less arbitrary than its principal alternative. But the ad valorem system requires very high-grade administration for its success and, in the absence of such administration, the gross earnings tax may be preferable.

Other Methods of Taxing Railroads

Taxation of railroads is by no means confined to the ad valorem and gross earnings taxes. Many states apply other forms of business taxes to these utilities—notably, the capital stock tax and the corporate excess tax. Massachusetts, New York, and Pennsylvania employ these taxes along with some use of the property tax and gross earnings tax. The New York system is conspicuous for its complexity.[24] The state-assessed franchise tax on capital stock of transportation companies is based alternately upon net value of issued capital stock, or dividends earned or declared above a certain minimum, or a low flat minimum payment. In addition to the franchise tax measured by capital stock, transportation companies pay a franchise tax of one-half of one percent of gross earnings. A local franchise for the use of city and village streets is assessed by the tax commission but appears on the local rolls at local rates. All this is superimposed upon a local assessment of tangible property.[25] Massachusetts relies on local assessment of certain property, plus state assessment of corporate excess to cover the remainder.[26] A good feature of the Massachusetts system is the distribution of state-assessed railroad taxes to *all* the local districts according to their contributions under the state property tax. In Pennsylvania the major tax is the capital stock tax.

Taxation of Other Utilities

Problems in the taxation of telephone and telegraph companies are not very different from those applying to railroads. Light, heat, and power companies have increased greatly in importance in recent years and, through consolidations and development of transmission lines, have assumed statewide and even interstate proportions. Local assessment survives in this field to an even greater degree than in the case of railroads. Likewise, the same objections prevail here, particularly those concerned with the inadequacy of local personnel and the impossibility of assessing adequately "one leg of the horse." Wisconsin has delegated the assessment of all interdistrict utilities to the state tax commission. Mississippi and Utah have the same practice except that it applies only to utilities extending into more than one county. However, the rule is local assessment, and the principal improvement in

[24] *McKinney's Consolidated Laws of New York*, Book 59, Part I, Sec. 184 (1943).
[25] *Tax Systems*, 1942, p. 269.
[26] *Ibid.*, p. 267.

this field lies in the centralization of the assessment process. As in the case of railroads, a wide variety of business taxes, outside the ad valorem tax, are also applied to other utilities.

Application of Federal Taxes to the Utility Field

Federal income and profits taxes apply to the utility companies and, during the Second World War, these levies were the cause of much complaint. The utilities contended that the excess profits tax levied before the deduction of income taxes, combined with income taxes at new high levels, frozen rates, and only a moderate increase in gross profits, resulted in less than a fair return upon their capital. These contentions were recognized to some extent by the Revenue Act of 1942, which allowed a deduction for surtax purposes on certain dividends paid on preferred stock.

Other Problems in Utility Taxation [27]

Double Standard for Rate-Making and Taxation. In many state legislatures at each session, and sometimes between sessions, one or more legislators demand to know why, in the name of common sense, the commission which determines the price to be charged the buying public should have one set of values for rate-making purposes and the tax commission a totally different one for taxation purposes. The legislator is convinced that a given utility is escaping its just share of taxes because it "gets away with one value for rates and another for taxes."

If it were merely a matter of two distinct bodies determining two different values, the double standard could be easily eliminated. But the explanation lies deeper than that. The rate base is not really a value at all; it is simply a quantity used in determining a level of rates which will continue to draw capital into the utility business. On the other hand, the tax base is truly a value. By statute it must represent, as nearly as can be determined, the selling value of the utility at the time chosen for the assessment. If all investments in utility property were wisely made, and if regulation were perfect, the tax base and the rate base would approximately correspond. But neither of these conditions exists in fact. In the case of a defunct railroad, the rate base will be much higher than the tax base. The company cannot earn a fair return upon either its investments or the cost of reproducing its plant. Nevertheless, these are the factors which must be taken into account when a rate problem is presented to the rate commission. On the other hand, were the tax commission to impose an assessment upon this company equal to its rate base, it would be violating the statutory standard of assessment as well as the uniformity clause found in most state constitutions. The company

[27] Much of this section is adapted from Harold M. Groves and Geo. M. Keith, "Some Solved and Unsolved Problems of Public Utility Taxation in Wisconsin," *Journal of Land and Public Utility Economics*, Vol. X, May 1934, pp. 109-119.

must be assessed at what it will sell for. And no one would buy this property without taking much account of its present and prospective earnings.

On the other hand, a strong utility presents an entirely different picture. The excess of tax base over rate base might be attributable to the unusually favorable location in which the company finds itself and its privilege of monopolizing this favorable location; it might be traceable to the failure of regulation (or at least its slowness) in reducing rates to the point where service is furnished at cost. In any case, the earning power is there and, except for the portion which is attributable to management, it can be passed on to a buyer in exchange. Therefore, it must be assessed.

Thus it is clear that the rate base and the tax base are two quite different things which ordinarily cannot be reconciled. Probably this explanation will never entirely satisfy the legislator who makes the inquiry. But it is difficult to see how anything further can be done to satisfy him, for the double standard is usually written in both the statutory law and the constitution, and, in addition, is defensible as a matter of equity.

Treatment of Leased Property. According to some state statutes, the property of centrally assessed utilities is to be assessed as a unit; all property used in the unit, whether belonging to the assessed company or not, is to be included in the unit assessment. This means that, if the XYZ Railroad leases a line from the ABC Railroad and the former operates this line as part of its system, the line is assessed to the XYZ Railroad and not to the ABC Railroad. Were the rule otherwise, it would complicate the process of making the unit assessment and perhaps make it impossible. Probably no great injustice results to the utilities as a result of this provision in the statutes; utilities can and do take account of it when property is leased. However, it does create a rather anomalous situation where a railroad is required to pay a tax to the state even though it owns no property in that state. The assessment of other property is on the basis of ownership rather than use.

It is apparent that, unless the commission follows the rule of the statute consistently, double taxation will result. For example, where an independent bridge company rents all property to one or more railroads, its property is fully included in the assessment of the railroads. If that property is now independently assessed it will result in double taxation. There are quite frequently instances where this has been done, which can be explained only on the ground that the tax commission is confused in its thinking. The commission "gets away with" this violation of the law probably because the taxpayer and his attorneys are likewise confused.

Taxation of Utilities Under the Net Income Tax. The question of whether utilities subject to the ad valorem tax should also pay a net income tax (in states that have one) raises some interesting issues.

Utilities claim that, under the unit rule and ad valorem assessment, their net income is taken into account in making their property tax assessments

and that to tax them again upon their net income would be double taxation. Through a process of assessment which takes into account capitalized net income, one of the factors determining value, utilities are assessed, so they argue, upon intangible property. The intangibles, whether passing under the name of goodwill, franchise value, or corporate excess, are all included in the value of the franchise assessed under the unit rule. In states where intangibles are exempt from the property tax, the utilities say that they alone among property taxpayers are assessed on such intangibles and that it is no more than fair, consequently, to exempt them from the net income tax.

Those who argue that a utility should pay an income tax like any other corporation claim that the same standard of assessment holds for utilities as for other properties. In all cases, the standard of assessment is what a property will sell for at a bona fide private sale. Moreover, it is contended that under regulation a utility is expected to furnish service at cost; that is, under conditions which will yield a fair return upon its capital. Except for the lag in or failure of regulation, there would be no excess earnings upon which "intangibles" could be based. In other words, as Professor Commons has ingeniously phrased it, the "good will" of a utility is the "good will of politicians." On this reasoning it is contended that the utility has no ground for complaint if its intangibles are included under both the income and property tax. This latter argument appears to be entirely sound and to warrant inclusion of all utilities under the net income tax even if intangible property in general is exempt from the property tax. (It is true, of course, that public utilities may legitimately have a form of intangible sometimes called "going concern value" or "organization value," consisting of its capitalized expenses of getting under way in the business. To that extent the utilities' argument is valid.) Railroad companies, by the same token, appear to have a special privilege if they are exempt from state income taxation. The railroads might base a claim for special consideration upon the ground that they have subsidized their competitors in paying taxes which were in part spent upon public highways.

The Disposition of Utility Tax Revenues. Under many state laws, utility property centrally assessed is apportioned among the local governments for taxation or, as in Wisconsin (except for railroads), the tax itself is in large part apportioned. Apportionment of assessment is usually on the basis of mileage or physical property; apportionment of taxes may be on a similar basis or it may include sales as a factor. Sales are less concentrated than property, but the distribution which results, even from apportionment with equal weight accorded to both factors, gives very substantial revenues to a relatively few municipalities. These few municipalities often receive more revenue than they are entitled to or can use to good advantage.

The contention will be made, of course, that any taxation district has as much right to tax the utility resources within its borders as it has to tax its

soil or its factories. However, the problem must be solved by weighing the social consequences of alternative policies. There is a substantial difference between localizing the revenues from factories and farms, on the one hand, and doing the same with a public utility generating plant, on the other. The public utility plant involves very little additional public expense to the district in which it is located. Very little new education and/or public welfare program is made necessary because a utility property is located in a district.

The likely conclusion in regard to revenues from utility taxes is that they should be earmarked for state and county use to a much greater degree than is now the rule. This conclusion would probably be accepted by most students of the subject. But important vested interests (of municipalities) have been built upon the existing practices, and these vested interests are likely to hold their own for the most part against a sounder and more equitable distribution.

Taxation of Municipally Owned Utilities. A majority of the states exempt public property from all taxes regardless of how it may be used. Of course, this includes publicly owned utility property. As far as local taxes are concerned, the exemption may result in no loss of revenue; a sum equivalent to taxes may be set aside from the earnings of the utility and transferred to the general city account. Local taxes in the case of a municipally owned utility are a bookkeeping transfer in any event. However, the bookkeeping transfer as a substitute for taxes is confusing. And, of course, it does not include the equivalent of taxes due to central units of government. The Tennessee Valley Authority pays local governments some equivalent of local taxes, but the payment is by federal legislation and is more or less gratuitous. Some states do provide that public property is exempt only so long as it is devoted to a public use. Such a qualification, however, is worse than none, for it can hardly fail to provoke useless debate as to what is and what is not a public purpose.

Utility companies, whether publicly or privately owned, should be taxed on the same basis as other business enterprises. Municipal ownership is looked upon by many as a yardstick with which to measure the efficiency of private business under public regulation. This yardstick is more suitable when there are no differences in tax burdens. The consumers of publicly owned utilities owe something to the state and municipal treasuries for the benefits they receive from government. Exemption of municipally owned utilities from the federal income tax is also difficult to justify. There are valid grounds of support for public ownership of utilities, but avoidance of the federal income tax is not one of them. Particularly if a municipally owned utility has property which extends beyond its home jurisdiction, it should pay taxes to the other districts in which it has property. A municipally owned utility should not only make its contribution to local expenses but also to the state and county expenses. Sometimes it is allowed to escape the latter of these obligations even though the former is required. Unless the con-

tribution to the central units is made, the municipality itself is favored among others in the distribution of the central tax burden. Also, the particular unit owning the utility benefits at the expense of the other taxing units within whose jurisdiction it may have property.

The American propensity to exempt public undertakings of a commercial character from taxation has no counterpart in England. The British impose taxes upon these enterprises as though they were private. The British example in this respect is a good one.[28]

Taxation of Rural Electrification Cooperatives. As a part of a depression public-works program and to extend electrical facilities to farmers, the federal government, beginning with 1935, encouraged the development of and loaned capital to rural electrification cooperatives. These cooperatives then developed on a substantial scale in many states. This created the problem of how these cooperatives should be taxed. Ad valorem taxation based on physical value appears harsh because, in many cases, the projects do not and cannot produce income to support such value. Nevertheless, the majority of states do apply ad valorem taxes to this rural electrification property, though what concessions, if any, are made in the administration of the law is not apparent.[29] Some states have applied a policy of subsidization to these projects (as, for example, in Georgia, where they have been exempted by constitutional amendment until 1962). Wisconsin collects a gross receipts tax of 3 percent in lieu of general property and other income taxes. In general, these projects, organized as farm cooperatives, pay no federal taxes. The problem is in many respects similar to that of taxing public housing projects.[30]

Taxation of Air Transportation. The taxation of air transportation is still in its formative stages. This field was called sharply to public attention by a recent decision of the United States Supreme Court [31] sustaining a personal property tax by Minnesota upon the entire fleet of the Northwestern Airlines Company, notwithstanding the fact that its routes traversed eight states and the other states in which stops were made taxed some part of the fleet. Minnesota's claim to such wide jurisdiction rests upon the fact that it is the corporate domicile of the company—that is, the state from which the company received its charter. A concurring opinion expressed the view that air transportation is the special province of the federal government and that Congress might control its taxation (as in the case of national banks [32]) but that states had the prerogative applied in Minnesota in the absence of legislative enactment. Congress subsequently called upon the Civil Aero-

[28] The problem becomes more serious as the federal government becomes more involved in utility enterprises. See Chap. XX for a discussion of this phase of the problem.

[29] Tax Systems, 1942, pp. 285-292.

[30] See Chapter V.

[31] Northwestern Airlines v. Minnesota, 322 U. S. 292 (1944).

[32] See next chapter.

nautics Board for advice upon which to found legislation outlining or prescribing a tax system for airplane transportation.

Obviously the Civil Aeronautics Board and Congress are confronted with a difficult problem, some of the important elements of which are the following:

1. Does Congress have the power to dictate the manner in and the degree to which states shall tax air transportation companies?
2. What forms of taxation—property, income, sales, gasoline—should Congress authorize the states to apply?
3. What formula of apportionment should be applied? Should it recognize the tax claims of the "bridge" states (those in which no stops are made)?
4. Should a federal or federal-state agency be established to revise and apply whatever standards are affirmed?

PROBLEM

Assume the following facts concerning a railroad which operates in State X:

1. Its net earnings in 1936 were $24,000,000. During the two previous years the net earnings had averaged $22,000,000.
2. The road had outstanding 200,000 shares of stock and 300,000 bonds. Average quotations on New York exchanges showed the stock selling at $500 per share and the bonds at $1,000 each.
3. The Interstate Commerce Commission's valuation of the railroad was $410,000,000.
4. The railroad had gross earnings in 1936 of $150,000,000.
5. An average of several ratios (including mileage of road, traffic units, etc.) showed 25 percent of the railroad's total property to be located in State X.
6. The assessed value of all taxable general property in the state in 1936 was $4,800,000,000; the equalized value was $5,400,000,000. The total general property taxes were $110,000,000.

Using the above data, calculate the state tax bill for the railroad and show quite concretely how the state would set about taxing this railroad.

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CHAPTER XII

Taxes upon Business (Cont.)

TAXATION OF SPECIAL BUSINESS: BANKS

Special Characteristics of Banks

From the standpoint of taxation, there are at least two important respects in which banks differ from most other businesses. The first is that banks carry a stock of intangible goods. Their assets consist mainly of various promises to pay, such as paper money, bonds, notes (some of them secured by mortgages), and the like. Banks specialize in the promises-to-pay of commercial customers who borrow when buying goods and pay when the goods are sold. A mercantile company has a stock of *tangible* goods upon which it usually pays property taxes. Perhaps the banking corporation should pay taxes upon its stock of *intangible* goods, but the fact that the latter are intangible and representative (of tangible goods) is an important difference.

In the second place, some banks are chartered by the federal government and are considered to be federal instrumentalities by the courts. Federal instrumentalities cannot be taxed by the states except by permission of the federal government. This goes gack to an old and very important decision rendered by Chief Justice Marshall of the United States Supreme Court.[1] The decision declared unconstitutional a discriminatory state tax on a federal-owned bank. Subsequent decisions have established the fact that federal-chartered banks can be taxed by the states, with or without discrimination, only as Congress permits and prescribes.

Banks are also unique in their monetary powers. They are privileged to create credit by loaning what they do not have (that is, beyond their capital and reserves) subject to certain rules prescribed by the government.

"Section 5219"

The separate treatment of banks in taxation has grown out of the second special characteristic rather than the first. It commenced in 1863, when

[1] McCulloch v. Maryland, 4 Wheat. 316 (1819).

Congress limited the state taxation of national banks organized under the National Banking Act. The Act was amended in 1868 and the legislation as amended emerged as the now familiar "Section 5219." [2] This section prescribed certain rules for bank taxation. Its two main provisions were: first, real estate owned by the bank might be taxed like other real estate; second, additional taxes might be levied on the stockholders' shares but at no higher rate than that imposed on "other moneyed capital in the hands of individual citizens." The second tax was theoretically on the shareholders rather than the bank, and in some instances the courts held bank share taxes invalid where shares were listed under the name of the bank rather than under the names of the individual shareholders.[3] Nevertheless, collection was usually from the bank itself and the tax has been considered a bank tax.

It will be observed that this law necessitated classification of personal property so as to place upon bank shareholders directly and banks indirectly a somewhat unique and distinctive kind of tax. On the one hand, banks had an advantage over other types of business (grocery stores, for instance) in that they were not taxed like the latter on gross assets, i.e., stock of goods regardless of debts, but rather, they were taxed upon net assets—or the value of the business as indicated by the total value of all the shares. To avoid double taxation many states provided that the value of a bank's real estate should be deducted from the value of its shares before they were put upon the assessment rolls.[4] On the other hand, in practice, banks were at a disadvantage because the shares proved much easier to find and evaluate than most other intangible personal property. For this reason the banks claimed that they were assessed at a higher percentage of true value than other property, which evidently was often true.[5]

The rule that national bank shares could not be taxed at a higher rate than that imposed on other moneyed capital in the hands of individual citizens was, for over 50 years, quite universally interpreted to mean that national bank shares could not be taxed at a higher rate than state bank shares. The federal statute sets no upper limit for the state taxation of state banks, but in the interest of fair competition most states have never discriminated against state banks. For the most part they have taxed all banks in the manner outlined in "Section 5219." Meanwhile, however, efforts were being made in many states to modify the general property tax in order to

[2] Ronald B. Welch, *State and Local Taxation of Banks in the United States*, New York State Tax Commission, Albany, 1934, Special Report No. 7, p. 16.

[3] First National Bank of Gulfport v. Adams, 258 U. S. 362 (1922).

[4] Ronald B. Welch, *State and Local Taxation of Banks in the United States*, p. 90. The author indicates that 32 states using (1934) the share tax permit deductions for at least part of the real estate owned by the bank and some of them provide for the deduction of other assets.

[5] It was also alleged, particularly by bankers, that the share tax had a bad nonfiscal effect in discouraging the provision of adequate capital and surplus by banks. Objective studies which have been made of the problem show very little if any connection between the burden of taxation and the financial structure of banks (*ibid.*, pp. 74-88).

make the tax on intangible property more effective and equitable. In some states, such as Wisconsin, modification took the form of a complete exemption of intangible property. In other states, such as Virginia, modification came about through classification of property and the application of low flat rates to intangibles. However, most states which adopted one or the other of these modifications retained the bank shares tax without any change. It was felt that this tax was well administered and that banks were generally prosperous businesses, quite able to pay taxes upon their intangible property.

The Richmond Bank Decision and Its Effect

In 1921, the United States Supreme Court, in the case of Merchants National Bank v. City of Richmond,[6] put an end to the special classification of bank shares. The Court held that "other moneyed capital in the hands of individual citizens" included "not only moneys invested in private banking . . . but investments of individuals in securities that represent money at interest and other evidences of indebtedness such as normally enter into the business of banking. . . ." [7] Broadly speaking, the Court interpreted "other moneyed capital" to include not only state bank shares, but also a very considerable portion of the whole field of intangible property. This meant, apparently, that the classified-property-tax states would have to surrender their tax on bank shares at general property tax rates or revert to the old system of including all or most intangibles in the general property tax base. The states were not prepared to accept either of these alternatives and vigorously protested the decision of the Court.[8]

In 1923, in response to numerous protests, Congress amended "Section 5219" to liberalize the taxation restrictions on national banks and make them more flexible. Two other methods of taxing national banks were added to the share tax, but only one of them might be used by any one state and then only in lieu of the share tax. Banks might be taxed on their shares *or* their net income *or* their dividends. If the net income alternative were chosen, the rate must not be higher than that imposed on the income of other financial corporations nor higher than the highest rate imposed upon mercantile, manufacturing, and business corporations. Furthermore, the tax on dividends must not be higher than that imposed upon dividends from other moneyed capital. However, if both corporate income and dividends were generally taxed, they might both be taxed in the case of banks.

The amendment also added a phrase which was thought to wipe out the effect of the Richmond decision and make possible, by classification, the separation of bank stock from other intangibles for taxation purposes. It stipulated that rates on national bank shares must not be higher than those on

[6] Merchants National Bank v. City of Richmond, 256 U. S. 635 (1921).

[7] *Ibid.*, p. 639.

[8] Some 20 states found the validity of established practices in the taxation of banks seriously imperiled as a result of this decision.

"other moneyed capital in the hands of individual citizens . . . coming into competition with the business of national banks," and added a proviso that "bonds, notes, or other evidence of indebtedness in the hands of individual citizens not employed or engaged in the banking business and representing merely personal investments not made in competition with such business, shall not be deemed moneyed capital within the meaning of this section."

The Hartford Bank Decision

A careful reading of the qualifying phrases thus added to the "no-discrimination" section of the federal law should convince one that they added nothing, not even clarification, to the law as it had previously existed. However some congressmen and many others apparently were of the opinion that the proviso limited "moneyed capital" to property employed in the banking business. These people were very disappointed when the Supreme Court handed down its decision in the case of the *First National Bank of Hartford v. Hartford*[9] early in 1927. It will be recalled that Wisconsin exempted stocks, bonds, notes, and mortgages from taxation. The bank doing business in that state contended that some of these constituted "other moneyed capital" within the meaning of the federal law. The trial court accepted this interpretation but its decision was reversed by the Wisconsin Supreme Court, which held that the protection granted by the federal law extended only to parity of taxation with persons, firms, and corporations engaged in the banking business, and that such concerns were obliged to incorporate under the Wisconsin statutes as banks. However, the Supreme Court of the United States rejected this strict interpretation of the banking business and other moneyed capital. The Court pointed out that national banks performed services other than accepting deposits, and any substantial loaning of money by institutions other than banks was sufficient evidence of other moneyed capital in competition with national banks. Since Wisconsin building and loan associations, bond and mortgage companies, insurance companies, and private individuals were engaged in the business of loaning and borrowing money, and since all of these were exempt from taxation upon their intangible property under the property tax, the Court declared the Wisconsin bank shares tax in violation of the federal statute. The case arose before the 1923 amendments, but the Court declared that these amendments in no way altered the "no-discrimination" clause of the federal statutes.

Congress amended "Section 5219" in 1926 to provide for a fourth alternative method of taxing national banks. By this new provision the states might impose an excise tax upon the franchise of a bank, the value of the franchise to be "measured by" or "according to" the net income of the bank. Attempts

[9] First National Bank of Hartford v. Hartford, 273 U. S. 548 (1927); also a similar case decided on the same day, Minnesota v. First National Bank of St. Paul, 273 U. S 561 (1927)

were soon made to measure the franchise by the total net income of the bank, including what would otherwise be tax-exempt interest on government bonds. The interest on these bonds is an extremely important item in the accounts of many banks. The amendment permitted the states to do indirectly what they could not do directly. After some wavering, this indirect taxation of interest received was sanctioned by the Court.[10]

Experience of Certain States with Bank Taxation

States have had a variety of experience with bank taxation. Some of them, Illinois, for example, have continued to levy a bank shares tax, protected in this course by the fact that their other intangible property was subject, nominally at least, to the full general property tax. Other states, such as Wisconsin, have shifted from taxing the banking business (except for bank real estate) under the property tax to taxing it under their net income tax. The shift has resulted in a considerable loss of revenue and has been criticized for undue leniency to the banks. Especially conspicuous is the fact that the banks, in some cases, escape taxation even on their *tangible* personal property, such as bank furniture and fixtures. California and several other states have attempted to meet these criticisms by imposing a franchise tax measured by net income, a procedure which allows what would otherwise be tax-exempt interest in the tax base. Washington, with no net income tax and no tax on intangibles, has been unable to make any special levy on banks. Minnesota maintained a bank tax system for a time by "gentlemen's agreement" and now levies an income tax at a special high rate. The latter procedure is defended on the legally doubtful grounds that no discrimination can be proved as long as the total tax burden upon banks is not higher than that upon competitors. Some states try to balance burdens more precisely each year and apply a rate to the banking business based on this annual calculation. This process involves many uncertainties and questionable comparisons. Iowa and Virginia apply to bank shares the special rates applicable to other intangible property. Many state tax departments have repeatedly recommended further amendment of the federal statutes to permit a return of the old shares tax without readoption of the property tax as to other intangible property.

How Should Banks Be Taxed?

The unique history of bank taxation suggests many problems of policy in this field, a few of which may now be considered.

Should the Federal Government Protect Banks as Such? It is questionable whether the federal government needs to protect national banks now that

[10] MacAllen v. Massachusetts, 279 U. S. 620 (1929); Pacific Co. v. Johnson, 285 U. S. 480 (1932).

opposition to the system of national banking has ceased; certainly, the government would be taking no chances by confining its control to the requirement that states may not discriminate in favor of their own banking institutions. The states have no disposition to do away with banking as a whole. The question of what taxes banks should pay might well be left to legislative discretion of the states. In effect the federal government has been protecting not national banks but the banking business from such taxes as state legislatures might see fit to impose.

Should Banks Pay Property Taxes? There is no reason at all, except the extraordinary series of historical accidents in this field, why banks should escape taxes on furniture and fixtures [11] and perhaps even livestock, whereas other taxpayers must pay taxes upon such property. The banks have a stronger case for exemption of intangible property, particularly if in general it is not subject to tax. As stated earlier, most intangible property consists of equities in tangible property which is subject in full to the property tax.

Should Banks Be Singled Out for Special Business Taxation? It is possible to conceive the bank shares tax as a special business tax imposed upon the banking business and justified by the peculiar character of much of the capital used in that business. Additional ground for the imposition of such a tax might be found in the fact that banks, like insurance companies, enjoy and require considerable protection and regulation from government. Whether it is reasonable and desirable to apply such a tax to commercial banks and not to other businesses whose capital is mainly intangible, such as investment banks and trust companies, is a close question. There are at least enough grounds for special classification so that the matter might be left to legislative discretion.

"Section 5219" permits no special business taxes upon banks, such as is permissible in the case of insurance companies and most other lines of business. What taxes states should apply were they not restricted need not here concern us. The point to stress is that Congress has overdone the protection of banks from taxation, both general and special. "Section 5219" is properly used to protect federal instrumentalities from discriminatory treatment. It was not designed and should not be used to protect the banking business.

TAXATION OF SPECIAL BUSINESS: INSURANCE COMPANIES

The Development of Insurance Taxes

After banks, the first businesses to break away from the general property tax were insurance companies.[12] But, unlike banks, insurance companies

[11] This is true in states no longer applying the bank shares tax.

[12] E. R. A. Seligman, *Essays in Taxation*, 10th ed., p. 161.

were never protected by the federal government. In fact, they have not even been accorded the federal protection that is usually extended to other interstate corporations under the commerce clause of the Constitution. Because early in the present century the United States Supreme Court held that insurance is not commerce, either state or interstate, it might be taxed without violating the Constitution. Although the Court has changed its view and has now held insurance companies subject to the operation of antitrust laws, this has as yet had no effect on taxation.[13] Thus, where there has been a relatively high degree of uniformity in the taxation of banks, there has been an impressive diversity in that of insurance companies.

The application of special taxes to insurance companies dates back at least to 1824, when New York provided that foreign fire insurance companies should pay 10 percent on premiums collected within the state. Gradually the other states followed New York's example, though not all of them used gross premiums as the base of the tax. Rates ranged considerably from state to state but were generally much lower than those of the first New York law.

Should Insurance Companies Be Taxed?

Insurance companies frequently claim they should be exempt from all except real estate taxes. They argue, first, that their property is mainly of an intangible character consisting of such assets as bonds, notes, and mortgages. They maintain (as do the banks) that the taxation of these assets constitutes double taxation since this property is only representative of other property. Second, these companies hold that they (particularly life insurance companies) perform a valuable service for the state in preventing dependent people from becoming public charges; this service, they say, has as much claim to tax exemption as that performed by benevolent societies, which are exempt. Thirdly, they argue that much of their business is conducted by mutual companies, which are cooperatives and nonprofit-making institutions. Receipts in excess of expenses go to policyholders in payment of losses or in reduced cost of insurance. Fourth, it is claimed that the incidence of insurance taxes is on the policyholders, many of whom are poor farmers, office employees, and clerks, who should be relieved of taxes rather than burdened with additional ones.

These are plausible arguments, but they have not succeeded in bringing about immunity from taxes for the insurance companies. The state provides the insurance companies with considerable benefits in legal protection for their many contracts. Only a portion of the public carries insurance and is thus benefiting directly by these governmental services. Insurance is a business "affected with a public interest" and therefore calls for close supervision. (However, it is rejoined that less than 5 percent of insurance taxes

[13] New York Life Insurance Co. v. Deer Lodge County, 231 U. S. 508 (1913). See also United States v. South-Eastern Underwriters' Association, 322 U. S. 533 (1944).

are needed to cover cost of supervision.) It is a form of saving and investment not unlike many others which are subject to general or special taxes.

Insurance, particularly in the United States, has grown to a business of enormous size. Someone has compared the insurance business to a Mississippi River of dollars flowing across the country; legislators, hard pressed for new revenue sources, could hardly be expected to forego the temptation to divert a little of this stream into the public treasury.

Nature of the Insurance Business

The insurance business is a fairly complicated mechanism but, in general, its outline may be briefly sketched as follows: Policyholders pay gross premiums to the company and these are used to meet losses and business expenses. A reserve is maintained in the form of investments that bring in an investment income. The company may be either building up or using up its reserves, depending upon the trend of the business and the nature of the policyholders. If gross premiums and investment income exceed losses and expenses, the excess may be retained as surplus or distributed as dividends to the stockholders or policyholders, or both.

In the course of this movement of wealth and property, there are many different places where the state may levy a tax. In practice, the methods of taxing insurance companies in the United States vary from state to state: levies are imposed on almost everything from gross premiums to dividends.

Forms of Insurance Taxation

The Gross Premiums Tax. This form of taxation, sometimes compared to the gross sales tax, is the most common of all levies on insurance companies. Not only is the tax simple in its application, but it is also founded on a broad enough base to yield well with even a low rate. From the premiums on insurance sold within the state (or to residents of the state), companies are usually permitted certain deductions (explained below). On the adjusted total of gross premiums, the domestic companies pay a flat tax varying upward to as high as 3 percent, as in Idaho. The rate is quite frequently more for foreign insurance companies (companies organized in states other than the taxing state).[14]

The gross premiums tax has the faults of a sales tax in that no account is taken of varying conditions in the different companies, such as requirements for reserves, for losses, and for the expense of doing business. Some attempts at refinement are found in the deductions allowed, the more common of

[14] Thus South Dakota taxes domestic companies at 1 percent and foreign companies at 2.5 percent. New Jersey taxes domestic companies at .35 percent and foreign companies at whatever rate New Jersey companies are taxed in the home state of the foreign corporation. The field of insurance taxation is marked by many retaliatory tax measures of this kind.

which are for canceled and rejected policies, reinsurance premiums, and dividends returned to the policyholders (analogous to the patronage dividend of cooperative societies). Occasionally, money paid out to compensate losses is also allowed as a deduction.

Property Tax Bases. Some states attempt to integrate the insurance tax with the general property tax, and their procedure follows closely the early experience with bank taxation. The market value of shares as a basis of insurance taxation is objected to because of its speculative fluctuations; book value is criticized because of the possibility of its manipulation by the taxpayer. The reserve (intangibles held by the company) is a logical base for a property tax, but it runs counter to the trend of exempting intangibles from property taxation. This form of taxation is dominant in the important insurance state of Massachusetts.

Taxation of Investment Income. This tax is levied by a number of states, including Connecticut (on mutual companies), and is based upon the income from investments, affording a much narrower base than the gross premiums tax. "This tax distinguishes between the income of an insurance company which is a payment for service rendered and the income which is the result of the profitable employment of funds." [15] Taxes on investment income usually make some allowance for the outlay necessary to maintain reserves. However, in the case of a domestic insurance company doing business in several states, the investment-income base for the home state is greatly enlarged by the fact that all the investment income may be taxed and not (as in the case of the gross premiums tax) only that portion which represents business done (or residents' payment) within the state.

The Net Income Tax. The federal government taxes insurance companies, along with banks, on net income. The net income of a life insurance company is peculiarly difficult to determine because of long contracts and uncertain losses. The tax applies chiefly to income from investments. Deductions allowed are those that can be associated with this income, although a special deduction to maintain reserves is permitted.

Under the federal income tax, insurance received is ordinarily not taxed to the recipient unless he is the insured, and then only so far as his insurance exceeds his investment; annuities are taxed to the extent of the interest factor involved. Insurance which matures at death is ordinarily treated for tax purposes as part of the estate of the insured.

Other Insurance Tax Problems

The states frequently distinguish between mutual and stock companies, between foreign and domestic companies, and among the different kinds of insurance. For example, Wisconsin imposes no business tax upon domestic

[15] Philip L. Gamble, *Taxation of Insurance Companies*, New York State Tax Commission, Special Report No. 12, Albany, 1937, p. 14.

mutual companies other than those doing a life insurance business.[16] The large number of taxes, classifications of companies, taxing jurisdictions, and the still more intricate reciprocal and retaliatory provisions found in the laws of nearly every state, make the pattern of insurance taxation very complicated.[17] These latter provisions apply to foreign insurance companies and set up the rule that the taxing state will apply the same rates to these companies as the home states of these companies apply to those chartered by the taxing state. The latter usually sets a low minimum, indicating that these laws are more retaliatory than reciprocal. These provisions afford some protection to foreign companies but tend to concentrate insurance tax revenues in the states where such companies are chartered.[18]

There has been some difference of opinion as to whether the taxes on insurance companies are conspicuously high. On the one hand, the insurance companies offer evidence to show how much more heavily taxed they are than other businesses. On the other, Dr. Gamble, in his study of the subject, concluded that the life insurance business is probably subjected to a considerably lower average burden than real estate, banks, and public utilities.[19] Some further studies of the comparative burdens of different businesses, taking account of the taxation theory involved, would be useful.

TAXATION OF SPECIAL BUSINESS: CHAIN STORES

Justification

Chapter V on property taxes presented the alleged inequities of the property tax as applied to merchants, and particularly to chain stores as compared with independent merchants. These alleged inequalities are said to arise because of the relatively greater inaccessibility of property tax information in the case of chain stores, their higher turnover with smaller stock, stock manipulation, and so on. These inequalities, it is said, justify special taxation of chain stores.

In addition to and separate from the contention that chain stores enjoy

[16] All attempts to extend business taxes to these untaxed classifications have been successfully resisted, in part because of the political power of the small town mutual fire insurance companies.

[17] See *Tax Systems*, 1942, pp. 293-296.

[18] It should also be mentioned that the insurance business is frequently subjected to local occupation taxes, particularly in the South and Middle West. A study in 1931 showed that there were three legal bases employed in the imposition of taxes locally: first, the agent, for the privilege of engaging in selling insurance as an occupation; second, the agency, for the privilege of engaging in the selling of insurance as a business; and third, the company, for the privilege of operating within a specified territory. (Lloyd B. Averett, "Local Taxation of the Insurance Business in the United States," *Tax Magazine*, Vol. IX, No. 12, Dec. 1931, pp. 438-442.) This study showed that from these special taxes about $2,400,000 was raised by the local units of government.

[19] Philip L. Gamble, *Taxation of Insurance Companies*, pp. 65-67.

tax advantages under the property tax is the contention that they enjoy certain unfair economic advantages. It is said that because of their size they are able to buy at a greater discount and that this advantage is an unfair one which should be compensated for by special taxes. Beyond this there is the argument that the chain store is a social menace and that it should be taxed either out of existence or at least to a degree which will discourage its development. The chain store tax is of principal interest as an attempt to tax business according to size.

Practice

Less than half the states now have some kind of special tax on chain stores. The most common type of tax is one determined by the number of stores in the chain. The longer the chain, the higher the average tax per store. Usually only the stores located in the state are counted in determining the length of the chain, but Louisiana graduates its rates according to the number of stores in the chain throughout the country.[20] Until the Supreme Court held it unconstitutional,[21] another type of tax on chains was in effect in a number of states. This was a graduated tax on sales. Occasionally, single-unit stores were also included in this system. Novel features to chain-store legislation have been introduced in Tennessee, which bases its tax on floor space, and Michigan, which includes a levy on the number of counters.[22] Florida applies a tax to chain store inventories.

Legality of Chain Store Tax

Indiana Law Sustained. An interesting series of judicial opinions have been handed down concerning the constitutional validity of special chain store taxes. In the case of Tax Commissioners v. Jackson,[23] the Supreme Court by a 5-4 decision sustained an Indiana law of the unit type which graduated the tax from $3 on one store to $25 for each store in excess of 20. The issue in this case turned on whether the segregation of chain stores for special taxation was reasonable classification. Justice Sutherland, for the minority, contended that the fact that business is carried on under more than one roof is not a sufficient basis for separate classification and that there is no necessary correlation between chaining and the size of a business or the volume of its trade. A department store may do as much business as a chain of smaller stores. Justice Roberts, for the majority opinion, held that the chain feature might be considered as giving a business additional ability to pay. To support this contention, he cited the standardization of equipment and display, the more rapid turnover, the uniformity of store manage-

[20] Rates in Louisiana range up to $550 per store on units in excess of 500.
[21] Stewart Dry Goods Co. v. Lewis, 294 U. S. 550 (1935).
[22] *Tax Systems*, 1942, pp. 225-228.
[23] State Board of Tax Commissioners v. Jackson, 283 U. S. 527 (1931).

ment, the special accounting methods, and the unified sales policy which are regular features of chain store business.

Florida Law Declared Unconstitutional. Two years after the Indiana law was sustained, the Court, by a 6-3 decision, declared unconstitutional the chain store tax of Florida.[24] This differed from the Indiana law in that it classified chains according to whether or not they extended into more than one county. The majority held this to be unreasonable classification. "There is no more reason for adopting the county line as the measure of the tax than there would be for taking ward lines in cities, or arbitrary lines drawn through the state regardless of county boundaries." [25] Justice Brandeis in his dissent stated that "size alone gives to giant corporations a social significance not attached ordinarily to smaller units of private enterprise," [26] and added that the state has as much right to prohibit the excessive size of a business as to prohibit the excessive size of motor trucks and the height of buildings. He contended that it is not unreasonable for a legislature to believe that certain chain stores further the concentration of wealth and power, promote absentee ownership, convert independent tradesmen into clerks, and sap "the resources, the vigor and the hope of the smaller cities and towns." [27]

West Virginia Law Sustained. In the case of Fox v. Standard Oil Company of New Jersey,[28] again a 5-4 decision, the Court sustained a West Virginia statute of the unit type ranging to a top rate of $250 on stores in excess of 75.[29] Justice Cardozo, in the opinion of the Court, stated that if the classification is reasonable the Court will not examine the degree of tax. He went even further by quoting an earlier case which held that, even if the tax should destroy a business, it would not be made invalid or require compensation upon that ground alone.[30] The Indiana case was cited as precedent for holding the classification reasonable.

Kentucky Law Invalid. In the case of Stewart Dry Goods Company v. Lewis,[31] the Court (with 3 justices dissenting) held a Kentucky statute unconstitutional. The Kentucky law differed from previous chain store taxes

[24] Louis K. Liggett Co. v. Lee, 288 U. S. 517 (1933).
[25] *Ibid.*, p. 534.
[26] *Ibid.*, p. 565.
[27] *Ibid.*, p. 569.
[28] Fox v. Standard Oil Company of New Jersey, 294 U. S. 87 (1935).
[29] The Standard Oil Company submitted evidence which proved that this was primarily a tax on chain filling stations; that these chains, if so they may be called, paid 84.46 percent of the tax while doing only 4.6 percent of the chain store business. The Standard Oil Company alone, it was alleged, paid 42.16 percent of the tax. It was contended that filling stations were not chain stores, but the very inclusive character of the definition of the term "store" in the statute was cited to refute this contention. The law states: "the term 'store' as used in this act shall be construed to mean and include any store or stores or any mercantile establishment or establishments which are owned, operated, maintained and/or controlled by the same person, firm, corporation, copartnership, or association, either domestic or foreign, in which goods, wares, or merchandise of any kind are sold, either at retail or wholesale" (*Ibid.*, p. 95).
[30] Alaska Fish Salting and By-Products Co. v. Smith, 255 U. S. 44 (1921).
[31] Stewart Dry Goods Co. v. Lewis, 294 U. S. 550 (1935).

in two ways: first, instead of graduating the tax according to the number of units, the tax was graduated with reference to the volume of sales of a business; it varied from one-twentieth of 1 percent on the first $400,000 of sales to 1 percent on sales over $1,000,000. Secondly, no specific reference was made to chain stores; both independent and chain stores were required to pay the tax. In its operation, both the large chains and the large department stores would be especially burdened. The Court held that classification by volume of sales alone was arbitrary and unreasonable. The Court said also that if some corrective for the general property tax is required it should be a net income tax or a flat sales tax.[32]

Importance of "Thickness" as Well as Length of Chain. Whether a tax based upon sales, but graduated according to the number of outlets, would be acceptable appears not to have been decided. On the surface, it would seem that a chain store tax law might well give some attention to volume. A chain of grocery stores each doing an annual business of $50,000 would seem to have more ability to pay than a chain of filling stations each with an annual business of $10,000. And what of a chain of chewing-gum automatic vending machines? One Wisconsin law solved this problem by exempting the vending machines and by classifying other chains. A lower rate than that applied to other stores was allowed filling stations. Many state laws exempt filling stations entirely.

Louisiana Law Sustained. In the case of the Atlantic and Pacific Tea Company v. Grosjean,[33] a 4-3 decision, the Court had before it the Louisiana chain store tax law which, as previously stated, was levied upon the stores in Louisiana but had a rate graduated according to the number of units in the chain throughout the country. Instances were cited of local chains that had considerably more Louisiana outlets than the Atlantic and Pacific Tea Company but yet were paying less per outlet. The majority held that, "If the competitive advantages of a chain increase with the number of its component links, it is hard to see how these advantages cease at the state boundary." ". . . all the stores of a retail chain contribute to the central purchasing power of the chain irrespective of state lines and location of stores, and increase the per unit multiple advantage enjoyed by the operator of the system; that the greater the number of units the greater the purchasing power of the chain, the greater the rebates and allowances, the greater the

[32] Justice Cardozo for the minority contended that there might be a correlation between volume of business and its profitableness and that the legislature should have the discretion to choose a graduated sales tax as a supplement to the property tax. It might prefer a graduated sales tax to a net income tax on the ground that the latter is difficult to administer.

In a Wisconsin Case [Ed. Schuster and Co. v. Henry, 218 Wis. 506 (1935)] the state supreme court held unconstitutional a Wisconsin statute similar to that of Kentucky except that it applied only to companies with more than one outlet. In this case it was argued that the law was unfair because it taxed very heavily the large department store with two outlets and exempted entirely a similar store with only one outlet.

[33] Great Atlantic and Pacific Tea Co. v. Grosjean, 301 U. S. 412 (1937).

advantages in advertising, the greater the capital employed, the greater the economic and social consequences, and the lower the cost of distribution and overhead." [34] The Court was impressed by the argument that the Louisiana system was more equitable and logical than the more usual chain store tax law which graduates rates according to the "length of the chain" within the state. The dissenting opinion expressed the view that this amounted to one state penalizing a method of doing business in other states.

Questions of Policy in Chain Store Taxation

The difficulty with chain store tax legislation is that it encourages rival merchants or groups of merchants to carry their problems of competition to the legislature, where the decisions are likely to be influenced by the more effective lobby rather than by consideration of the public interest. In every legislature there are attempts to settle competitive battles politically. A familiar case is that of restaurants seeking prohibitory legislation against the selling of sandwiches in drug stores. Suffice it to say that, in the settlement of these issues, the public interest frequently drops out of the picture.

In a country where half the business assets are owned by 200 corporations and where monopoly has become a crucial problem, certainly a case can be made for a tax on size as such. The principal difficulty lies in making such a tax "sufficiently discriminating." Usually there is no available evidence or even a clear consensus of opinion as to the optimum size of a business in different lines. Whether the criterion in judging optimum size should be maximum efficiency, adequacy of competition, or other factors of social welfare, is also in dispute.

Some disinterested support can be found for a chain store tax which merely seeks to neutralize certain unfair advantages possessed by the chains under the property tax. Some disinterested support can also be found for a chain store tax which seeks to neutralize other unfair advantages in competitive merchandising. But very few disinterested students will accept a chain store tax which seeks to eliminate or discourage the chain store on the ground that it is socially undesirable.

SUMMARY

In addition to general taxes, business in general is often subjected to special taxes. These special taxes are sometimes supported on nonfiscal grounds, mainly as a possible means of checking the size of business units. But the soundest and strongest support of them is based on fiscal grounds, contending that business enjoys special benefits for which it may equitably be

[34] Great Atlantic and Pacific Tea Co. v. Grosjean, 301 U. S. 412 (1937), p. 420.

charged a tax and that such levies yield substantial revenue. The argument is somewhat confused because of the uncertain incidence of business taxes.

Among the familiar methods of general business taxation, the most common are the gross income and sales taxes, occupation taxes, capital stock taxes, and corporate excess taxes. In practice all of these are open to important objections because of their erratic results, arbitrary classification, or weak administration. A single composite business tax based upon net income, with an alternative minimum levy based upon gross income, would be an improvement over the existing confusion of state business taxes.

Turning to the taxation of special business, attention may be given to the problems of taxing public utilities, banks, insurance companies, and chain stores. The consensus is that public utilities should be subjected to the general level of taxes applied to other business. The ad valorem system of taxing railroads, quite generally applied, is conspicuously ill-adapted to local assessment. State assessment may apply the unit rule and assess the railroad as an organism. This method of administration also encounters many difficult problems, chief of which is the determination of an exchange value for property that rarely exchanges. Among the evidences of value customarily employed are the value of outstanding securities, capitalized income, and physical value. Once an assessment is determined, apportionment between the taxing state and other states is necessary and in some cases, unfortunately, values are also apportioned to local districts.

Railroads are also taxed by several other methods, of which the tax on gross earnings is most common. The relative merits of gross earnings and ad valorem taxation as applied to railroads has been the subject of much argument. Proponents of each system accuse the other system of being arbitrary. With excellent administration the ad valorem method is probably superior, but the gross earnings system is the choice where administration is weak.

Other utilities present much the same problems of taxation as railroads, though local assessment is more common in the case of the former. These businesses require state assessment (at least of interdistrict properties) for satisfactory results.

Interesting special problems in the field of public utility taxation arise in the acceptance of two distinct values, one for rate-making and another for taxation; in the disposition of utility taxes according to origin; and in the application of the tax system to municipally owned utilities. The taxation of airplane transportation presents interesting new problems of multiple taxation and intergovernmental relations.

Banks are distinguished from other businesses in that much of their property is intangible and that some of them are chartered by the federal government. The latter gives them more or less the character of governmental instrumentalities, a factor which has had a dominant influence upon bank taxation. In other words, the whole field is in effect subject to the

authority of Congress, which has outlined certain closely circumscribed alternatives for the states to follow. These alternatives are subject to interpretation by the United States Supreme Court, which has spoken emphatically and repeatedly on the subject. Some states are still permitted to employ the familiar bank shares tax developed during the latter half of the nineteenth century. Others, because of certain features of their general tax system, must apply another alternative and usually choose a net income or franchise tax. The system unduly limits the discretion of the states and results in special privileges for the banking business.

Insurance companies, like banks, have special characteristics but, unlike the banks, they are not under the protecting wings of the federal government. Although such companies offer plausible arguments for exemption from taxes other than the property tax on real estate, these arguments have not prevailed, and insurance is subject to many forms of business taxation, chief of which is the gross premiums tax.

Chain stores are subject to special taxation in many states. In this field the Supreme Court has been presented with some nice questions of reasonable classification. Usually with a divided court, it has sustained some types of special chain store taxes and outlawed others. The so-called unit tax, graduated according to the length of the chain, is clearly valid. On its merits, special chain store taxation within reasonable limits can be reasonably supported, but such taxation tends to degenerate into legislative arbitration of competitive struggles. The extreme position that the chain store is a social menace and must be taxed out of existence has little following among disinterested people. A tax on "excessive size" has much to recommend it but there is no available evidence or accepted criterion of what constitutes "excessive size."

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CHAPTER XIII

Taxes on Consumption

DEFINITION

Consumption taxes are levies paid by the consumer in the price of the commodities he purchases. These taxes vary with expenditures, quite in contrast with property taxes, which vary with the value of goods owned, and income taxes, which vary with the receipts during a definite period of time. Consumption taxes also differ from property and income taxes in that the former are not as a rule directly imposed upon those who are expected to bear the ultimate burden. Their existence depends upon shifting. It has already been observed that there is no general agreement as to the incidence of taxation. Some hold that all taxes in the last analysis are paid by the consumer; many others believe that property taxes, not customarily thought of as consumption taxes, are nevertheless paid, in part at least, by the consumer. However, a fairly definite group of taxes are treated generally as consumption taxes, partly because they are intended to be paid by the consumer and partly because the probability of shifting is especially strong in their case.

EXTENT OF CONSUMPTION TAXES

Consumption Taxes in the Individual's Budget. Few people realize how much of their expenditures is absorbed by consumption taxes. If the average low-income family with no taxable property or income could be shown how much it is contributing to the government, it would be startled at the discovery. It would find, for instance, that 7 cents of the price paid for a standard package of cigarettes is federal tax alone (1944 rate) and that, at the rate of one package per day, this amounts to an annual tax of $25.55 on this single item. To take another illustration, it has been estimated that the sugar tariff in peacetime costs each American family $10 a year. To be sure, both cigarettes and sugar belong to a group of commodities that are singled out for especially heavy levies. But even under the 2 percent retail

sales tax, which is quite common among the states, an individual pays $20 in taxes for every $1,000 spent on taxable merchandise.

Consumption Taxes in Federal and State Tax Systems. During much of its history the federal government relied exclusively upon consumption taxes for its tax revenue and, although this has ceased to be true in recent years, these levies (tariffs and excises) still play an important role in its revenue system. In 1940, for example, before the impact of the special war levies was fully felt, consumption taxes accounted for 35.8 percent of federal revenues, and the percentage was even higher during the depression era of the thirties. Ranking first in yield among the consumption taxes during the prewar years were the levies on alcoholic beverages, which were followed closely by those on tobacco. The customs ranked third and another fairly important source was the motor fuel tax. Finally came a miscellaneous group of other excises (those on lubricating oil, automobiles, electrical energy, refrigerators, radios, toilet preparations, furs, sporting goods, chewing gum, matches, telegraph and telephone messages, theater and other admissions). These sources, in spite of additional levies, increased rates, and increased yields, did not hold their proportionate place during the war. A federal retail sales tax as a war measure was much discussed, but, up to 1945, was not adopted.

In the state revenue systems, consumption taxes have played a very minor role until about the past two decades. Formerly the states relied almost exclusively upon the general property tax, and it is only in recent years, under pressure for revenue, that they have gone in more and more for levies on consumption goods. State consumption tax sources overlap those of the federal government considerably. Twenty-nine states tax cigarettes, with rates ranging up to 5 cents on a standard package, and state liquor taxes are universal (with qualifications for prohibition areas and places where sale is a public monopoly). Some of the states have a considerably developed system of special excises including levies on cosmetics, admissions, soft drinks, and electrical energy.

Consumption Taxes in Other Countries and Eras. Consumption taxes rank high in revenue systems other than those of the United States. During the period between the World Wars, most of the European countries inaugurated and came to rely heavily upon general "turnover" taxes. Great Britain is the classic example of a country depending mainly on direct taxation; but it has for many years relied on heavy liquor and tobacco taxes and it accepted a "purchases" tax (a selective tax, mainly upon luxuries) during the war. The fiscal monopoly (exclusive government distribution of certain commodities, such as tobacco or matches) is very common in Europe. Less familiar now than formerly but still found frequently, especially in the Orient, is the tax on salt. Here is a commodity with an inelastic demand; a considerable tax on this source will yield substantial revenue but is subject to criticism because of inequity and bad social consequences.

Heavy as are the consumption taxes of the present era, they are probably

less burdensome upon the necessities of life than those of the eighteenth and early nineteenth centuries. Favorite sources of revenue in those periods were levies on salt, leather, soap, candles, coal, and other similar commodities.[1]

ARGUMENTS FOR CONSUMPTION TAXES IN GENERAL

Ease and Convenience of Payment. Consumption taxes are generally defended on the ground that they are relatively painless—"easy to take," so to speak. The fact that such taxes are hidden in the prices of the goods purchased means that people are seldom fully conscious of them. How many people have ever stopped to calculate their annual cigarette tax? And even if they did, would it make any difference to them? The charge is on an automatic installment plan, which collects a few pennies at a time and consequently is not felt too keenly. There is many a man who can meet payments of 10 cents a day but would find himself unable to cope with a bill of $36.50 once a year. Convenience of payment was one of the four canons of taxation proposed by Adam Smith and has been universally recognized as an important consideration in choosing sources of revenue.

Consumption taxes do not usually encounter any problem of tax delinquency, although, of course, the relief population is unable to pay such taxes without more relief or the reduction of living standards below those previously prescribed.

Ease and Economy of Collection. Closely associated with the above argument is the proposition that consumption taxes are easy and inexpensive to collect. Actually, this argument applies to only a few of them. The average cost of administration of the tariff is at least as high as that of the net income tax and, as for ease of administration, in many respects the gross income tax (a consumption tax) is more difficult to administer than the net income tax. The gross income tax, for instance, often carries no exemptions which would reduce the numbers whom the government must contact. This entails the upkeep of an extensive administrative force. On the other hand, the relatively low rate which usually goes with consumption taxes, and the fact that they are thought to be passed along to the consumers, help to reduce resistance to these taxes on the part of those who pay them in the first instance.

General Contribution to Government. Consumption taxes are also defended on the ground that they make everyone contribute to the government. This is said to be desirable because, first, everyone receives some benefit from the government and, second, it tends to make everyone interested in the government and less inclined to support extravagant public

[1] William Raymond Green, *The Theory and Practice of Modern Taxation*, Commerce Clearing House, Chicago, 1933, pp. 20-21.

expenditures. Where a few people pay all the taxes and the masses enjoy the benefits of government, the many are likely to exploit the few by voting for every new bond issue and public service.

It will be observed, of course, that the latter part of this argument is inconsistent with the first main argument presented above. If consumption taxes are painless, they are poor protection against governmental extravagance. A direct tax—the poll tax, for instance—would be much more effective in making everybody tax-conscious. Concerning the benefit argument, the reader is referred to Chapter II, where this subject has been discussed at greater length. The correlation, if any, between benefits and consumption is weak, and the imposition of consumption taxes upon even those who are recipients of relief would be like charging the inmates rent at a poorhouse.

Sumptuary and Fiscal Objectives Harmonize. Consumption taxes are often more or less of a sumptuary character. It is contended that huge sums of money are being spent in the United States upon nonessentials; if these expenditures were taxed, they might be curtailed with no harm—and perhaps positive good—to the consumer. If they were not curtailed, the taxpayer could hardly complain of a tax which might so readily and harmlessly be avoided. This argument is particularly applicable to liquor and tobacco taxes, but it is used to support many other special excises as well. One estimate of recreational expenditures in the United States for 1929 was placed at approximately $10,000,000,000.[2] To be sure, a large portion of this was spent for auto travel, motion pictures, and plays, upon which there are now levies in the form of gasoline and admission taxes. Almost half this sum, however, was entirely free of any immediate excise tax. Some other outstanding and so-called nonessential expenditures include those for personal servants, chewing gum, cosmetics, flowers, jewelry, and silverware. The last four items were estimated to have cost the public about $1,500,000,000 in 1929.[3] Tobacco products alone took $1,700,000,000 of consumers' income in 1937. When all these expenditures are compared with those for public education, for instance, roughly $2,500,000,000 in 1941, it appears quite proper to suggest siphoning off some of the financial support of the former to the latter.

There are two kinds of so-called luxury expenditures. One is expenditure for goods and services which are purchased only or mainly by the rich, and the other is for goods and services that are very generally purchased but which the purchaser could quite well get along without, if necessary. Pleasure telephoning, social club admission, and personal servants are examples of the first type of luxury; beer, tobacco, moving pictures, and cosmetics are examples of the second type. It is the second type of luxury that has been the favorite object of consumption taxes, for it is here that substantial

[2] J. F. Steiner, in *Recent Social Trends*, McGraw-Hill Book Co., New York, 1933, Vol. II, p. 949.

[3] Robert S. Lynd and Alice C. Hanson, in *Recent Social Trends*, Vol. II, p. 889.

yields may be obtained. However, the very large and general consumption of these goods and the inelasticity of the demand for them indicate the importance they have in the budgetary psychology of the masses.[4] In other words, it is quite possible that a tax on fur coats may cause some low-paid stenographer not to forego a fur coat but rather to go undernourished, and that a tax on tobacco or moving pictures may cause some poor family not to smoke or attend moving picture theaters less but to reduce the number of visits to the dentist. One may rejoin, of course, that this is the consumer's own fault and that he should know better; but perhaps human nature, at least to some extent, should be understood and accepted as it is.

A trenchant criticism of the fiscal-sumptuary argument for consumption taxes has been made by Professor Henry C. Simons. He says: [5]

> Many liberal persons defend levies like the tobacco tax on the curious grounds that tobacco is not a necessity—that poor people may or can avoid the burden by not consuming the commodity. This position invites two comments. First, it is hardly accurate to say that no burden is involved in getting along without the commodity. Second, it seems a little absurd to go around arguing that poor people could or ought to do without tobacco, especially if it is taxed, in the face of the facts that they simply do not do anything of the kind, that the commodity was selected for taxation because they are not expected to do so, and that the government would not get much revenue if they did. The plain fact, to one not confused by moralistic distinctions between necessities and luxuries, is simply that taxes like the tobacco taxes are the most effective means available for draining government revenues out from the very bottom of the income scale. The usual textbook discussions on these points hardly deserve less lampooning than their implied definition of luxuries (and semi-luxuries!) as commodities which poor people ought to do without and won't.

In contrast to this criticism, the British Committee on National Debt and Taxation, in appraising the British tax system, defended certain special excises of the type discussed above on the ground that these commodities might be avoided by the taxpayer with no bad effects upon either him or the nation.[6] No doubt, the overwhelming consensus is in line with the viewpoint of this committee and does support the taxation of some consumption goods.

Correlate Well with Progressive Income and Inheritance Taxes. It is often pointed out that consumption taxes, like income taxes, may be defended as

[4] A representative of the cosmetics industry took the position before a Congressional Committee that cosmetics are not a luxury and, when pressed for a supporting argument, she replied, "Cosmetics are essential to the average woman's morale."

[5] Henry C. Simons, *Personal Income Taxation*, pp. 39-40.

[6] *Report of the Committee on National Debt and Taxation*, H. M. Stationery Office, London, 1927, pp. 211, 241.

a part of the tax system without attempting to justify their use to the exclusion of all other taxes. Thus, it is said by many that the income tax is an effective means of reaching the ability-to-pay of the well-to-do, but that it cannot be successfully applied to the larger number of relatively poor people; these people, it is contended, enjoy benefits and also have some ability to pay which can best be reached through consumption taxes. It may be added that partly because of exemptions the income tax is often disappointing in its yield. Many have also favored the sales tax as an alternative to part of the property tax, which is regarded as excessive.

On the other hand, it may be answered that the techniques for applying the income tax to the great masses of people are slowly being perfected and that no sufficient effort in this direction was made in the United States during the years before the Second World War. Also, the question may be asked: Why add another regressive tax to the tax system as a way of relieving the property taxpayer? Actually, the poorest of small home owners might find themselves paying more rather than less were the sales tax substituted for part of the property tax.

ARGUMENTS AGAINST CONSUMPTION TAXES

Regressivity. The main argument against consumption taxes is that they are highly regressive—that they take from people with small earnings a greater percentage of their income than from the wealthy. There is no diffi-

TABLE 10

Approximate Amount per $1,000 of Income a General Sales Tax Takes from Different Income Groups

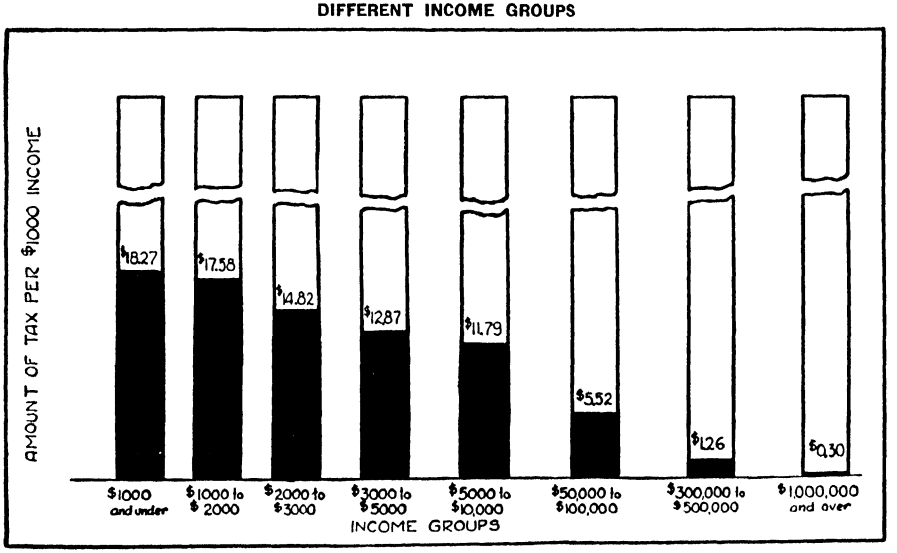
Income	*Amount Taken Under a 2% Tax*	*Amount Taken Under a 3% Tax*
$ 1,000 and under	$12.18	$18.27
1,000–$ 2,000	11.72	17.58
2,000– 3,000	9.88	14.82
3,000– 5,000	8.58	12.87
5,000– 10,000	7.86	11.79
10,000– 25,000	6.34	9.51
25,000– 50,000	4.44	6.66
50,000– 100,000	3.68	5.52
100,000– 150,000	3.10	4.65
150,000– 300,000	2.42	3.63
300,000– 500,000	.84	1.26
500,000– 1,000,000	.50	.75
1,000,000 and over	.20	.30

Source: *The Home Owner and the Sales Tax*, Tax Policy League, New York, 1935, p. 6.

culty in demonstrating that this is true, at least for the general retail sales tax. Those with small incomes spend practically all of their earnings and that mostly for commodities which are purchased at the retail stores. On the other hand, the recipient of a $1,000,000 income does not and cannot spend all he receives. Much of his income more or less automatically goes into savings, while another substantial part is spent for services—personal servants, caretakers, chauffeurs, and the like. Table 10, based upon estimates by the Tax Policy League from statistics collected by *The Business Week*, gives an indication of the proportion of income affected by a retail sales tax in different income groups. The graph which follows shows the amount per thousand dollars of income which would be taken by a 3 percent retail sales tax upon all retail purchases, including food.

FIGURE 4

APPROXIMATE AMOUNT PER $1000 OF INCOME WHICH A 3% RETAIL SALES TAX TAKES FROM DIFFERENT INCOME GROUPS



(Based on data in the General Welfare Tax League publication: *Where the Sales Tax Falls*, New York, 1934, pp. 6-7.)

The arguments for progressive as against regressive taxes have already been discussed. In addition to the issue of equity involved, there is also the important economic consideration of conserving the purchasing power of the consumer and a market for the large volume of goods which can now be produced.

If one were to superimpose a curve representing the net income tax upon Fig. 4, he would present an issue of class and economic conflict which plays a large part in consumption tax argument. In general, income taxes in the United States are (or at least had been until the passage of the tax measures

of the Second World War) paid to a large degree by people with income of more than $2,000. About 60 percent of the commodity purchases are made by people with incomes of less than $2,000. It is these people who pay a large proportion of the sales tax.[7]

It may be pointed out in opposition to the regressivity argument that the sales tax, although showing a steeply falling curve, strikes such a large base that nobody has to pay much of a tax under it. But this can be answered by reference to the fact that the $1,000-per-year man has a considerable load of other taxes to pay, including heavy burdens under the very persistent and usually increasing property tax.

The sales tax has been used to illustrate the regressivity of the consumption tax family. Some of the special excises might not show much regressivity, particularly on those goods used mainly by rich people. But even here consumption taxes are likely to show some regressivity above a certain range of income.

During the 1930's it was often argued against consumption taxes that they discouraged spending and thus aggravated an unbalance between consumption and saving. Consumption taxes might be deflationary because they take purchasing power from those who are likely to use it for consumption. On the other hand, public expenditure returns the purchasing power to the public and in some cases to those no less likely to spend than the taxpayers. Deflationary tendencies may also arise from the fact that the tax is applied to the spending function. The propensity as well as the ability to spend may thus be affected. Of course, a deflationary effect may not always be undesirable. During the Second World War, consumption taxes gained considerable support because of their alleged deflationary character. A balanced economy in the postwar period will probably require extraordinary levels of consumption, and in these conditions consumption taxes, especially if employed by the federal government with its ample alternatives, will be singularly inappropriate.

SPECIAL EXCISES

Gasoline Tax. This tax will be treated as one of the members of the motor vehicle tax family. It has some features in common with the consumption taxes but, were it considered as one of them, it would be quite unique in that the tax paid is closely correlated with the special benefit which the taxpayer receives from a governmental expenditure, namely, the use of the highways.

Liquor Taxes. The liquor tax field is a very lucrative source of revenue, yielding all units of government well over one billion dollars. These taxes, more than any other consumption tax, have a sumptuary purpose. Most

[7] Where the Sales Tax Falls, pp. 10-11.

people (especially the wealthy) accept the view that cheap whiskey would be "bad for the country."

However, in the United States it is generally agreed that a top limit to these taxes is necessary in order to minimize "bootlegging," which was so active during the prohibition period. The problem is not important in the case of beer. It is taxed, as a rule, about two and a half cents on a 10-cent glass, which is substantial but hardly excessive. It has often been claimed that the tax on hard liquor is sufficient to invite wholesale evasion of it. Some prewar estimates place the amount of the illegal traffic in hard liquor as high as 25 to 50 percent.[8] In order better to control the liquor business and retain all of the profit from the distributive end of it, a number of states now have assumed a monopoly of the retailing business. These states receive profits from the business in lieu of taxes.

It is argued that, to achieve the best results from a sumptuary standpoint, heavier taxes should be placed on hard liquor than on beer. Since this makes hard liquor relatively expensive compared with beer, it might induce people to change their drinking habits in favor of the latter. This is desirable from a social standpoint because the consumption of beer has fewer evil social consequences than the consumption of hard liquor. The British are said to have achieved substantial success with this social objective of liquor taxation.[9]

In the consumption tax field, as in many others, one of the most disturbing problems is the invasion of the field by both the states and the federal government. It was hoped that, with the end of prohibition in 1934, this conflict could be avoided, at least as to the liquor tax. It was suggested that the federal government should collect all the excises and that the states should confine themselves to license fees charged those engaged in the business. In order to persuade the states to stay out, the federal government was to distribute part of its collections to the states. However, as had been characteristic of all similar attempts, there was no clear agreement on how the money should be distributed. A complication arose from the insistence of the dry states that they were entitled to some of the proceeds. Thus the effort proved abortive and we now have both levels of government in the field, with the consequent wide range of practices among the various states. Diversity may serve a useful purpose, however, in giving expression to a variety of opinion concerning liquor consumption. Moreover, the liquor tax field is one in which federal-state cooperation as to administration has been highly developed with quite salutary results. Efforts to hunt out the "bootlegger" have been characterized by joint use of facilities and information to a remarkable extent. In this respect the field furnishes an example of collaboration that might well be cultivated elsewhere.

The problem of liquor taxation is closely associated with the prohibition

[8] Elizabeth Lamont, "The Bootlegger Is Still with Us," *The Journal of Commerce and Commercial*, Vol. 187, No. 14, 441, Jan. 24, 1941, p. 20.

[9] Twentieth Century Fund, *Facing the Tax Problem*, p. 199.

movement. Proponents of prohibition object to liquor taxation on the ground that this creates a strong vested interest in the retention of the legalized distribution of liquors. Those favoring the liquor business have sometimes succeeded in getting the receipts from liquor taxes earmarked for education. This would provide them with a good defensive argument should prohibition threaten to return.

The liquor traffic field is perhaps the one most heavily clogged with trade barriers. The twenty-first amendment empowers the states to exercise virtually complete regulation over liquor imports and takes precedence in this respect over federal constitutional provisions which might otherwise prevent discrimination. This immunity, intended to facilitate regulation, has been widely used not only for this purpose but also to protect home industry, to retaliate against discrimination by other states, and to favor some states as against others.

Tobacco Taxes. The federal excise tax on tobacco products has long been a part of the United States revenue system and is usually regarded as one of the most productive, easily administered, and socially justified of the existing taxes. It is collected from the manufacturer with little expense and small chance of evasion.

State taxes on tobacco (now used in 29 states) are not as defensible as federal taxes. These taxes must be collected from wholesalers and retailers, the latter of which there are about a million in the United States. In addition to a high expense of collection, the tax creates difficulties for borderline merchants who must compete with untaxed sales across the border and who frequently absorb the tax rather than lose business. All merchants in the state must compete with mail-order sales, which cannot be taxed because they are interstate commerce.[10]

During the depression the following argument was presented by The Wisconsin Leaf Tobacco Dealers' Association against tobacco tax legislation: [11]

> There are less than 2,000,000 individual income taxpayers in the United States, whereas cigarettes and tobacco are used by not less than 35,000,000 consumers; so at least 33 out of every 35 tobacco users are people whose incomes are less than those of the minimum income taxpayer. They constitute the great army of laborers and wage earners, to say nothing of the idle, to the maintenance of whose morale a smoke or a chew is particularly essential. And yet these very people would be the ones to bear a large part of a tax on cigarettes or tobacco.
>
> Tobacco is the poor man's friend, and this levy would be felt by him every day of his life. In a period of decreasing wages and widespread unemployment, it is as cruel as it is unjust to add to his cost of living.

[10] Except under the use taxes which often are not easy to administer.

[11] *A Solemn Plea to Save the Tobacco Farmers in Wisconsin from Destructive Taxation*, The Wisconsin Leaf Tobacco Dealers' Association, Edgerton, Wisconsin, 1935, p. 23.

> A tax on tobacco is as far-reaching in its consequences as a tax on milk or bread—definitely and peculiarly a tax on the poor, upon whom it falls with a weight entirely out of proportion. It is distinctly contrary to the American principle that taxes be based on ability to pay.
>
> It is a grim paradox, indeed, to attempt to provide relief for the poor by forcing them to pour their own dear pennies into the relief chest.

The Association was also concerned for the welfare of the tobacco farmers, who received $156,000,000 for their 1931 crop as compared with $436,000,000 paid in tobacco taxes to the federal government. No mention was made, however, about the profits of the tobacco manufacturers, which have been quite substantial in spite of both taxation and depression.

Liquor and tobacco taxes, unlike most sales taxes, apply chiefly to the consumption of adults. They do not affect the family group adversely as compared with childless couples or single individuals.

An interesting feature of tobacco taxation is the discrimination shown certain tobacco products in contrast with others. The federal government discriminates only in favor of pipe and chewing tobacco, which pays less than half as much tax ad valorem as cigarettes and cigars. Of the 29 states taxing tobacco products, the majority tax cigarettes only. This favoritism toward the cigar smoker may be explained in two ways: first, the survival of a prejudice against the cigarette and, second, the fact that most politicians have a fondness for a cigar, either for their own consumption or as petty bribery before elections. The trend of demand away from cigars has also been used in support of favored treatment for this tobacco product. From the standpoint of ability to pay, the cigar smoker is at least as able to support the government (and usually more so) as the cigarette smoker. Cigarette taxes are made more regressive than they need be by virtue of the fact that they are specific (based on number) rather than ad valorem (based on value). Probably poor consumers patronize cheaper cigarettes to a greater extent relatively than do the well-to-do.

The tobacco taxes, like the liquor taxes, yield well and the receipts from this source fall off very little even during years of intense depression.

Taxes on Miscellaneous Luxuries. It has already been indicated that the federal government and a few states tax a variety of "luxury" expenditures in addition to those just discussed. Some of these levies have been successful from the fiscal standpoint but others have produced barely enough to cover the cost of administration. New possibilities in this field are not as abundant as might be supposed. Both the federal government and some of the states have been reasonably successful in taxing admissions and electrical energy. The states have not done too well in the taxation of soft drinks; a fairly elastic demand and the inaccessibility of the manufacturer have proved handicaps.

THE GENERAL SALES TAX

General Sales Tax Types [12]

Sales taxes differ from each other principally in the breadth of their coverage.

1. The most prevalent in the American states is the *retail sales tax*, the distinguishing feature of which is that it is intended to be imposed only on sales to the final consumer. This levy may be confined to the sale of tangible commodities, although in practice it ordinarily applies to certain kinds of services as well. For example, the tax may include the sale of admissions, communications, publications, advertising, banking and public utility services.

2. Another type of levy is the *manufacturers' sales tax*. This is like the retail sales tax in that it is limited to commodities and one level of exchange. It differs from the latter, however, in that it applies to the first sale of finished goods—that is, by the manufacturers to the dealers rather than to the consumers. Canada has this kind of a tax.

3. A sales tax which applies to the sales of tangible property at both wholesale and retail points is sometimes referred to as a *general sales tax*. The name is also applied when the base includes certain business services (but not personal and professional services), admissions, and sales of real property.

4. If, in addition to the base of the general sales tax, the income from the sale of professional and personal services is added, the levy is usually referred to as a *gross receipts tax*.

5. Finally, other miscellaneous sources of income may be thrown in to make the list complete. These include income from the sale of real property and securities, investment returns, real estate rentals, and all other income. Such a tax is applied in Indiana and is called a *gross income tax*, or sometimes, as in European countries, a *turnover tax*. It appears not to differ greatly from the "transactions tax" proposed by the Townsend Plan for financing old age pensions. The Indiana measure, however, carries certain features of the net income tax, including a $1,000 exemption for each taxpayer ($3,000 for retail merchants).[13]

Unfortunately, there is too much confusion in the use of the above terminology. With the exception perhaps of the first two categories, the *retail sales tax* and *manufacturers' sales tax*, none of them is accepted as standard. For convenience a distinction has been made between the first two categories and the others combined. The former may be called single-stage sales taxes,

[12] Most of the definitions in this section are given in *The Sales Tax in the American States* by Robert Murray Haig and Carl Shoup, Columbia University Press, New York, 1934, pp. 3-4.

[13] *Tax Systems*, 1942, p. 257. A transactions tax might be broader than a gross income tax were it to include all transactions between persons and banks.

that is, those levied on only one level of production; the others are levied at more than one level and may be called multiple-stage sales taxes.

Relation of Sales Taxes to Other Tax Families

A gross income tax applicable to the income of all business or some special business is frequently classed as a business tax. It may be in lieu of the property tax entirely, as is sometimes the case with gross earnings taxes levied upon public utilities. Or it may be a supplementary business tax. Volume of business may be defended as at least as reasonable a basis for a business tax as property. However, when a gross income tax is applied to all exchanges whether or not in the course of business, including even the wages of employees, then the gross income tax cannot be thought of as a business tax. Rather, it must then be classified with the net income tax, the consumption taxes, or given an independent classification. Some of the gross income taxes in practice bear a superficial resemblance to the net income tax. They include a personal exemption, occasionally some degree of graduation, enforcement by self-reporting, auditing, and so on. As to incidence, however, these taxes differ radically from the net income tax. Their inclusion in the consumption tax family on this score probably constitutes as reasonable and useful a classification as may be had.

A sales tax applied to the sale of natural resources is sometimes referred to as a severance tax. A retail sales tax is a business tax specially applied to merchants but, because of its actual and intended incidence, it seems most appropriate to consider it among consumption taxes. There is no clear-cut distinction among these various classifications and there is of necessity considerable overlapping.

The Development of the General Sales Tax

Like most other taxes, the general sales tax is no modern invention. In Roman times it was employed by Augustus, who "laid a tax of one percent upon all articles, movable goods, or fixtures, sold in the markets or by auction . . ." [14]

The modern European sales taxes, however, grew out of the First World

[14] A. G. Buehler, *General Sales Taxation*, The Business Bourse, New York, 1932, p. 3. It was used by Spain from the beginning of the fourteenth century until the early nineteenth century. This was the famous *alcavala*, excessive application of which, with rates of 10 and 14 percent, was thought by Adam Smith to have ruined the manufacturing industries of that country. Spain also tried to introduce the system into the Netherlands but without success. However, it did successfully carry the tax to Mexico, where it has continued down to the present. (*Ibid.*, pp. 3-4.) Attention has already been called to the role of sales taxes in pre-revolutionary France and the contribution of these taxes to the revolution. (See Chap. I.) They were also levied on various items of consumption in England and other European countries. During the Napoleonic period, special levies became so numerous in England as to constitute almost the equivalent of a general sales tax (A. G. Buehler, *General Sales Taxation*, p. 5).

War. Most of the belligerents, with Great Britain a notable exception, adopted some form of sales tax during the period from 1918-1923. None of the neutral countries succumbed to this new epidemic. These European taxes, labeled "turnover taxes," carried a broad base. The German tax, for instance, included receipts from the liberal professions as well as business receipts.

These European turnover taxes came to occupy an important place in the revenue systems of the various countries on the continent. The French tax ranked close to the income tax in yield, and the same was true of the prewar tax in Germany and Belgium. In the Austrian national tax system it was the most important single producer of revenue, though it was closely rivaled by the customs.[15] The Russian tax was by far the most important in that country, producing about 90 percent of the revenue of the Soviet government.[16] Perhaps it should be added that the latter was not comparable with the sales taxes of other countries, as the Soviet government employed them not merely as a revenue means but also as a regulator of prices and production.[17]

The Canadian sales tax took root in 1920. It has undergone many modifications, but during most of its history it has been confined to manufacturers' sales. Many exemptions, particularly of the necessities of life, have led some to describe it as a selective rather than a general sales tax. Its rates have ranged from 1 to 8 percent. The yield has been somewhat disappointing, due, perhaps, to the extensive exemptions. Nevertheless, the tax produced, at its peak in 1924, over 35 percent of the Canadian national revenues, and from that time until 1929 it occupied a rank second only to customs among Canadian sources of revenue.[18] Total sales tax receipts increased during the Second World War but the relative importance of the tax declined.

The United States federal government, like the other participants in the First World War, experienced an urge for a sales tax. The comprehensive excise system of the Civil War period was the nearest to a general sales tax that the federal government attained prior to that time. During the pressure of war and postwar finance, several sales tax measures were debated in Congress, particularly "the manufacturers and producers" tax of 1921 and a similar measure linked with the soldiers' bonus in 1922. Support for these measures was fostered by a considerable number of organizations, such as The Tax League of America and the National Association of Manufacturers. Businessmen in general endorsed the sales tax idea. However, it failed to pass Congress, and another proposal in 1932, although recommended by the Ways and Means Committee, was again defeated.[19]

[15] *Tax Systems of the World*, 1938, pp. 376-381.
[16] Paul Haensel, "The Sales Tax in Soviet Russia," *Tax Magazine*, Vol. XIV, No. 1 Jan. 1936, p. 18.
[17] *Ibid.*, p. 20.
[18] A. G. Buehler, *General Sales Taxation*, pp. 116-121.
[19] *Ibid.*, pp. 7-19, 24-38.

During the Second World War, federal experience with the sales tax closely resembled that in the First World War. Sales tax measures were debated and attracted a strong following, but they were not enacted into the revenue system. The federal government did intensify its special excise tax program.

Great Britain and Australia, as well as Canada, employed a sales tax as a part of their Second World War tax systems. The British tax was enacted during the war but the Australian tax is of somewhat longer standing. Both taxes were levied at the wholesale level. They were selective rather than general; the selectivity took the form of exemption of necessities and differentiation in rates according to the class of goods or services. The rates were high, running to a maximum of 66 percent in the case of the British law. These taxes did not differ greatly from the American special excise levies except that the latter had a considerably narrower coverage and lower rates.

During the thirties the sales tax made substantial progress among the American states. West Virginia was the pioneer in this field with its gross income tax law as early as 1921. Georgia provided a similar tax in 1929, but with low rates and a high flat exemption. Beginning with the depression of the thirties, the tax spread very rapidly, with Mississippi passing a "gross sales" and a "gross income" tax law in 1930, and Pennsylvania a retail sales tax in 1932 (only for a period of six months). Thirteen states joined the procession in 1933.[20] Others have followed since, so that about half of the states have such laws.[21] Except for New England and the North Atlantic states, the adoption and retention have been quite uniform throughout the country.

In addition to the states, some six cities have local sales taxes; the best known is that of New York City. The New York tax, enacted in 1934, has been well administered and productive. It was accepted with good grace by the citizens of New York, partly because of the general appreciation of the harassing financial problem that resulted from wholesale unemployment.[22]

Professors Haig and Shoup, in summarizing the spread of sales taxes over four continents in 15 years, conclude: "In the history of public finance no other tax, save perhaps the one on gasoline, has spread so swiftly over the world."[23] In the American states a variety of factors seems to have conspired to bring about the sales tax movement. Most of the states adopted the tax during the depression, when local sources of revenue were depleted and pressure was exerted to maintain educational outlays and to provide unem-

[20] Carl L. Nelson, Gladys C. Blakey, and Roy G. Blakey, *Sales Taxes*, League of Minnesota Municipalities, Minneapolis, 1935, pp. 10-13. Of these the New York law lapsed in 1934 and the Oregon law was defeated by referendum.

[21] *Tax Systems*, 1942, pp. 256-262.

[22] *Tax Policy*, Vol. III, No. 8, June 1936, p. 3.

[23] Robert Murray Haig and Carl Shoup, *The Sales Tax in the American States*, p. 5.

ployment relief and old age assistance. The extension of the property tax had encountered vigorous opposition and the distressing phenomena of tax delinquency and foreclosure. In several states the sales tax was "forced" by the enactment of property tax limitation laws under the pressure and leadership of real estate associations. Homestead exemption laws worked toward the same end. The graduated net income tax requires constitutional amendment in several states and has proved a poor or unsteady producer of revenue (as administered) in others. Caught in this situation, many who might otherwise have opposed the adoption of a sales tax accepted or promoted it as inevitable.[24] Although many of the sales taxes have been adopted as emergency measures, most of them have been retained and probably will be retained until most of the causes behind their development have been removed.

Features of State Sales Tax Laws

Coverage. It has already been suggested that sales taxes differ widely in coverage. The retail sales tax is most popular among the American states, prevailing in about twenty states at present. The broadest taxes, such as those of Indiana, West Virginia, and Mississippi, are levied at several stages of production and on all or almost all gross income. Mississippi exempts wages and salaries and bank income. Other states limit multiple-stage sales taxes to a smaller area. Retail sales taxes differ also in their coverage. Several are confined to tangible property, whereas others cover a relatively large number of services sold to the ultimate consumer.[25]

Rate Differentiation. States which have a wide coverage do not apply a uniform rate to all classes of sales. Thus, Mississippi specifies 14 different classifications with rates ranging from .125 percent on sales of wholesalers and jobbers to 2.5 percent on sales of natural gas. The most common rate is 2 percent, which applies to retailers, public utilities, and most of the extractive industries.[26]

Exemptions. Aside from differences in coverage, state laws also differ in the exemptions they provide. Exemptions fall mainly into two categories: those which relate to commodities and those which relate to institutions. Illustrating the first classification, the California law exempts food, and a number of states exempt seeds, feed, and fertilizer sold to farmers. In the second category, sales to or by religious and charitable institutions are exempt in nearly half of the states. In addition, it is common to exempt "isolated and casual" sales for administrative reasons and sales made to federal bodies or in interstate commerce for legal reasons. Sales otherwise taxed (motor fuel, liquor, and tobacco) are usually exempt.

[24] Including teachers, farmers, and labor organizations.

[25] *Tax Systems*, 1942, pp. 256-262; University of Denver Reports, *Sales Tax in State Systems*, Vol. 14, No. 3, June 1937, p. 4.

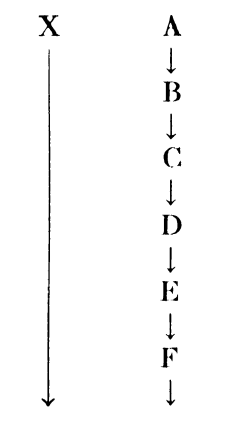
[26] *Tax Systems*, 1942, p. 258.

An important question of policy is involved in the exemption of food. On the one hand, special dispensation for food sales is likely to attract strong support on the ground that food is a prime essential of life. On the other, the exemption badly undermines the tax base and yield of the tax. It is questionable whether food is much more essential than many other items included in a general sales tax. It has been said of the California tax that "in well over 96 percent of its yield the retail sales tax is a levy upon the essentials of modern living." [27] The exemption of foodstuffs in California reduces the tax base to the extent of 23.37 percent.[28] Moreover, exemptions greatly complicate the administration of the tax since they involve a separate accounting and checking for exempt sales.

Yield. The sales tax is most commonly justified on the ground that "it does bring in the money," and this its critics can hardly deny. As previously stated, it continues to yield more than state income taxes although the latter are applied in a greater number of states and have received a considerable stimulus from war prosperity.

Problems of Sales Taxation

Integrated Industry. Sales taxation involves many problems of administration and equity. One such problem arises because the number of turnovers in an "integrated industry" is less than in one made up of independent units. This problem applies only to multiple-stage sales taxes. By an integrated industry is meant one in which industrial combinations have proceeded in a vertical direction (as when the Ford Motor Company acquires iron mines, rubber plantations, and other factors used in the assembling of a Ford car). The multiple-stage sales tax gives an advantage to the integrated industry. If, as in the accompanying diagram, the integrated firm X combines all steps in the processing and distribution of a commodity up to and including the sale to the final consumer, and, if parallel to this integrated combination is a series of six independent processing and distributing concerns, *A*, *B*, *C*, etc., among which goods move by sale and exchange, there will be six levies on the commodities of the second system of manufacture and distribution, but only one on the first. In order to avoid this discrimination, Germany at one time attempted to apply the turnover tax to the "exchanges" made between the branches or divisions of the integrated industry, an innovation described by Professor Buehler as "more interesting than helpful." [29] On the



[27] H. Dewey Anderson, *Our California State Taxes*, Stanford University Press, Stanford University, California, 1937, p. 117.

[28] *Ibid.*, p. 118.

[29] A. G. Buehler, *General Sales Taxation*, p. 101.

other hand, it can be argued that the gross sales tax is a tax on middlemen, which tends to discourage an expensive and overdeveloped feature of production.

Double Taxation. A gross income tax which makes no allowance for losses or expenses of any kind is usually regarded as a tax on the consumer. But, when this tax is applied to the wage earner, a complication arises because the wage earner in all probability cannot shift his tax on to anyone. The wage earner thus must bear several taxes: his own, as he is taxed on his gross income, and those of the merchant and manufacturer, since their gross income taxes are shifted on to him as a consumer. The injustice of the situation is enhanced by the fact that the wage earner with four children to support necessarily contributes in this way much more than a single man with the same salary.

Interstate Commerce. Another problem involved in the state sales taxes in the United States is that of the federal prohibition of state taxes on interstate commerce. As a result, sales made to the residents of the taxing state by mail-order houses and borderline merchants outside the state are immune from taxation. However, recent decisions have widened the powers of the state to tax such transactions, and it is now allowed to do so if the seller maintains a place of business in the taxing state.[30] Sales made over state boundary lines by sellers inside the taxing state are also immune. Not only does this involve a loss of revenue but it also creates an unfair disadvantage in trade. Determination of the volume of such sales may be difficult from an administrative point of view, and their exemption may cause considerable shrinkage in the tax base, particularly in the application of multiple-stage sales taxes.

This problem involves important legal questions as to what constitutes an interstate sale. If a New Jersey resident orders a rug by telephone from a New York store and has the rug delivered, would this be interstate commerce? Would it make any difference if the customer took the rug himself instead of having it delivered, or if he ordered the rug in New York to have it delivered later in New Jersey? [31] If a man on a railroad diner orders his dinner in a sales tax state and it is delivered to him in that state, but he eats and pays for it in a non-sales-tax state, must he pay a sales tax? Not all of these subtle points have been adjudicated. Legal opinion seems to hold that if either the bargain or the delivery is across state boundary lines, the exchange is interstate commerce.

Attempts have been made to circumvent the interstate commerce restriction. States applying the gross income tax may include out-of-state sales by calling the tax, as applied to manufacturing and the extractive industries,

[30] McGoldrick v. Berwind White Coal Mining Co., 309 U. S. 33 (1940); Nelson v. Sears, Roebuck & Co., 312 U. S. 359 (1941).

[31] Carl Shoup, *Retail and General Sales Taxes*, Memorandum No. 7, New York State Commission for the Revision of the Tax Laws, 1932.

a production tax rather than a sales tax. Several states have now enacted a "use tax," which taxes storage or use of goods within a state even though they may have been purchased outside. It was thought by many that this law would not be sanctioned by the United States Supreme Court, but in a 7-to-2 decision the Washington use tax was sustained.[32] Justice Cardozo in the majority opinion made much of the fact that equality rather than discrimination was the purpose of the tax. However, administrative difficulties loom very large in any attempt to apply a use tax to the entire field of goods purchased over state boundary lines. In the case of automobiles, a check can be made when the vehicle is registered for its annual license. Possibly, information concerning mail-order shipments could be obtained from railroads or, better still, from the company itself in case it has offices or stores within the taxing state. It is questionable that the use tax can be effectively applied to goods purchased over state lines from borderline merchants. In general, the observation may be made that the use-tax device and the Supreme Court's decision have transformed a difficult legal problem into an equally difficult administrative problem.[33]

Incidence. A number of important issues center around the shiftability of sales taxes. It has been assumed that the sales tax is paid by the consumer, and in general this is probably true, but the exceptions to the rule may be very important. It is practically impossible for a borderline merchant to shift a state retail sales tax when he is competing with untaxed sales from across the state line. The same situation in lesser degree confronts merchants who compete with untaxed mail-order business. Nor is it always possible to shift a retail sales tax entirely, even if all the competitors are subject to a tax. When the demand for a good is highly elastic, the merchant may be prompted to absorb the tax on it. Ordinarily he is more likely to do this on luxury articles, the demand for which is unstable, than on the essentials of life, which maintain a persistent and inelastic demand. The tax may be, and usually is, absorbed in the case of standard-priced goods, particularly when the tax is small. Thus, the price of chewing gum may not be changed by a small tax, and the same is true of the price of soft drinks.

Undoubtedly, a small tax is more often absorbed than a large one; it is also contended that small merchants have more difficulty in passing on a tax than large ones.[34] In a survey of the sales tax in Mississippi, the University of Mississippi questioned retailers, wholesalers, and manufacturers concerning the shifting of the sales tax. Only 55 percent of the 740 retailers questioned thought they were shifting the tax; 22.6 percent thought they absorbed it entirely; and 22.4 percent thought part was shifted and part absorbed.[35] The wholesalers and manufacturers who had a tax of only one-

[32] Henneford v. Silas Mason Co., 300 U. S. 577 (1937).

[33] Maurice Criz, *The Use Tax*, Public Administration Service, Chicago, 1941.

[34] Robert Murray Haig and Carl Shoup, *The Sales Tax in the American States*, p. 31.

[35] *Mississippi's General Sales Tax*, Bulletin of the University of Mississippi, Series XXX, No. 3, Jan. 1933, p. 14.

eighth and one-fourth of one percent, respectively, to deal with were of the opinion that they almost universally absorbed their tax.

On the surface it may appear that it makes no difference whether the tax is shifted or not. If the tax cannot be shifted, it can be defended as a business tax. But where the shifting follows no regular rule, the business burden is likely to be capricious. Moreover, the retail sales tax as a business tax may be objected to on the ground that it is confined to merchants.

Sometimes the legislature requires the merchant to inform the customer of the tax, and many conclude that where this is true the incidence must be on the customer. But the problem of shifting is not so simple as legislators and others often think. Informing the customer as to the amount of the tax may only mean that he is made tax-conscious. Shifting cannot be required; it is a matter of economic rather than legislative law.

Although shifting is not always perfect, it is sometimes more than perfect; that is, the tax is "pyramided." A tax imposed upon the manufacturer and added to his price increases the cost of goods when they reach the wholesaler, the jobber, and retailer; if each calculates his customary percentage of profit or "mark-up" on this augmented base, the ultimate consumers will pay considerably more in increased prices for goods than the government receives. It is the merchants who receive the difference, and, so to speak, make a profit on the tax. Of course, given time and perfect competition, pyramiding, except to pay for interest upon the capital advanced as taxes for the consumer, could not exist. But one or the other of these conditions is often absent.

Closely related to pyramiding is the accumulation of taxes resulting under the multiple-stage sales taxes from a large number of exchanges in the course of getting the goods to the final consumer.[36] The total tax might be more or less as the number of exchanges were greater or less. This piling up of taxes on the consumer, assuming that he pays them, is criticized not only on the ground that it is onerous, but also because it is unreasonable to make a commodity tax depend on the number of exchanges involved in preparing the commodity.

Difficulties of Administration. Ease of administration is said to be one of the virtues of a sales tax, but on close examination it will be found that its administration is far from simple. It is said that, even after the French "turnover" tax had been in effect for four years, 40 percent of the taxable turnover was still evading the tax. Contrary to expectations, it was found by the

[36] Assuming perfect shifting, the price which the final consumer pays for a commodity includes not merely the tax levied on the sale to him, but also those levied on exchanges of the commodity during its preparation. This, of course, does not mean that a two percent sales tax on all exchanges would accumulate to a total of ten percent by the time the article passed from the producer of raw materials to processor, to jobber, to wholesaler, to retailer, and finally to the consumer. The price of the commodity in the course of its preparation is less than its final price, and thus the levy on the earlier exchanges is not on the latter, but on the lower prices which prevail at these earlier exchanges.

French authorities that "no levy known up to that time demanded from the tax agents more sustained vigilance, greater perspicacity, keener knowledge; none raised more delicate and even more difficult questions of interpretation; none necessitated such extensive and diverse information." [37] Similarly, one of the officials in charge of the New York retail sales tax law referred to the latter as "the most difficult and perplexing statute which we have ever tried to administer." [38]

However, there is some authority supporting the view that the sales tax is easily and cheaply administered. Professor Buehler, summarizing the judgment of certain German authorities, says: "They are of the opinion that the turnover tax involves much less administrative work than the income tax and relatively less administrative work than the property tax or the inheritance tax; and that the administrative costs are lower in the case of the turnover tax than any other national tax, except the transportation tax." [39]

In sales tax administration some states require reports and audits which involve many of the difficulties connected with the administration of the net income tax, except that here every "hole-in-the-wall" concern is involved in the problem. Some independent check can be made through examination of numbers of employees, size of establishment, and the like.[40] Ohio has attempted to administer its sales tax through the use of a prepaid receipt, half of which is given to the customer at the time of sale. This device seeks to enlist the customer's help in administering the tax.

Administration is made more difficult if sales of certain commodities or sales under specified circumstances are exempt from taxation, as it is extremely difficult for a state to check the exact character of sales.

Available figures on the cost of administration of the state sales taxes show that they are moderately but not conspicuously low. According to one study of costs in 10 states, the variation is between 1.61 and 4.30 percent of state sales tax revenue.[41] The cost of compliance by the taxpayer is also considerable. Professors Haig and Shoup suggest that a fairly high percentage of the tax can be cheaply collected but that the remainder requires expensive administration.

Administration of the sales taxes is greatly facilitated by the fact that such taxes have a broad base and can carry a relatively low rate.

Small Purchases. Treatment of the small purchase under the sales tax involves either discrimination or penny-splitting. In New York City a purchase

[37] Carl L. Nelson, Gladys C. Blakey, and Roy G. Blakey, *Sales Taxes*, p. 18.

[38] *Ibid.*

[39] A. G. Buehler, *General Sales Taxation*, p. 109.

[40] As might be expected, the French, who have a strong penchant for the use of indirect indices in the administration of taxes, have made use of this means of administration.

[41] *The Sales Tax in State Systems*, University of Denver Reports, p. 11. Professor Martin found an average cost of 2 percent. (James W. Martin, "Costs of Tax Administration: Statistics of Public Expenses," *Bulletin of National Tax Association*, Vol. XXIX, No. 5, Feb. 1944, p. 134; also "Costs of Tax Administration: Examples of Compliance Expenses," No. 7, Apr. 1944, pp. 194-205.)

of 1-12 cents originally involved no tax; 13-62 cents, 1 cent; 63-100 cents, 2 cents. On more than a dollar of purchase the tax was 2 cents on every dollar plus the above rates according to the amount of excess over the even dollar. A one-cent sales tax on a 13-cent package of cigarettes represented a tax of about 8 percent of the purchase price. A 50-cent purchase also called for a 1 cent tax, representing in this case exactly 2 percent of the purchase price.

In dealing with the merchant who has many small sales, the state has three alternatives: it can assess the merchant on his total sales regardless of the fact that he may not be able to pass the tax on with any acceptable degree of equity; it may exempt the small sales from taxation, in which case it is hard to check the true volume of such transactions; or it may tax all sales and provide the merchant with tokens [42] to facilitate proper collection from customers. The tokens now in use in several states are small bits of metal or plastic, appropriately stamped as mills, which constitute change for a penny. The tokens eliminate most of the inequity in applying the sales tax to small purchases, but they are a source of annoyance and inconvenience to the taxpayer and create some danger of counterfeiting. About half the sales tax states have adopted this device, and it appears to be the best available solution of this sales tax problem.[43]

The Sales Tax as a War Measure

There are arguments both for and against a wartime sales tax that would not apply to a peacetime levy. For the measure it is argued that the tax has an exceptionally wide coverage and is a proper way to bring everybody in on financing the war. It is also argued that a tax on spending will reduce purchases and thus help to check inflation. On the other side it is contended that any but a retail sales tax would aggravate the problem of price stabilization (taxes would be shifted in higher prices; only the retail sales tax would permit the separation of tax and price). A retail sales tax would, moreover, require considerable outlay for manpower and machinery in its administra-

[42] The tokens are usually in mill denominations, which makes it possible to apply a 2 percent tax equitably to the nearest 5 cents of the purchase price.

[43] *The Sales Tax in State Systems*, University of Denver Reports, p. 6.

In the case of the retail sales tax the separation of commodities from services frequently causes trouble. Separation is necessary where the tax is confined to the sale of commodities. Shampoos by barbers, repairing performed by a garage, tailor-made clothing, are examples of cases involving difficult separation. With regard to this point, no uniformity in administration is practiced, but it is customary to permit the merchant to deduct from his gross sales what is regarded as a reasonable compensation for services.

The identification of retail sales also involves difficulty. Retail merchants frequently make sales for resale while jobbers and wholesalers sometimes sell directly to the final consumer. Sale of feed to a farmer may be regarded as a wholesale exchange if the farmer uses the feed to prepare livestock or dairy products for market. What about sales of a retailer-contractor in the plumbing business? And sales of fuel to a manufacturer? Considerable difficulties both of definition and administration are here involved.

tion. Finally, the exemption of a subsistence in wartime is important, not only on grounds of equity but also for production.

A General Spendings Tax

A general or over-all spendings tax would differ considerably from the usual conception of a sales tax. It would be based on total rather than specific expenditures and would be administered through personal reports like a net income tax. Further features resembling those of a net income tax would be graduated rates and personal exemptions. It could include services purchased by consumers, an item which causes great administrative difficulty if included in the retail sales tax. The spendings tax could be useful not only as a curb on extravagance but also as a check on inflation and as a supplementary source of revenue.

There are, however, serious objections to this tax. Added to the income tax, it would complicate income tax reporting and administration. Substituted for the income tax, it would do little to relieve the concentration of economic power. In the type of high-consumption economy anticipated after the war, checks on spending, except, at least, those of a highly extravagant sort, would appear inappropriate.

Conclusion

Sales and gross income taxes may be regarded as business taxes assessed according to the volume of business; in this capacity they have been discussed in a previous chapter. They may also be regarded as a supplement to the net income tax, designed to reach, with a minimum of administrative difficulty, ability to pay of small income recipients. Many critics would accept the proposition that some impersonal or indirect taxes are necessary for fiscal adequacy. Here the dispute becomes a matter of the degree and kind of impersonal tax. Social and economic balance and equity weigh heavily against such taxation, even to its present degree. And taxes on the necessities of life are its worst possible form.

It has been said that, "for centuries Anglo-Saxon traditions have opposed heavy internal consumption taxation." [44] Most students of taxation would applaud these traditions and regret their failure to include external consumption taxes (tariffs) as well. Professor Seligman expresses this sentiment very aptly when, in commenting on the subject, he says: "The sales tax constitutes the last resort of countries which find themselves in such fiscal difficulties that they must subordinate all other principles of taxation to that of adequacy." [45]

[44] A. G. Buehler, *General Sales Taxation*, p. 5.
[45] E. R. A. Seligman, *Studies in Public Finance*, 1st ed., p. 131.

THE TARIFF

Nature of Tariff

For many centuries taxation upon territorial trade has been a major source of revenue for a large number of governments. Such taxation may take many forms. Duties, as these taxes are usually called, may apply to internal trade within the borders (that is, to trade among the divisions of a country) or they may be confined to international trade. The former were common in the United States during the colonial era but were eliminated by the federal constitution in 1789. They were an important but onerous feature of the French tax system before the French Revolution and have only recently been abolished in China.

Duties may be upon exports or imports. The former were extensively applied during the Middle Ages and are still an important feature of the revenue systems of certain countries, particularly in South America. But import duties are now much more common.

Tariffs may be levied to protect domestic industries, or for revenue, or both. As between nations, they may be discriminatory or nondiscriminatory. A mutual arrangement between two countries for favorable treatment in the taxation of trade is called a reciprocal agreement. An agreement against discriminatory tax treatment is said to afford the parties involved "most-favored-nation" treatment. Taxes, of course, are only one form of trade restriction. Another familiar one is the imposition of quotas upon foreign trade, which restrict the quantity of goods allowed entry during a given period.

Coming more specifically to the details of tariff legislation, duties may be *ad valorem* or *specific*. An ad valorem duty is based on the value of the commodity imported or exported and is a percentage of that value. A specific duty, on the other hand, is based on quantity, as, for instance, so much per unit, yard, or pound. Compensatory duties may be levied on the importation of manufactured goods in order to enable domestic manufacturers to compete without disadvantage resulting from the imposition of levies upon raw materials. The term "drawback" is sometimes used to cover the refund of a duty imposed upon materials imported, processed, and exported again.

Tariffs may be general or specific, that is, they may apply to all imports or only to certain ones. In practice they have been usually of the latter type, though a general tariff was proposed for Great Britain before the Second World War. Sometimes, particularly in cases of tariffs for revenue, they apply to but few commodities. The tariff law of 1816 was a simple affair and covered only four pages. On the other hand, modern protective tariffs are likely to be very complex. The latest American tariff law covers nearly 200 pages and includes thousands of commodities, most of them separately

classified and rated, although some are included under broad general classifications with a common rate.

Tariff History of the United States [46]

Some account of the tariff history of the United States, particularly the important place this tax has occupied in the revenues and public affairs of the country, has been presented in Chapter I. Up to 1816 the tariff was mainly for revenue purposes, but thereafter it rapidly assumed a protectionist character. The change aroused bitter opposition, culminating in the tariff crises of the early 1830's. The average rate on protected articles in the "tariff of abominations" of 1828 was 44 percent,[47] which, however, was low compared with some of the post-Civil-War tariffs. The period from 1833 to 1861 is usually described as mildly protective, and in the fiscal year of 1861, with an average of 18 percent [48] on dutiable goods, the rates were at their low point for the century from 1812-1912. What might have been the subsequent tariff history of the United States without the influence of the Civil War is hard to say. During the Civil War, import duties were pushed to new high levels—averaging 47 percent on dutiable commodities under the 1864 law. Although it was felt that these rates were for the emergency only, they fostered vested interests which could not be challenged after the war. In fact, in 1870 there were a few increases in the tariff schedule. Tea and coffee, which had been taxed for revenue, were put on the free list in 1872, and some other revisions downward were made then and subsequently. But in general the tariff continued up to 1890 much as it emerged from the Civil War.[49]

The Underwood tariff of 1913 was one of the few revising the existing schedules downward. It changed the form of many duties from specific to ad valorem, put wool (in part) on the free list, reduced the rate on sugar, and abolished the tariff on agricultural implements, on many agricultural products, and on some manufactured articles. When this new tariff went

[46] See Chap. I.

[47] D. R. Dewey, *Financial History of the United States*, p. 189.

[48] *Ibid.*, pp. 252, 263.

[49] F. A. Shannon, *Economic History of the People of the United States*, pp. 384, 572-574. The McKinley tariff of 1890 was highly protective and included an increase in many duties, although the mathematical average was somewhat reduced by the substitution of a bounty to domestic producers for the levy on imported sugar. The presidential campaign of 1892 was fought largely on the issue of protection. With the anti-protectionists in power, there was an attempt to eliminate or lower many of the duties, but the reductions in the Wilson-Gorman tariff of 1894 were not very sweeping. With the Dingley tariff of 1897, strong protection again returned and was maintained in the Payne-Aldrich measure of 1909. (*Ibid.*, pp. 579-587, 782-784; D. R. Dewey, *Financial History of the United States*, pp. 438-440, 455-458, 463-465, 483-485.) The latter introduced a new principle into tariff-making, namely, that the tariff equalize the domestic cost of production with that abroad. The principle is paradoxical since differences in cost are the very foundation of trade.

into effect, the average rate on dutiable commodities was about 40 percent. By 1916 it fell to about 30 percent.[50]

Following the First World War, very high protection was again resumed in spite of the new creditor-status which the United States had assumed during the conflict. The Emergency Tariff Act of 1921 and the Fordney-McCumber tariff of 1922 in general undid the revision of the Underwood tariff and returned to the Payne-Aldrich schedules of 1909. The principle of equalizing costs was reaffirmed and, to facilitate its application, the President was given power to raise or lower duties within limits. For the farmers, who were in the throes of an acute depression, large increases in the tariff on agricultural products were granted but, since most of these commodities are exported, the duties were largely ineffective.[51]

There was much dissatisfaction with the Fordney-McCumber tariff, but despite that fact the Hawley-Smoot tariff of 1930 raised rather than lowered rates.[52]

In 1934 an important departure in tariff policy was made when the President was given power to negotiate trade agreements with other countries and to reduce the tariff by proclamation in accordance with these agreements. No tariff could be lowered or raised by this means more than one-half. Although agreements were to be bilateral, reductions were general except for nations that discriminated substantially against United States trade. Between 1934 and 1939, reciprocal trade agreements were signed with twenty-two nations, eleven of which were South American countries. The power to make such agreements was granted for a three-year period only, but the power has been extended several times and the 1945 legislation permits reductions of 50 percent in existing rates, including those previously reduced.[53]

Fiscal Aspects of the Tariff

Importance. The tariff as it is applied in the United States has been mainly imposed for nonfiscal objectives. But this is not necessarily true; nor are the customs unimportant as a source of revenue. Up to the Civil War the customs were virtually the entire federal tax system; from the Civil War

[50] F. A. Shannon, *Economic History of the People of the United States*, pp. 785-788.

[51] *Ibid.*, pp. 790-792.

[52] The following are examples of some of the rates established in the latter legislation: On woolen textiles the duty averaged around 75 percent; on many types of leather gloves it was over 100 percent; on some kinds of dolls, and straw hats, it was over 150 percent; on many steel products it ran from 100 to 200 percent; on one type of pipe bowl it was over 400 percent. Duties on alcoholic liquor were over 100 percent in some cases, in addition to the internal revenue tax. The specific duty of 2 cents a pound on sugar was for a time over 200 percent of the price of sugar in Cuba. (F. W. Fetter, *The New Deal and Tariff Policy*, Public Policy Pamphlet, No. 7, University of Chicago Press, 1937, p. 4.)

[53] See Grace Beckett, *The Reciprocal Trade Agreement Program*, Columbia University Press, New York, 1941.

down to the First World War they furnished about half of the federal revenues. Because of the new sources of revenue introduced during the First World War and retained thereafter, the proportion decreased between the wars and was less than 10 percent before the Second World War introduced abnormal conditions.

The trend is illustrated by the following table:

TABLE 11

Receipts from Customs Duties by the United States for Selected Years 1795-1941

Year	*Receipts in Millions*	*% of Ordinary Revenues*
1795	5.6	91
1825	20.1	91
1845	27.5	91
1865	84,9	26
1885	181.5	56
1905	261.8	48
1915	209.8	30
1925	547.6	14
1935	343.4	9
1941	391.9	5

Source: U. S. Secretary of Treasury, *Annual Report for Fiscal Year Ended June 30, 1941*, p. 412 (percentages computed).

Instability of Yield. The tariff tends to be quite unstable in its yield. During the years when it was one of the principal sources of revenue for the federal government, the Treasury experienced alternating abundance and famine. Between 1791 and 1854, customs exceeded the ordinary expenses of the government about half of the time, and once in 1807 by more than 80 percent. In 1837, by way of contrast, the customs brought in less than 35 percent of the ordinary expenditures of the government.[54]

That this situation left much to be desired in the way of a revenue system is evident enough. Professor R. F. Hoxie described its shortcomings as follows: [55]

> On the whole it may be asserted, without fear of contradiction that, throughout the history of the customs revenue system in the United States, the income from this source has been determined, not by government need, but, almost wholly, by the character of temporary industrial, and, more especially, temporary commercial conditions. As a consequence, in war the current public income has proved utterly in-

[54] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, pp. 105, 136, 140, 163, 216, 232, 259.

[55] R. F. Hoxie, "Adequacy of the Customs Revenue System," *Journal of Political Economy*, Vol. III, Dec. 1894, p. 64.

> sufficient, unstable and inflexible; in peace it has shown itself extremely uncertain, fluctuating with every crisis and even with the changes in the policy and condition of foreign nations; in times of prosperity it has forced upon the treasury embarrassing surpluses, leading to extravagant expenditure, speculation and crisis; in adversity it has left the treasury empty, necessitating the lavish use of the public credit.

It is true, no doubt, that fluctuations might have been very much less had the tariff been designed for revenue rather than protection.

Difficulties of Administration. The tariff, contrary to general impression, is a relatively expensive tax to administer. In 1943 every $100 collected cost the government $5.74.[56] In the case of certain commodities many obstacles are encountered in proper enforcement. Here again much depends upon the commodities selected for taxation.

Incidence. The main incidence of the tariff is on the domestic consumer.[57] As in the case of other taxes, it is inequitable to apply it to the necessities of life, such as food and certain varieties of clothing.

Characteristics of a Good Tariff for Revenue. An ideal tariff for revenue imposes a substantial tax on a few commodities not among the necessities of life nor subject to an elastic demand, and preferably not produced within the country which levies the tax.[58] In its nonprotective fiscal tariff before the First World War, Great Britain taxed less than 50 commodities and received the great bulk of its revenue from tobacco, sugar, tea, and alcoholic beverages. The first three are not produced in Great Britain at all. What the British have done with their tax on tea, the United States could do with a tax on coffee, chocolate, and tea. In ordinary times, rubber also might be taxed because of its luxury uses. It is significant that all of these commodities now enter the United States duty free.

Incompatibility of Fiscal and Protective Objectives. It has often been pointed out that the protective and revenue aspects of the tariff are incompatible; a tariff may both yield revenue and protect at the same time, but insofar as it performs one of these functions, it fails at the other. The best protection is provided by a tariff so high that it keeps out foreign goods entirely; this would be worthless as a revenue measure. The best revenue tariff is upon goods which must be produced entirely outside the country; such a tariff cannot defeat its own ends by encouraging a domestic source of supply, but, of course, this kind of a tariff is worthless for protection.

Observations Concerning Fiscal Aspects of a Nonfiscal Tariff. Insofar as the tariff raises domestic prices, it taxes the consumer and makes business more profitable for domestic producers. On the other hand, if the tariff

[56] *Annual Report of Secretary of Treasury, for Fiscal Year Ended June 30, 1934*, pp. 233-234.

[57] For a more detailed discussion of the incidence of the tariff, see Chap. VI.

[58] A tariff on commodities produced at home may still retain its revenue character if it is accompanied by an equivalent excise tax upon domestic production.

excludes goods from abroad, the government receives no revenue. Moreover, even where the tariff does not exclude goods entirely, the rise in domestic prices may cost the consumer more than the government receives. Thus a protective tariff may in effect constitute a tax upon consumers for what is in effect a government bounty to domestic producers.[59]

Observations Concerning Nonfiscal Aspects of a Nonfiscal Tariff. The nonfiscal aspects of a nonfiscal tariff are very largely outside the field of public finance. No attempt will be made to review in detail the voluminous debate between protectionists and free traders. Economists are agreed that many of the arguments for protection, such as that protection is necessary to support high wages and avoid unemployment, are unsound and fallacious. More respect is paid to the infant-industries argument, but it is pointed out that infant industries grow very easily and surely into vested interests. The argument for independence of foreign trade because it strengthens a nation for war may be entitled to weight at different times and places but, of course, should carry with it a calculation of the cost of independence. It is relevant to observe that the United States, which has built up an extraordinary trade independence, nevertheless feels obliged to spend freely upon its navy, partly in order to protect such foreign commerce as it does have. The economist's case against the tariff is mainly that it is an impediment to the territorial division of labor which, like other forms of specialization, adds to economic efficiency.

Two recent changes in the United States undoubtedly have an important bearing on its future tariff policy. One is the dawning awareness among farmers that the tariff in the main is injurious to their interests. Most agricultural commodities are on an export basis and the prices of these commodities are determined on the world market without aid from the tariff. On the other hand, the farmer must pay some of the cost of industrial tariffs in the price of the goods he buys for the farm and his own consumption. The revolt of the farmer against the tariff has taken the form of various programs, involving restriction of output and agricultural bounties. Export subsidies are predicted for postwar protection of agriculture. Among the many problems which they involve is the resentment of foreign competitors and the possibility of retaliation. The second change is the new status of the United States as a creditor instead of a debtor nation. It is generally agreed that eventually a creditor nation must accept imports if it is to collect the interest and principal on its investments.

Perhaps it is more important to account for the prevalence of high tariffs than to justify or condemn them. There are psychological, political, and sociological factors which have been more significant in tariff history than arguments. Among them is the widely prevalent prejudice against persons and things not of one's country. Another factor is the refusal of voters to

[59] But see Chap. VI concerning the incidence of the tariff.

think of themselves as consumers. A third is the political strength of an organized special interest with much at stake, in opposition to an unorganized and widely dispersed general interest. A fourth is the political strength of special territorial interests which achieve their objectives through a process of trading votes or log-rolling in Congress.

In recent years there has been much support for the view that it is impossible for Congress to pass a tariff in the public interest and that it should somehow be relieved of this task. In 1916 the Tariff Commission was established and supported by some with the hope that it could be used to create a scientific tariff. It has proved very useful as a research organization, which was about all that could reasonably have been expected of it. The flexible tariff provisions gave some tariff-making power to the President, but to no great avail. By far the most important innovation in tariff-making procedure was the 1934 law, under which the President was given the power (within limits and with qualifications) to modify tariffs through the negotiation of treaties. This has resulted in significant tariff reductions. Eventually, perhaps, nations will surrender some of their sovereignty to international legislative bodies, and they might well start with the power over international trade.

Specific Tariffs

If space permitted a thorough presentation of the tariff problem, it would be necessary to examine in some detail the specific taxes on imports, each of which has its own problems and its own effects, even though all are lumped together as *the* tariff or *the* customs.

Sugar. Probably the two most important duties on raw materials are those on sugar and wool. Except for a short period when bounties were given to domestic producers in lieu of a tariff, sugar imports since the first tariff law of 1780 have always been subject to a tax.[60] For many years the sugar tariff produced from 20 to 30 percent of the total customs duties collected in the United States. However, rates have been greatly reduced since 1934. Exhaustive studies of the sugar tariff indicate that before recent reductions it cost American consumers annually about $10 per family, that less than half of this tax went to the United States Treasury as revenue, and that the

[60] Lippert S. Ellis, *The Tariff on Sugar*, The Rawleigh Foundation, Freeport, Ill., 1933, p. 44. Much sugar is produced within the United States, some by the cane growers of Louisiana and some by the beet growers, principally in the Rocky Mountain states. In addition, the colonial possessions of the United States produce much sugar and have operated for many years within the tariff wall. These include the Philippines, now nominally independent. In addition, the protectorate, Cuba, is heavily interested in the American sugar market and has enjoyed for some years a tariff concession in the form of rates well below the general duty. The preferential duty of 75 cents per 100 pounds of sugar is equivalent to about 43 percent on an ad valorem basis. (*Foreign Commerce Weekly*, Vol. VI, Jan. 3, 1942, pp. 10-12.)

principal beneficiaries of the remainder were the island producers.[61] It is estimated that the .9-cents-per-pound sugar tariff on imports from Cuba in 1936 cost the consumer about 2.61 cents. This was because, in addition to the duty, there was also a limit to the amount of sugar that might be imported. Consequently, the curtailment of supply from foreign producers forced the price up on the United States market.[62] This quantitative restriction has been abolished.

Wool. The wool tariff is also one of the oldest and most controversial of the tariff duties. Wool is produced in large quantities in the United States, but an increasingly larger percentage of the domestic consumption has been quite regularly imported.[63] Much confusion and controversy in the case of wool tariffs have been occasioned by the compensatory duties on woolen manufactured goods imposed to equalize the cost of wool to foreign and American manufacturers. It has been estimated that the tax on wool and woolens costs an average American family about $2.50 per annum, of which a little less than half goes to the federal treasury.[64]

The sugar and wool tariffs produce about 20 percent of the tariff revenue of the United States. This data, of course, relates to prewar conditions.

Manufactured Goods. Of manufactured goods, the textiles are subject to very high duties. Beside the duties on woolen goods previously mentioned, there are high duties on silk, rayon, and cotton manufactured goods. Iron and steel products have been and are highly protected. This includes pig iron, cast iron pipe, razor blades, surgical and scientific instruments, and many other such items. Chemicals, cement, glassware and leather goods are also subject to high duties. Needless to say, these are only a few of the very numerous items which are a part of the American tariff taxation system.

Free List. Although our tariff coverage is very extensive, it by no means includes all the incoming commerce of the United States. On the contrary, approximately three-fifths of the imports into the United States before the Second World War were on the free list. Table 12 gives the trend in imports of dutiable goods for selected years from 1926 to 1941.

Conclusion

It can be seen from what has been said that the tariff constitutes a heavy tax burden upon the American consumer, not only in the volume of the taxes which he pays in this form but also because of the fact that many of the taxes are upon the prime necessities of life. The extension of the tariff system to aid the farmer through processing taxes on bread and meat was

[61] Lippert S. Ellis, *The Tariff on Sugar*, pp. 146-160.

[62] C. R. Whittlesey, "Excise Taxes as a Substitute for Tariffs," *American Economic Review*, Vol. XXVII, No. 4, Dec. 1937, p. 667.

[63] Haldor R. Mohat, *The Tariff on Wool*, Tariff Research Committee, Madison, Wisconsin, 1935, pp. 48-49.

[64] *Ibid.*, pp. 142-147.

TABLE 12

Imports of Merchandise into the United States
Free and Dutiable Goods

(Selected years 1926-1941)

(In Thousands of Dollars)

Year	*Free Goods*	*Dutiable Goods*	*Total*	*% Free*
1926	$2,853,411	$1,577,477	$4,430,888	64.4
1930	2,051,110	1,009,798	3,060,908	67.0
1934	991,161	644,842	1,636,003	60.6
1936	1,384,937	1,039,040	2,423,977	57.1
1939	1,397,280	878,819	2,276,099	61.39
1940	1,648,965	891,691	2,540,656	64.90
1941	2,030,919	1,191,035	3,221,954	63.03

Source: *Statistical Abstract of the United States, 1943*, p. 505.[65]

but a logical supplement to the existing system and met with little protest, probably because we had become so accustomed to taxing the consumer for the benefit of the producer.

SUMMARY

Consumption taxes are levied upon manufacturers or distributors with the intent that they will be shifted on to the consumers in the price of the goods they purchase. Like death taxes, consumption taxes are of ancient lineage and have been levied in one form or another throughout history. At present they appear most commonly as special excises on tobacco, liquor, salt, and so-called luxuries, as general excises on sales (general sales and turnover taxes) and international trade (tariffs), and in the charges of fiscal monopolies.

Consumption taxes are generally supported on the ground that they are convenient to pay (they involve an automatic installment payment and are concealed in prices), they are easy to administer, they make everyone contribute something to the government, they can combine sumptuary and fiscal objectives, and they complement the progressive income and inheritance taxes. Some of these alleged virtues of the consumption taxes are disputed by their opponents, who put much weight on the regressive incidence of this type of levy.

[65] Classified by stage of manufacture, it was found that in 1936, 76.5 percent of crude materials came in duty free; crude foodstuffs and food animals, 67.6 percent free; manufactured foodstuffs, 20.5 percent free; semi-manufactures, 65.8 percent free; and finished manufactures, 40.2 percent free. Of sugar, rubber, coffee and raw silk, all fairly important in our foreign trade, only sugar is taxed.

Other goods on the free list at present include cocoa, bananas, railroad ties, cork, agricultural implements, binding twine, gunpowder, type-setting machinery, and so on.

Of the special excises in the United States, those on liquor and tobacco are the most productive as well as the most defensible. There are many other miscellaneous special so-called luxury taxes, both federal and state, but most of them have not been fiscally important in peacetime. Generally, however, those levied by the federal government are much more efficiently administered than those levied by the states.

The general sales tax has made sensational gains in many countries since the First World War. In the United States during the depression of the thirties, many groups and individuals who normally would be opposed to the sales tax were led by a combination of circumstances to support it. In practice this tax assumes many forms ranging from the retail sales tax, most common in the American states, to the transactions tax proposed in the Townsend old-age pension program. Even retail sales taxes differ in many respects, an important one of which is the exemptions. Some laws exempt food, a feature which has a popular appeal in that it is supposed to make the tax more equitable, but one which limits its productivity, complicates its administration, and leaves many necessities still taxed.

The sales tax is generally thought to be simple in its application, but actually it encounters substantial difficulties and complications. Among the chief of these are the legal obstacles to taxing interstate sales and the application of the law to small sales. The use tax and sales tax tokens have been developed to cope with these difficulties. Some forms of sales tax are prejudicial to independent producers as compared with integrated industries, and all have some uncertainty and irregularity of incidence. Contrary to the general impression, the sales tax is quite difficult to administer.

A tariff is a consumption tax on the consumer of imported goods. Many tariffs, including most of those of the United States, have been imposed largely for the nonfiscal purpose of encouraging domestic industry. As a fiscal measure, tariffs have been characterized by instability of yield and considerable difficulty of administration. Nevertheless, until the First World War they were the mainstay of federal finances in the United States. From the fiscal standpoint, tariffs could be improved by concentrating upon a few articles which are not among the necessities and which are produced mainly abroad. Nonfiscal tariffs may tax the consumer without adding to the public treasury; in effect, the revenue is paid out as a bounty to producers. Recent innovations giving the President power to change tariffs, with limitations, by reciprocal trade agreements are significant in the history of the tariff as a nonfiscal device.

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CHAPTER XIV

Motor Vehicle Taxes

INTRODUCTION

The meteoric rise of the motor vehicle to almost universal use in the United States has created a demand for many large new governmental expenditures. Of these, foremost has been the demand for a vastly more expensive type of highway with a co-ordinated system of through routes. In addition, new needs made their appearance in the forms of parking facilities, protection for pedestrians, traffic regulation, and so on. The expanding expenditures to meet these needs brought the problem of raising the required revenue. In solving the latter, a new family of taxes—which may be called "the motor vehicle tax family"—was developed. Although these levies are usually called "taxes," they have a high degree of correlation with special benefits to the taxpayer. Moreover, the receipts from them are usually set aside for the specific purpose of financing roads and streets.

Of course, these taxes do not cover all the expenditures on highways and streets; the rest of the needed fund comes from various sources such as special assessment, general taxes, and borrowing. This chapter will be devoted particularly to motor vehicle taxes, but some attention will be given to alternative ways of financing highways. However, no consideration will be given to borrowing, as ordinarily it is but a postponement of one of the other revenue-raising alternatives.

ALTERNATIVE METHODS OF FINANCING HIGHWAYS

Special Assessments

Special assessments for highways are usually on a frontage basis and confined to the land abutting improvements. They are levied on the theory that the highway renders a special service to land, thereby adding to its value.

Special assessments are ill-adapted for financing through rural highways. One reason for this is that such highways are likely to benefit the cities lo-

cated on them much more than the abutting owners. The centers of large population gain because their trade areas expand, but the small villages along the highway may actually suffer a loss in trade due to the ease and economy with which their residents may now journey to the larger centers. Another factor to consider here is that the abutting property owners might be better served by a less costly road. Concrete highways, particularly, may prove something of a nuisance to farmers. High-speed traffic drives the horse-drawn vehicles off the concrete and is a handicap in getting livestock to pasture. Fast-driven vehicles also endanger the lives of children and do some damage by killing the farmers' poultry. Other disadvantages to the farmers include noise and some loss from petty thievery. On the other hand, the road may give them a direct outlet for produce through sales to tourists as well as a better access to the urban markets.

Actually, the use of special assessments is confined mainly to cities. Some of the objections to their use in financing rural highways apply also to their use in financing city streets. A through street particularly is likely to benefit those at either end more than those who live along it. Fewer objections are encountered when special assessments are used to finance streets which serve mainly those residing on them. Even in this case, however, their use is fraught with considerable difficulty. The special assessment is levied before actual benefit to property has occurred, and the estimation of benefit involves considerable guesswork.

The degree to which special assessments are used to pay for streets and other improvements varies widely from city to city even within a given state. During recent years (due to depression and war) the degree has been decreasing, but nevertheless this method of financing still occupies a fairly substantial place among sources of city street revenue.[1]

Motor Vehicle Taxes and General Taxes

Should the Motorist Pay for the Roads? It is generally conceded that motor vehicle owners should contribute to the cost of constructing and maintaining highways, but to what extent is a highly controversial question. One view holds that all the costs of roads and streets should be met by special motor vehicle taxation. This is based on the assumption that provision of improved highways is essentially a business undertaking and should, therefore, be economically self-supporting. It is admitted that society as a whole derives many benefits from this business, but in this respect highways are in the same position as public utilities. The service rendered in the latter case, such as the supplying of water, gas, or electricity, may be of general as well as special benefit, but the special benefit is of such greater relative importance that it justifies a charge sufficient to pay for the entire service.

[1] For a more extended discussion of the problems involved in special assessments see Chap. XVIII.

On the other hand, those who oppose the above view maintain that highways serve other functions than those directly relating to motor vehicles and that to place the entire cost of highways upon motorists is unfair. They emphasize the benefit society as a whole derives from the free and rapid transportation of goods and services. A person who never drives a car may still benefit greatly from the highways, as, for instance, when he can procure a physician at his home without delay in case of sudden illness. This theory also distinguishes between the different components of the highway system. The main highways, serving primarily as arteries of motor vehicle travel, render more service to the majority of motorists than do local roads and streets. The cost of the latter is thought to be a "land service expenditure," since the land and those dwelling on it benefit more than does the general highway user. Consequently, it is alleged that, in an equitable allocation of highway costs, some payment for "land service" is rightly chargeable to the land served.

Sources of Highway Funds in Practice. Until the late twenties streets and roads were financed mainly by general taxes, particularly general property taxes. Within the last two decades, however, motor vehicle taxes have come to occupy an increasingly important place in highway finance. But the preponderant part of the elaborate and expensive system of improved highways and streets in the United States has still been constructed with funds raised from the general property tax. It has been calculated that, in the period between 1923 and 1932, special automobile taxes throughout the United States yielded $7,312,500,000, whereas the cost of highways, including streets, amounted to $16,587,000,000.[2]

The receipts from highway-user taxes in most states are now sufficient to cover all construction and maintenance costs of the main highways. But some of this revenue is used to finance local roads and streets, which means in some cases that the general taxpayer is called upon to finance even main highways.

"Subsidies" in Highway Expenditure. From the standpoint of those who maintain that highway users should pay for the highways, the motorists and the manufacturers and distributors of motor vehicles have enjoyed a substantial "subsidy" in the construction of an improved system of roads mainly at general public expense. From this point of view it appears that the government has repeated to some extent its earlier experience with railroads. Whether the policy of building expensive roads at general expense was and is advisable involves not only the question of equity discussed above but also the effect of such policy upon the automobile industry and upon the general use of automobiles. Very likely the "subsidy" has been a material factor in the phenomenal success of the automobile industry. Great Britain appears to have followed a different policy and has experienced a slower develop-

[2] A. G. Buehler, *Public Finance*, 2nd ed., p. 650.

ment of its automobile industry and the use of automobiles. On the other hand, a less rapid "motorization" of this country, without special favor, might also have had advantages. At least the burden of proof is upon those who defend subsidies. Suffice it here to indicate the broad issues which highway financial policy has involved. As a matter of fact, the prevailing policy of the recent past was adopted under the press of circumstances and without much deliberation. The demand for highways preceded the development of techniques for taxing motor vehicles, and this alone might account for the fact that the highway system was built in large part without the aid of these taxes.

Motor Vehicle Taxes and Their Uses

Once it is decided what proportion of the total highway cost should be borne by motor vehicle taxes, there still remains the problem of determining which of the several motor vehicle taxes should be used and to what extent. This problem will be considered along with others in the discussion of the various members of the vehicle tax family which follows.

THE GASOLINE TAX

The two principal members of the motor vehicle tax family universally used in the United States are the gasoline tax and the motor vehicle license tax. The gasoline tax appeared upon the scene considerably later than the motor vehicle license tax, but the former swept the country in a decade and is now the most productive of the highway-user taxes.

Growth. The first gasoline tax in the United States was adopted by Oregon in 1919. Colorado, North Dakota, and New Mexico followed Oregon's lead in the same year. By 1929 all the 48 states had enacted gasoline taxes. The initial levies of Oregon and Colorado were 1 cent per gallon. New Mexico ventured a 2-cent rate, but North Dakota decided to be content with a fourth of a cent per gallon. By 1929, after a 10-year interval, the rate had reached 6 cents in several states; by 1942 three states [3] applied a 7-cent rate and only one state and the District of Columbia had a 2-cent rate. In this latter year the median rate was 4 cents. In 1932 the federal government also entered the field and added its 1-cent levy (1½ cents, 1945) to that of the states.

The cities and counties in several states also levy a tax in addition to that of the state and federal government. In Alabama, for instance, in addition to the 6-cent state tax, counties and cities may levy taxes of 3 cents and 2

[3] Florida, Louisiana, and Tennessee. The rate in Florida was raised to 8¢ for a short interval.

cents respectively. This means that a total aggregate levy of more than 12 cents, including the federal levy, is possible in the cities of Alabama.

From the standpoint of productivity the levy on motor fuel has become the most significant of all state taxes. The combined yield in all the states in 1941 was $914,000,000.[4] In addition to this the federal government collected $343,000,000,[5] and a number of cities reaped further revenues from this source. For all the states the gasoline tax produced over one-fifth of total state tax revenues and over 40 percent in Georgia, Nebraska, Tennessee and Florida.[6]

Advantages. Of all the taxes which have ever been employed in the United States, the gasoline tax probably comes nearest to being a popular tax. From the government's standpoint, its first virtue is ease and inexpensiveness of administration. When rates were low this was particularly true. Even today the cost of administering gasoline taxes is lower than that of any other major state or local tax, the cost being less than a half of one percent in about half the states and less than 1 percent in practically all of them.[7] Another advantage to the states is that the gasoline tax exacts contributions from out-of-state tourists in rough proportion to their use of highway facilities. Finally, the tax has proved to be a consistent producer of substantial revenue. Its yield can be depended upon in poor as well as in good years.

The principal merit of the gasoline tax from the viewpoint of the taxpayer is its fair adjustment to the benefits he receives from and the cost he occasions the government. The theory that taxes should be distributed according to benefits received, as has been observed, encounters two important objections. One is that benefits cannot be measured, and the other is that society may prefer a wider consumption of certain public services than that which direct beneficiaries could afford. Neither objection is entirely applicable in the case of the gasoline tax. Gasoline consumed is not a perfect measure of highway services enjoyed by the taxpayer, but it is generally accepted as tolerably close. There is a high correlation between gasoline consumed and miles traveled, and at least some correlation between gasoline consumed and the weight of the vehicle and the speed with which it is driven. Most of the beneficiaries of highway services are well able to pay for special benefits received from government.

However, there is a growing realization that gasoline consumption has some limitations as a measure of benefits received. The correlation between gasoline consumption and wear and tear upon the highways is particularly low for vehicles of different weights. This point will be further discussed later in this chapter.

[4] U. S. Department of Commerce, Bureau of Census, *Financing Federal, State and Local Governments: 1941*, State and Local Government Special Study No. 20, Sept. 1942, p. 35.

[5] *Annual Report*, Sec'y of Treas., 1941, p. 483.

[6] *Tax Systems*, 1942, p. 324.

[7] Twentieth Century Fund, Inc., *Facing the Tax Problem*, p. 339.

Moreover, the correlation between benefits and taxes is much higher for motorists as a group than for specific individuals. All the motorists of a state may pay the equivalent of what is spent on the highways for the service of all motorists. But a particular motorist who uses his car exclusively in some city may get far less than equivalent service for the gasoline taxes he pays. City streets are not usually financed to any great degree out of motor vehicle tax receipts, most of which are earmarked for rural highways. Similarly, the motorists of a county where the highway system is largely completed may now be paying for the construction of highways in some other part of the state.

It has always been possible for the proponents of the gasoline tax more or less to disarm their opposition. To the typical motorist they have presented the plausible claim that improved highways save him from 1 to 2 cents per mile in cost of operating his automobile. The modal state gasoline tax costs him less than a half cent per mile. To the automobile manufacturers and distributors the proponents of the tax have pointed out that good roads, financed with motor vehicle taxes, add much to the pleasure and economy of owning a car, which in turn augments the sale of automobiles.

Administration. Gasoline taxes were conspicuously free from administrative difficulties when the rates were low, but, with successive advances in the rates, a considerable problem of evasion appeared. With a seven- or eight-cent gasoline tax, the levy may amount to a third or a half of gross sales and substantially more than the profit. Such a situation may be depended upon to strengthen the ingenuity and weaken the integrity of some dealers.

The most prevalent form of gasoline tax evasion is smuggling across state boundary lines. The state from which the shipment originates cannot collect the tax because the sale is interstate commerce and as such is immune from state taxation. It is the responsibility of the state to which delivery is made to get information concerning the importation. This may not be easy, particularly when gasoline is brought in by truck. Some states have established borderline patrols or ports-of-entry to reduce smuggling. These may be effective, but they are also expensive. Many states now have working agreements with their neighbors, under which they require exporters to report out-of-state deliveries and supply the state of import with this information. This is one of the first and most important achievements in interstate cooperation in tax administration. In addition, states often have the cooperation of refiners and railroads in supplying information concerning shipments. Gasoline tax administration has been facilitated by the fact that the great majority of those in the petroleum business make no attempt to evade the tax and resent the untaxed competition of those who do. Individually and collectively these "honest dealers" have been vigorous allies of the states in their efforts to administer the gasoline tax. Good and cheap

administration of the gasoline tax is not impossible, but it is not to be had without an aggressive program.

Unfortunately, there is no uniformity among states in the agencies charged with administration and collection of the gasoline tax. This task may be assigned to the highway commission or the state treasurer or some other of a variety of agencies. The best choice is considered to be the state tax commission.

Exemption and Refunds. Most states exempt from tax all or most motor fuel not used on the highways. Since the tax is regarded as a toll for the use of the roads, it seems quite illogical to tax gasoline used in farm tractors, airplanes, stationary engines, or on railways. However, where the same taxpayer owns both a motor vehicle and a mechanism that consumes gasoline off the highways, it is exceedingly difficult to determine how much gasoline is used on and how much off the highways and thus how much should be taxed and how much not taxed.

In order to avoid taxing gasoline not used in motor vehicles, a common procedure is to require the purchaser of such gasoline to pay the tax at time of purchase and then seek a refund. To qualify for the refund he must present to some state official an invoice of the purchase and an affidavit of use off the highways. The state has scant check upon the honesty of the affidavit. Beyond the assurance of purchase evidenced by the invoice, the possession of a mechanism using gasoline off the highway (which can be checked), and the plausibility of the amounts upon which the refund is demanded, the state must rely largely upon the honesty of the taxpayer.[8]

Exemption and refunds are very important in a state like North Dakota where the majority of the population are farmers, most of whom own tractors and automobiles. In states like this the annual amount of refunds may range as high as 30 or even 40 percent of collections.[9] Nebraska has attempted to solve this problem in an ingenious way by taxing all gasoline and using the estimated revenue from the sale of gasoline used in tractors for various purposes of particular interest and special benefit to agriculture. This procedure can be recommended for consideration by other states.

Twenty-one states levy a net tax on gasoline used for aviation purposes. Of these, ten states collect the tax on aviation fuel at the same rate as on highway fuel, and the others apply lower rates. In several states the proceeds

[8] An investigator appointed to check up on flagrant cases of abuse of the refund privilege in Oklahoma found many such cases, including use of untaxed gasoline in a school bus operated by the claimant under a contract with a school district, use in dairy delivery trucks, and reselling from a filling station operated on a farm. Not all of these abuses could be proved but they were suspected upon plausible ground (advance sheets from the *Third Biennial Report* of the Oklahoma Tax Commission, 1939).

[9] Finla G. Crawford, *The Gasoline Tax in the United States*, Publication No. 54, Public Administration Service, Chicago, 1937, p. 26; *Hearings*, Revenue Revision of 1942, Committee on Ways and Means, 77th Congress, 2nd Session, Mar. 3, 1942, p. 79.

from the tax on aviation gasoline are earmarked, fully or in part, for the promotion of aviation in these states.[10]

Incidence of the Tax; Elasticity of Demand. It is generally accepted that most, if not all, of the gasoline tax is paid by the purchaser in higher prices for gasoline than he would otherwise pay. To be sure, the price of gasoline varies considerably from state to state and there is no perfect correlation between taxes and prices. However, this is probably due to other factors than the tax, such as differences in the degree of local competition. Where merchants must compete with sales less burdened with taxes, as often happens at state boundary lines, the handicapped dealers may have to absorb the differential in order to retain their business.[11]

Some controversy has existed also concerning the question of whether gasoline consumption falls off materially as higher taxes are imposed and (presumably) prices rise accordingly. Fortunately for the success of the gasoline tax, the period during which the tax was introduced and developed was one in which gasoline prices were decreasing. Considerable inelasticity in demand is suggested by the fact that gasoline consumption (and taxes) contracted very little during the depression of the thirties. It seems quite probable that there is a point at which taxes would result in substantially less consumption, but it is not clear where that point is. The much higher taxes abroad, roughly 15 cents per American gallon in Great Britain before the Second World War, may account in some degree for the lesser use of automobiles there.[12]

THE MOTOR VEHICLE LICENSE TAX

The most important member of the motor vehicle tax family other than the gasoline tax is the motor vehicle license tax.[13] It is an annual payment for the privilege of using a motor vehicle on public highways and streets.

[10] North American Gasoline Tax Conference, *Report of the Committee on Taxation of Aviation Gasoline*, 1945.

[11] In Arkansas, dealers within 300 feet of the state's borders are allowed to pay, in lieu of the state tax of 6½ cents, a tax based upon rates imposed by the adjacent state (*Public Roads*, Vol. XIX, No. 4, June 1938, p. 75, Footnote 10).

[12] The discouragement of consumption might be urged in favor of as well as in opposition to higher gasoline taxes. For many years there have been alarming reports that the available supply of petroleum will be exhausted in the relatively near future. So far we have managed to escape a shortage and any immediate danger of one. But a little conservation as a by-product of the highway tax system might be all to the good.

As other fuels are developed to supply power for highway-driven vehicles, the problem of taxing such other fuels arises. At the present time there are a considerable number of trucks which burn "Diesel" fuel, a crude oil, instead of gasoline. Several states provide for taxes upon this gasoline-substitute roughly equivalent to those imposed upon gasoline.

[13] The license charge is sometimes called a fee, but since it is imposed primarily for revenue rather than as an incident to and in payment for administrative services, it is more properly called a tax. See Chap. XVIII.

Development. The registration tax first appeared as a regulatory measure. Beginning in New York in 1901, it spread rapidly to other states, becoming almost universal by 1910. These early taxes were low flat sums and were nonrecurrent, being payable only at the time the vehicle was purchased. By 1910, however, the license fee in the United States had assumed its more modern form; it was generally an annual charge for revenue and graduated either according to the weight of the car or on some other principle. With the advent of the gasoline tax, some states reverted to the low flat-rate ($2-$3) license. Most states, however, still retain the graduated license tag as a major source of highway revenue.[14] Top registration fees per passenger vehicle in 1942 ranged from a low of $3 in Louisiana and California to a high of $37.50 in Missouri.

Motor vehicle levies rank fourth among the state taxes in productivity. In 1941 the tax yielded some $417,000,000, a little less than half the yield of state gasoline taxes and over 8 percent of the total state-collected revenues.[15]

During the Second World War the federal government entered the motor vehicle tax field with its so-called "automobile use tax," a small flat charge on all motor vehicles in operation on the highways. Among the objections to this very dubious move is the fact that the federal government has no economical means of administering such a levy. Use of state licensing facilities is unprecedented and otherwise difficult to arrange. Creation of similar federal facilities would be expensive. The tax thus far has been enforced largely by an appeal to patriotism and through the informal cooperation of local authorities. The states have strong claim to the motor vehicle tax and, when revenues permit, the federal government would probably do well to withdraw from this field.

Advantages. If the gasoline tax is so popular and has so many advantages as the previous discussion has suggested, the question naturally arises, Why have any other motor vehicle tax? The place of the motor vehicle license tax in the tax system is defended on the following grounds.

1. It can be used to correct a low correlation between weight and gasoline consumption. A 6-ton truck may wear out the highway considerably more than twice as much as a 3-ton truck and use considerably less than twice as much gasoline. Figures compiled from surveys made by the Highway Cost Commission in the State of Washington show that the average gas tax per gross ton mile paid by private passenger cars under a 5-cent tax was 2.25 mills per ton mile, whereas that paid by a 34,000-pound truck and a 68,000-pound truck-trailer combination was only 0.83 and 0.53 mills per ton mile

[14] "Motor Vehicle Taxes," *Tax Policy*, Vol. V, No. 4, Mar. 1938, pp. 1-21.

[15] U. S. Department of Commerce, Bureau of Census, *Financing Federal, State and Local Governments: 1941, 1942*, p. 22.

respectively.[16] In order to serve as a corrective for the low correlation between gasoline consumption and the weight of a vehicle, the license fees should be graduated so that rates advance more rapidly than weight. For example, if the license tax schedule imposes a $25 tax on a 3-ton truck, then it should impose a tax higher than $50 upon a 6-ton truck.

2. The license tax is justified as a sort of overhead charge on the ownership of a car whether the owner uses it often or not. The contention is that public outlay for automobiles, such as that for highways, parking space, traffic officers, and so forth, must be geared to a peak load, and the more cars there are in the community the higher the peak load is likely to be. Miss X may use her automobile only on rare occasions, but these occasions may be when most everyone else is on the road. Thus it is thought that the cost of motor vehicles to the public depends upon their ownership as well as use; as in the case of public utilities, there should be a minimum charge for readiness to serve. The license tax is such a charge.

The cost of administering the motor vehicle license tax is impressively high, particularly in contrast to that of the gasoline tax. On the other hand, it can be argued plausibly that much of this cost is inevitable in any event, since a licensing system is required in order to police the highways adequately.

Tax Base. States have experimented with many bases for measuring license taxes, including horsepower, value of car, piston displacement, wheel base, gross weight, and net weight. Horsepower and piston displacement vary with speed requirements and are very rough measurements of a vehicle's wear and tear upon the highway. The most generally accepted base at the present time is gross weight (which differs from net weight in that it includes the capacity load of the vehicle as well as its own weight). This standard has been endorsed by the National Tax Association,[17] and it has the obvious point in its favor that, of all those which have been in use, it is most closely correlated with cost of highway service. Special consideration may be given to vehicles with hard rubber tires or with more than the usual number of axles or tires.

As a matter of fact, the design of a car or a truck may be more important than total weight in measuring its effect upon the highway. Factors such as the surface area covered by the wheel or tire, the springs, and so forth, are of great importance. However, no administratively practical means of incorporating these factors into the base for calculating registration fees has as yet been devised.

Of course, the motor vehicle tax system is based mainly upon the benefit principle. But there are critics who feel that ability to pay should not be

[16] *Supplemental Report of the Highway Cost Commission to the State Legislature*, State of Washington, Jan. 1937, p. 64.

[17] "Report of Committee of the National Tax Association on the Problems of Highway Finance," *Proceedings of the National Tax Association Conference*, 1924, pp. 411-431.

entirely ignored. Some states no longer retain the personal property tax on motor vehicles as part of their general property tax system, and where this is true, it appears especially plausible to give some weight to ability to pay. Actually, the concession frequently made in practice is to allow a reduction in the license fee where vehicles (particularly passenger cars) have passed a certain age. Some concession to old cars can be justified also on the benefit principle. It is true that as cars get older they do not weigh any less. But they use more gasoline per mile traveled and probably are driven fewer miles upon the highway than newer cars. On the other hand, they are a greater traffic hazard. Such cars often have poor brakes and their owners often neglect to carry liability insurance.

COMMERCIAL USE OF THE HIGHWAY

The motor vehicle tax problem is complicated by the fact that highways are used for business purposes. There is a public as well as a private interest in preserving fair competition between trucking and bus transportation on the one hand and railroads on the other. For some years the railroads have contended that the government has given unfair advantage to their competitors. Before the Second World War, railroads lost a great deal of business, with the result that there was considerable unemployment among railway employees and default in obligations to bondholders.

The railroads have contended for many years that they were being taxed to provide a road bed for their competitors. This charge has been the subject of much heated debate, which, however, has not been well fortified with evidence. Determining the amount of taxes which trucks should pay to compete on equal terms with the railroads requires an exceedingly complicated analysis. One procedure is to estimate the property tax that would be paid were commercial users of highways to provide their roads privately. But the highway plant was built for both commercial and noncommercial users and some proration of this joint cost is required. Interest, depreciation, and taxes on this hypothetical private road system must be calculated. Some consideration must be given to the fact that some highways are not, nor were they intended to be, prudent investments. If there are no personal property taxes on motor vehicles, an additional sum must be added as the equivalent of the tax on "rolling stock." Federal taxes, as well as those of the states, may be brought into the picture. To enliven the dispute, it may be recalled that most public carriers are receiving or have received public assistance in some form and to some degree.

A Board of Investigation and Research was created by the Transportation Act of 1940 to make an exhaustive inquiry concerning this controversial subject. To be included in the scope of the inquiry were all public carriers: pipe lines, intercity bus lines, trucking companies, railroads, water carriers, and

air transportation companies. Federal, state, and local taxes were to be taken into account. The Board submitted its report in 1944.[18]

The most favored bases of comparing burdens were those of balancing actual taxes paid against those that would have been paid had a "model system of taxation" been in effect, and of calculating and comparing the ratios of taxes paid to the national income contribution of each class of carrier. The model tax system included highway-user taxes sufficient to cover reasonable payment for the use of public improvements. It was concluded that the commercial users of highways do have a substantial tax advantage over their railway competitors. The fact that the study necessarily involved a great many debatable assumptions and that it reversed the conclusions of a previous federal study [19] leaves the issue still somewhat in doubt.

Many states have experimented with taxes designed "to make the trucks and buses pay their share." One form which such legislation has taken is the ton-mile tax. As the name implies, the measure of this tax includes both factors, weight of the vehicle and distance traveled. This affords (except for administrative difficulties) an admirable correlation between taxes levied and wear and tear upon the highways.

There are three types of carriers in the trucking business: common carriers, who carry for hire and fulfill a regular schedule upon a regular route; contract carriers, who carry for hire but have no regular schedule or route; and private carriers, who do not offer their services to the general public at all. The ton-mile tax was first applied in many states to common carriers and in most cases has been confined to them.

In some states it has been contended that, if the ton-mile tax is just and proper as applied to common carriers, the same holds for its application to contract and private carriers. It is said, moreover, that the application of special taxes to common carriers or common and contract carriers discriminates against small business, since the latter in many cases cannot afford its own fleet of trucks. Certain states have attempted to apply the ton-mile tax to all carriers. But experience with general ton-mile taxes has not been encouraging. In the absence of available information concerning loads carried, capacity-miles are accepted as the base of the tax. Often this works a hardship on those who travel with less than a full load. Information concerning capacity-miles can easily be obtained for common carriers, but there appears to be no way of getting it for other carriers except from their own reports.

Several states, such as Colorado and Kansas, continue to tax private carriers on a mileage basis, but administration of such taxes has proved highly difficult. The use of sealed speedometers mounted on one of the wheels of each taxable vehicle has been considered but has not been applied successfully. On the other hand, not all state administrators have lost faith in the

[18] Ronald B. Welch, *Carrier Taxation*, report submitted to the Board of Investigation and Research, Washington, D. C. (unpublished at date of writing).

[19] Federal Coordinator of Transportation, *Public Aids to Transportation*, Part IV, 1940.

mileage tax system as applied to private carriers, and many believe so strongly in the equity of the practice that they are prepared to tolerate some evasion.[20]

Several states impose special taxes on commercial users of highways in the form of gross receipts taxes. These taxes have been necessarily confined, however, to vehicles operated for hire, i.e., common and contract carriers. States which apply a gross receipts tax to railroads may feel that consistency requires the same type of tax applied to commercial highway users. In practice this tax becomes a levy on benefits received as measured by the amount of business a carrier does on the highway rather than the number of miles traveled. This version of "benefits received" has an obvious imperfection as a measure of highway costs.

OTHER TAXES AFFECTING MOTOR VEHICLES

Although the principal taxes which affect the motor vehicle have been covered, there are numerous others which may be mentioned in passing. Within the motor vehicle tax family are the drivers' and chauffeurs' license fees imposed by most states. Usually they are unimportant as revenue sources and are incidental to administration. Occasionally, however, as in New York, they produce a fairly substantial revenue.

Among the taxes outside the motor vehicle tax family, but which affect motor vehicles, is the personal property tax. It is applied to motor vehicles in over half of the states. The trend, however, is away from taxing motor vehicles as personal property. The sale of motor vehicles is usually subject to a sales tax. Occasionally, filling-station sales of petroleum products are included in the general retail sales tax; more often they are exempt. The sales tax is objected to by petroleum retailers because it is said to be a tax upon a tax; that is, the selling price which is the base of the tax already includes the state and federal gasoline tax. However, there seems to be no good reason why the consumer of gasoline should not contribute to general government along with other consumers. Finally, filling stations are sometimes subject to the chain store tax and this may or may not be passed on to the motor vehicle owner and user.

DIVERSION OF MOTOR VEHICLE TAX FUNDS

Another problem which has come to the fore in recent years is diversion of gasoline and motor vehicle license tax revenues to other than highway purposes. During the lean years of the early thirties the gasoline and motor

[20] Ronald B. Welch, *Carrier Taxation*, Vol. 2, pp. 417-423.

vehicle taxes were among the few that produced a relatively constant flow of revenue. Many of the states were hard pressed for funds with which to meet relief and school expenditures and to balance their budgets. The result was a considerable diversion of gasoline taxes from highway to other purposes. Sometimes this was by the express authorization of the legislature and sometimes as a result of a delay in expenditures by the executive, who under some state laws must authorize construction contracts. In some cases the executive persuaded highway administrators to slow up highway construction in order to protect the treasury. A second type of diversion has been the use of state highway aids by localities for other purposes than that intended. This latter type of diversion might be checked, as a rule, by vigorous administration, but such has not been always provided.

Diversion by legislative appropriation of motor vehicle tax revenue for other purposes than highways increased steadily from $9,260,562 in 1929 to $196,579,000 in 1940. In 1940, 14.8 percent of the total motor vehicle tax collections for all states was expended for miscellaneous purposes.[21]

The diversion policy has been vigorously criticized on the grounds that the justification for the gasoline tax is its use for the construction and maintenance of highways; that without this justification the gasoline tax becomes an ordinary sales tax and a very high sales tax at that. In the federal Hayden-Cartwright Act of 1934, the principle was laid down in a federal-aid statute that "it is unfair and unjust to tax motor vehicle transportation unless the proceeds of such taxation are applied to the construction, improvement, or maintenance of highways." [22] Under this statute Maryland and Pennsylvania were forced to restore the motor vehicle revenues used for nonhighway purposes by the threatened withholding of federal aid funds.[23] Considerable pressure, sometimes successful, has been exerted to procure the enactment of nondiversion provisions in state constitutions.[24]

Concerning the diversion problem, it must be remembered that in local expenditures for roads and streets there has been much diversion of general property taxes for highway purposes. Since in few, if any, states total expenditures for highways even in depression years has been less than total motor vehicle taxes, it can be argued that there has been no *net* diversion.

[21] *Hearings*, Revenue Revision of 1942, Committee on Ways and Means, Seventy-seventh Congress, 2nd session, 1942, Vol. 3, p. 2638.

[22] *U. S. Statutes at Large*, 48, Chap. 586, Sec. 12.

[23] *California Highways and Public Works*, Department of Public Works, State of California, Vol. XVI, No. 7, July 1938, p. 20.

[24] "Chiseling Away the Taxing Power," *Tax Policy*, Vol. VI, No. 1, Nov. 1938.

California amended its constitution in November 1938 to provide that "all moneys collected from any tax now or hereafter imposed by the State upon the manufacture, sale, distribution or use of motor vehicle fuel, for use in motor vehicles upon the public streets and highways over and above the cost of collections, and any refunds authorized, by law, shall be used exclusively and directly for highway purposes." A discussion of the merits of this measure will be found in *California Highways and Public Works*, Vol. XVI, No. 8, Aug. 1938, p. 7.

This is on the assumption, of course, that the motor vehicle owner should pay for the entire cost of roads and streets.

There has been considerable popular misunderstanding and abuse of the term "diversion." In the broadest and soundest sense there is no diversion of motor vehicle tax revenues until motor vehicles and the sale of such vehicles and of motor fuel have paid the same taxes for the support of general government as other property or sales, in addition to paying for the entire cost of highways and streets. This heavy imposition may not be advisable, but until it is made there is no diversion. The attempt to put an anti-diversion clause into state constitutions not only encounters difficulties of definition, but represents one more effort to put beyond legislative discretion a matter which is clearly within the proper range of legislative policy. Here is another manifestation of the power of well-organized pressure groups to fasten undesirable tax restrictions upon what should be "the sovereign state."

Waiving the question of whether or not there is diversion, the legislature should have the right to levy an excise tax on gasoline if it sees fit. Probably there are better ways of raising general revenue than the gasoline tax, but there are also worse—for example, the retail sales tax which includes in its base, as a rule, most of the necessities of life.

The cities particularly have cause for complaint on the ground that they receive only a very small proportion of the motor vehicle tax receipts or of their outlay for roads and streets out of revenues collected from the road user. According to one report,[25] about half of all the mileage traveled by motor vehicles in the United States is on city streets. On the other hand, only about 4 percent of the gasoline tax collected in 1940 was returned to municipalities for use on streets. Only sixteen states allowed cities to participate in gasoline tax revenues at all, although highway and street costs in 1941 represented about 8 percent of the average cost of government for cities of 100,000 and over.

It can be contended, of course, that city streets are of considerable benefit to other than motor vehicle owners and that property taxes and special assessments can be very properly used to pay for much of the cost. This argument is certainly not convincing as applied to that portion of the highways which pass through cities and villages. And it is not convincing even as applied to more strictly local streets. Certainly there should be no talk of diversion as long as the vehicle owner pays such a small portion of his benefits from city streets.

[25] Public Roads Administration Release, Oct. 1941, Table G3.

INTERGOVERNMENTAL RELATIONS IN THE MOTOR VEHICLE TAX FIELD

Intergovernmental relations in the entire motor vehicle tax field presents something of a problem. The states were first to develop the field and claim it as their own on the grounds that it is well adapted to state administration, that motor vehicle taxes are most logically applied on the benefit principle at the state level, and that these levies are correlated and integrated with state and local property taxes. Federal collection, with the states sharing, is precluded by the great range of differences in local conditions and tax institutions throughout the country. It was recently recommended that the federal government withdraw from this field as soon as its finances permit. If a compromise is in order, it was suggested that the federal government confine itself to the taxation of aviation gasoline. Aviation is a field peculiarly federal in character and one which the states have developed very little.[26] On the other hand, federal motor vehicle taxes are defended on the ground that the national government contributes substantial highway aids to the states.

CONCLUSION

The motor vehicle tax family has a legitimate place in the revenue system, and the trend toward an enlarged place for it is to be commended. It is one spot in the tax problem where the benefits-and-cost principle can be defensibly and practically applied. The trend toward the gasoline tax as against motor vehicle license taxes is also to be commended. Probably there is some upper limit beyond which the gasoline tax should not be raised—a limit which depends upon considerations of administration, elasticity of demand, and the need for highway revenues. The license fee is entitled to a place in the motor vehicle tax system, particularly in its application to heavy vehicles where gasoline consumption does not adequately measure the cost of highway service. Both research and legislation are required to equate tax burdens upon commercial users of highways and those upon railroads. Cities are entitled to more financial support from motor vehicle tax revenues. Despite much talk of diversion, many motorists still enjoy special privileges in highway services for which they do not pay. The attempt to write anti-diversion clauses into state constitutions is an unnecessary and unwise surrender of taxing power. There are strong grounds for the view that the federal government should abandon the motor vehicle tax field in favor of the states.

[26] Committee on Intergovernmental Fiscal Relations, *Federal, State and Local Government Fiscal Relations*, U. S. Treasury Dept., Senate Document No. 69, 78th Congress, 1st Session, 1943, p. 527.

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CHAPTER XV

The Poll Tax

Everyone is familiar with the flat membership fee required of members in clubs and societies. The poll tax is like these per capita charges except that membership in the government is not a matter of choice; it is compulsory and universal.

HISTORICAL

The poll tax is an old institution extending back to the ancient civilizations of Egypt, Greece and Rome. It is recorded in the New Testament that Joseph and Mary went to Bethlehem to be enrolled for the poll tax, because Caesar Augustus decreed "that all the world should be taxed." [1] In ancient times the poll tax was paid mainly by conquered people and was generally regarded as a badge of servitude. Curiously enough, in the southern part of the United States, poll-tax payment has become a badge of freedom. Reference has already been made to the use of the poll tax in medieval England.[2] It was transplanted to America during the colonial era. In 1623 it was imposed in the Virginia Colony in order to finance military expenditures against the Indians; it remained a principal source of revenue in that state until it was abolished in 1816. But it was revived again in 1850 in the form of a dollar-per-head tax on free Negroes to help pay for a Negro colonization program in Liberia. In 1860 the tax was made uniform and applicable to both white and Negro males.

In many places the poll tax has been payable in personal service to the government, which at the option of the taxpayer might be commuted into a cash payment. Forty years ago a common form of poll tax in the United States (and surviving in many states today) was the road tax under which each male person in the town or road district was required to perform a certain amount of work upon the highway. The school poll tax is said to have originated at a time when it was customary for the teacher "to board around"; those who did not wish or were in no position to furnish board

[1] St. Luke, Chapter II.
[2] Chap. I.

were required to pay the poll tax. Although most roads now require specialized maintenance and teachers are paid salaries to board themselves, the poll tax still survives in more than half of the states in the United States.

ARGUMENT FOR THE POLL TAX

The principal argument for the poll tax is that it requires those who otherwise pay no direct taxes to contribute something to support the government. This argument rests upon the proposition that all *should* contribute something to the government; the theory behind this is that all receive benefits from government and that voters are less likely to be extravagant when aware that it is their money in part which governments are spending. The sales tax is similarly supported but, because of its indirect and hidden nature, this tax is thought to be inferior to the poll tax in achieving these objectives.

ARGUMENT AGAINST THE POLL TAX

Administrative Difficulties. One of the main objections to the poll tax is its administrative difficulties. Administrative procedure which would ensure proper, prompt, and productive revenues from this tax has been almost impossible to design. Applied to persons with property or substantial incomes, the poll tax is reasonably easy to collect; levy on their property or attachment of part of their income is always possible. However, these people pay substantial taxes without the poll tax. Successful administration of this tax must be judged by the degree to which people with little or no property or income are reached. The grocer, the meat merchant, and the small loan company have all learned how difficult and expensive it is to collect from these people. The government has generally been less skilled and less ruthless in collection than most of these private agencies. The small loan companies are frequently authorized by law to collect up to 42 percent interest from small borrowers, most of which must go for collection costs. The government can hardly hope to do better.

Some poll taxes have been collected at the source from employers. In other cases provisions have been made for imprisonment as a penalty for nonpayment. In some states the poll tax is collected by a house-to-house canvass. One state allows a 10 percent commission for collection. Frequently payment is made a voting prerequisite. In three states[3] the poll tax must be paid before an automobile license can be obtained.

All of these methods have their difficulties or limitations. Collection at the source, of course, cannot be made universal. Imprisonment is sure to be

[3] New Hampshire, Rhode Island, and Vermont.

expensive and smacks of imprisonment for debt. The house-to-house canvass finds many people not at home or without ready cash. Those with little property or income are in an advantageous position in dealing with collectors. Payment as a voting prerequisite does ensure that those who do not pay have no voice in spending "other people's money." But this is criticized as undemocratic and as likely to lead to political corruption and petty bribery. Making the poll tax a condition for granting an automobile license can be effective in reaching only those owning automobiles.

Regressivity. The poll tax is also objected to on the ground that it is regressive and contrary to the ability-to-pay principle. The objection involves the theory of equity in taxation discussed in Chapter II. The poll tax is an example of pure mathematical equality in taxation, but legislators hesitate to carry this principle to its logical end. All poll tax laws in the United States fall short of universal application; instead they apply the principle of reasonable classification and make exceptions. Many laws apply to men only; frequently age limits are set at 21 and 60 or 65 (in some instances special bachelor taxes have been proposed), and often additional exemptions are specifically made for some of the following: paupers, insane, feeble minded, disabled, ministers, students, war veterans, and others. Attempts have been made in foreign countries to graduate the poll tax, with one rate for artisans, another rate for peasants, a third for the clergy, and so on. This has led logically to an attempt to graduate the tax according to the income of the recipient, which in turn has led to a graduated income tax.

POLL TAX IN PRACTICE

Although it has long been customary for tax students to speak of the poll tax as mainly of historical interest, all but six states[4] either provide for or permit its use. However, not all of these states use the tax, and in some only the local units impose it. Most states will permit the individual to work out his tax, with credit for labor ranging from 50 cents to $2 per day. In some counties in Alabama 10 days per year would be required in order to pay the tax. Rates of the tax range from 25 cents to $12.00 per year, with those from $1 to $2 the most common.[5] Generally, the yield suffers not only

[4] Ohio, Oregon, Maryland, Utah, New York, and Wisconsin. The first four have provisions against poll taxes in their constitutions.

[5] Concerning a proper rate for Georgia, Professor Lutz comments as follows: "It [the poll tax] should be collected from all who do not pay the personal income tax, in an amount which represents a fair minimum personal tax. As to the particular rate which would fit this description, opinions will differ. The exact rate is not to be determined precisely, but in order to give the tax a respectable standing it should be at least one grade higher than the dog tax, in view of the pertinent criticism of the New York Tax Commission. A rate of $3.00 seems fair" (H. L. Lutz, *The Georgia System of Revenue*, submitted to Governor L. G. Hardman, Atlanta, Georgia, 1930, p. 94). The Georgia poll tax was repealed in 1945.

from the difficulties of administration previously mentioned but also because, in states where nonfiscal objectives are paramount, no attempt is made to collect the tax. Statistics of yield are incomplete because some local governments do not report the funds collected from this tax. A study as of 1930 [6] placed total collections at $20,000,000, of which $4,000,000 was retained by the states. This figure indicates the relatively minor fiscal importance of poll taxes.

USE OF THE POLL TAX FOR NONFISCAL PURPOSES

In 1942 seven states required payment of the poll tax as a condition for voting. All of these states were in the South. Vermont, however, required payment as a condition of voting at town meetings, and Philadelphia as a condition of participating in local elections.

As a result of the Civil War the Negro was emancipated and given the ballot; at the same time many whites were temporarily disfranchised. An era of Negro domination under Northern "carpetbagger" leaders followed, with much confusion, resentment, and ill feeling throughout the South. When Southern whites regained control, various *extra-legal* means such as the Ku Klux Klan were instituted to keep the Negro from voting. This era was distinguished by little use of the poll tax as a nonfiscal measure. As the South regained confidence, and fear of Northern retaliation (such as in a reduction of Southern representation in Congress) gradually disappeared, payment of the poll tax as a prerequisite to voting began to appear. Mainly from 1890 to 1902 most of the Southern constitutions were rewritten for the purpose of *legally* disfranchising the Negro. Before this period the Georgia Constitution, adopted in 1877, made payment of poll tax, current and in arrears, a condition for voting, a fairly effective method of achieving its purpose. In Mississippi, with the Negro population at that time considerably larger than the white, the constitution of 1890 made payment of the current and two previous years' poll taxes a prerequisite for voting. The effectiveness of these clauses was increased by the fact that no attempt was made to collect the tax. Similar provisions were incorporated in the constitutions of most other Southern states.[7]

[6] *Double Taxation*, p. 158. Preliminary Report of Sub-Committee of the Committee on Ways and Means, 72nd Congress, 2nd Session, 1933.

[7] For only one state, Louisiana, are reliable figures available to show what the new constitutions did in the way of eliminating the Negro vote. "For the 1896 elections, the last before the disfranchisement code [which included the poll tax], there were registered in the state 130,344 Negroes; Negro registrants were in the majority in 26 parishes [the Louisiana equivalent of county]. For the 1900 national elections, two years after the adoption of the new constitution, there were registered only 5,320 Negroes and no parish showed a majority of Negroes. While Negro registration fell off by 125,000—96 percent—white registration fell off only 30,000" (Paul Lewinson, *Race, Class, and Party*, Oxford University Press, New York, 1932, p. 81).

The poll tax has not been the only means of disfranchising the Negro. It has been described as "a private soldier among an army of safeguards." For example, the Alabama constitution of 1900 contained property, employment, understanding, and educational qualifications for voting besides the poll tax qualification. Complete abolition of the poll tax, it has been said, would not entitle a single Negro to vote in the 7 poll tax states of the South.[8]

The restraint of Negro voting is a well-known fact, but what is not well known is that the program (including the poll tax) barring Negro voting in the South has also disfranchised some of the poorer whites—the sharecropper, laborer, mill hand, and mountaineer. In Texas in the 1940 presidential election, only 1,041,168, or 28 percent, of the potential electorate of 3,220,880 voted. In four nearby states, New Mexico, Oklahoma, Kansas, and Colorado, with a potential electorate of less than that in Texas, 2,418,527 votes were cast in the same election, which was nearly two and one-half times that in Texas. The state of Virginia, the mother of eight Presidents, shows a similar result. Whereas Virginia polled 22 percent of her potential electorate in 1940, the four surrounding states of Maryland, West Virginia, Kentucky, and North Carolina averaged 57.6 percent of their potential electorate. However, one must not pass judgment too quickly on this subject of nonvoting, for the one party system in the South makes the primary election the all-important election; the results of the general election usually are a foregone conclusion and, because this is generally understood in the South, many whites do not take the trouble to go through the formality of voting in the general election. In some instances the voting in the primary is twice as large as in the general election. Then, too, one must also keep in mind that the effect of the poll tax cannot be separated from the effects of the other voting restraints.

The poll tax qualification for voting involves the important difficulty that it is a constant invitation to buy votes by paying poll taxes for other people. In some states it is a penal offense to pay another's poll tax on the ground that such conduct is equivalent to bribery. The danger of corruption is also reduced by the requirement in some states that poll taxes, to qualify a voter, must be paid six months before election. Nevertheless, the temptation to corrupt elections is not entirely avoided.

Recent poll tax debates in Congress have involved the question of state-imposed qualifications for voting in federal elections. It has been argued that such qualification, requiring the payment of a poll tax as a condition for voting, is equivalent to a state tax on a federal function. Thus far, the proponents of this point of view have been unsuccessful.

[8] Since 1936, three states, Louisiana, Florida, and Georgia, have repealed the poll tax. States which still retain the poll tax as a voting prerequisite are Alabama, Arkansas, Mississippi, South Carolina, Tennessee, Texas, and Virginia. An effort to repeal the tax in Arkansas received legislative approval in 1937, but was voted down in the 1938 General Elections. A similar effort and approval in Tennessee in 1942 was outlawed by the Tennessee Supreme Court.

Some countries fine qualified persons who do not participate in elections. This seems to be the opposite extreme from the poll tax. Perhaps a compromise which abandoned tax qualification for voting would be the happy medium.

CONCLUSIONS

As a fiscal device the poll tax encounters too many obstacles in administration and yields too poorly to be recommended. Insofar as the very poor should be required to support the government, indirect taxation or income taxation without exemptions is better. Indirect taxes create less tax consciousness, to be sure, but have overwhelming advantages in convenience of payment and ease of collection. As a nonfiscal device to disqualify poor people from voting, the poll tax will be applauded or condemned according to one's views concerning democracy. The sympathies of the present writer are toward the expansion rather than the contraction of the voting public.

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CHAPTER XVI

Social Security Taxes

INTRODUCTION

The Social Security Act of 1935 introduced an entirely new kind of "tax" into the federal revenue system—and with it a series of new financial problems which affect both the federal government and the states. These taxes yielded the federal and state governments close to $2 billion in 1941 and, with expanded payrolls and increased rates, their yield in the postwar period might double or even triple this amount. These figures may be compared with the total revenue of the federal income tax, corporate and personal, of roughly $2.5 billion in 1937 and the total federal tax collections of $3.3 billion in 1929.

The Social Security Act is clearly much more than a financial measure. It is a far-reaching venture into the field of social insurance and labor legislation, the social and economic aspects of which for the most part lie outside our field. This chapter will be confined mainly to the special financial problems created by the taxes and reserves for which the Act[1] provides.

FINANCIAL PROVISIONS OF THE SOCIAL SECURITY ACT

Briefly, the Social Security Act imposes three so-called taxes. Two of them are designed to finance a contributory old-age insurance system. One is called an "income tax" on wage earners, measured by their wages. Beginning in 1937 with a rate of 1 percent, it was to rise at three-year intervals until it reached a maximum of 3 percent in 1949. It is collected by the employer, who deducts it from wages. The other is an equal amount, but it is levied

[1] The problem of shifting and incidence of social security taxes has been previously discussed (Chap. VI). The effects of the Security Act upon the pattern of public expenditure and upon federal-state and state-local financial relationships will be discussed to some extent in later chapters.

on the employer and cannot be deducted from wages. This is called an "excise tax."

The advance in rates scheduled for 1940 and 1943 has been postponed, with the result that these two taxes are still at their original level of 1 percent. These taxes have a wide coverage but include only the first $3,000 of wages paid to an employee during a year and do not at all apply with respect to compensation to wage earners over the age of 65, nor to agricultural labor, domestic labor, public employees, and a few other classes of employees. The benefits feature of the Act is based on insurance principles, with an amount for each employee and benefits proportioned in the main [2] according to accumulated balances. Some provision is also made for the payment of benefits or a lump sum to dependents or other heirs in the case of the taxpayer's death.

The third tax is designed not to finance any program directly but to encourage the states to inaugurate and finance unemployment insurance or compensation plans. This is an excise tax levied upon employers of 8 or more persons, the rates being 1 percent of payrolls in 1936, 2 percent in 1937, and 3 percent in 1938 and thereafter (the full 3 percent rate is now in effect). This tax may not be deducted from the employees' wages. The law contemplated that the unemployment compensation system would be set up and administered by the states. The federal government levies the tax but allows a 90 percent credit on taxes paid by employers under approved state unemployment compensation plans. The funds collected under state administration are turned over to the federal government to hold in trust until they are requisitioned for benefits by these states. The 10 percent which the federal government collects directly in cash is retained by it. However, the federal government grants aids to the states to defray proper administrative cost of their unemployment compensation systems.

In addition to the three taxes and the two systems of insurance, the Social Security Act provides for extensive federal aids to the states. The principal ones of these are for old-age assistance [3] and for dependent children. They are granted in the form of reimbursement for state outlays, not to exceed one-half such outlays for old-age assistance and one-third for aids to dependent children. These aids need not concern us in this chapter, except to point out that they must be financed from general taxes, which constitute a fourth source of revenue for the program. About $330,000,000 was appro-

[2] Low-paid employees and employees under the system a relatively short time receive more benefits relative to taxes paid on their account than better-paid employees and those under the system for many years.

[3] Not to be confused with the old-age insurance system previously described. Old-age assistance is given to the needy aged only, excludes no classes of employees, and is not contributory. This is no innovation; it was already paid in some states at the time of the enactment of this Act.

priated for these grants in 1941.[4] This amount may increase as a result of expanding state programs and the growing number of old people. On the other hand, it tends to drop off when high levels of prosperity are achieved. And eventually the old-age insurance program should replace the old-age assistance program to a considerable extent.

NATURE OF SOCIAL SECURITY TAXES

Social security payments are designated as taxes in the law creating them. Actually, however, they resemble contributions or premiums and might be reasonably classed as such. They are termed "taxes" in the federal law largely to establish a constitutionally valid basis for the program. Many other countries have social insurance systems with contributions based upon payroll, but nowhere to the author's knowledge are these classified as taxes. Likewise, the accident compensation systems of the states are similarly financed and the payments are classed as contributions. Nor are the contributory payments made under retirement systems for public employees, federal, state and municipal, regarded as taxes. Massachusetts also has a system of compulsory liability insurance for automobile owners, with payments, however, regarded as ordinary insurance premiums. All of these systems involve the same degree of compulsion as does the Security Act.[5] Furthermore, the contributions in all cases except workman's (accident) compensation and compulsory automobile insurance are collected by the government, and the former is so collected in some states. The fact that the social security taxes are collected by the Treasury instead of some other department or public corporation, such as is usually the case with social insurance contributions in other countries, is only a formal difference. It is urged in defense of the term that the correlation between contributions and special benefits provided in the Social Security Act is very imperfect, but this is also true of European insurance systems, as well as of many retirement plans. Much is made of the fact, further, that Congress is not obliged to appropriate revenues raised under the payroll taxes for the purposes of the Act. This provision is accounted for mainly by the peculiar constitutional difficulties under which the Act was inaugurated. The congressional discretion is an important factor, but it is largely a formality as long as Congress does in fact appropriate all the payroll tax receipts for the purposes of the Act.

It makes relatively little difference, perhaps, whether or not these payments are classed as taxes as long as their true nature is understood. For statistical purposes it will be confusing to find these large payments classed as taxes in the American revenue system and in no other. However, allowance

[4] Treasury Department, *Combined Statement of Receipts, Expenditures, and Balances of the United States for the Fiscal Year Ending June 30, 1941*, pp. 712-714.

[5] Except that workman's compensation is formally not compulsory in some states.

can be made for this difference. The important thing is to recognize that, as taxes, the social security payments have some quite distinctive characteristics.

These taxes are correlated to a high degree with special benefits to the taxpayer. This is particularly true of the employees' contributions under the old-age insurance system, where the payments represent little more than compulsory savings. In the case of the employers' contribution, the correlation is not with special benefit but rather with special responsibility. This suggests the fact that actually, although avoiding that formal appearance, there is a high degree of regulation under the Act. The federal government some years ago passed a law compelling employers to pay certain minimum wages. This is frankly a regulatory measure, perhaps permissible under recent Supreme Court decisions, but in many respects not unlike the social insurance obligations.[6]

These taxes are unique, also, in that they involve a transfer of funds from one group of private citizens to another or from one group to the government at one time with a return to this same group at a later time.

Professor Seligman's definition of taxes as "compulsory contributions levied to defray the expenses incurred in the common interest, without any reference to particular advantages accruing to the taxpayer" [7] is perhaps no longer in conformity with usage since the development of the gasoline tax, but it nevertheless suggests the very unusual character of the social security taxes.[8]

CRITICISM OF SOCIAL SECURITY TAXES

The social security taxes have been criticized on many grounds, some of the most important of which are that they are regressive and unduly burdensome to low-paid employees and that they tend to create unemployment.[9]

Regressivity. The regressiveness of these taxes depends in considerable degree upon their incidence, which, as was pointed out in Chapter VI, is an uncertain and complicated matter. Insofar as the incidence is upon the employees and comes out of their wages, which is probably the case at least in

[6] Not that social insurance requires more wage payments; rather it requires certain new procedures in the payment of wages to labor. It is true that Congress has no power to regulate industry beyond interstate commerce and that the Social Security Act applies to industry not engaged in interstate commerce. This is one of the reasons that it is necessary to preserve the formality of exercising the taxing power. This does not alter the fact that essentially the Social Security Act is a regulatory measure.

[7] E. R. A. Seligman, *Essays in Taxation*, 10th ed., p. 415.

[8] For an argument supporting the view that social security payments are taxes see the "Report of the Committee [of the National Tax Association] on Social Security Legislation and Administration," Roy Blough, Chairman, *Proceedings of the National Tax Association Conference*, 1937, pp. 64-65.

[9] *Ibid.*, pp. 64-67.

some part, the regressiveness is due to the fact that wages constitute a larger portion of the net income of the lower paid employees than of the higher paid ones. On the other hand, under the old age insurance system the better paid employees contribute to some extent to the benefit of those not so well paid. Moreover, with these taxes no pretense is made of applying the ability-to-pay principle. This principle is not the sole criterion of propriety in taxation. Many employees contribute voluntarily to trade union benefit plans, where payments are far less proportioned to individual ability to pay than in the federal plan.

Insofar as incidence is on the consumers, the tax is as regressive as any other consumption tax. Nevertheless, the payroll tax may be regarded in a different light. It may be regarded as a proper element in labor cost. In buying a commodity the consumer should be expected to pay all the costs of production; he has no reason to complain if some of the overhead costs of doing business, hitherto avoided by the businessman, are now included among his costs and in his prices. Thus, if a large amount of seasonality occurs in the production of a good, somebody must pay for the involuntary unemployment, and it is not unfair to expect the consumer to shoulder this "overhead cost" of production. The cost of maintaining old employees after years of productive labor has long been accepted as a reasonable charge upon production.

If the incidence of these taxes is on the businessman, the burden is likely to be erratic and discouraging to business initiative, but this is equally true of property and sales taxes. It is fatuous to contend that all taxes can be levied on net income.

There can be no doubt that the Act, taken as a whole, is not regressive in the sense that its net effect will be to require more from low income groups than they will receive in return. On the contrary, the low income groups stand to gain very decidedly and substantially.

Burdensome to Poorly Paid Employees. The argument that these taxes are unduly burdensome to the poorer paid employees has some validity. Undoubtedly many employees are so poorly paid that they have no capacity to save without cutting into their outlays for the prime necessities of life. They are compelled to save under the Social Security Act regardless of their ability to do so. Perhaps a higher minimum wage enforced by law is the answer to this difficulty. It has been calculated that roughly from 2 to 6 percent of the income of industrial workers is spent for industrial insurance.[10] Considering the wastefulness of industrial insurance, it is safe to say that diversion of these private outlays into the social security system would constitute a social gain. At any rate, there are very real and important advantages in a contributory system of old-age insurance; that is, one under which employers and employees contribute to the fund which supports benefits. From the fiscal

[10] Maurice Taylor, *The Social Cost of Industrial Insurance*, Alfred A. Knopf, New York, 1933, p. 193.

point of view it would probably be impossible to finance even tolerably adequate benefits without considerable application of the contributory principle. Moreover, the contributory principle has the great advantage that it reduces to a minimum the element of subsidy in this huge welfare program. It avoids pauperization of the population. Finally, a contributory system carries far more stability than a gratuitous one. The proprietary interest acquired by contributors supports a sustained program.

Certain critics, for the most part not too familiar with the tax situation, have advocated the net income tax, particularly on the higher brackets of income, as the financial support for all or most of this program. The highest brackets of income now pay a very high federal income tax in addition to other taxes. If the net income tax has further elasticity (and there are still many ways in which its productivity can be augmented), the additional revenue is needed to balance the federal budget and to aid the states. As it is, the general taxpayer is required by the social security program to finance old-age assistance, aids to dependent children and, in addition, outside the program he has the responsibility for relief and other welfare obligations.

Many critics have argued that the government should make a contribution toward the social insurance program through some form of general taxation.[11] On general principles much can be said for this proposition, but it is doubtful if the tax system as now conceived and administered is equal to the task. It is significant that no specific taxation measures other than vague ones concerning the income tax have been advanced by proponents of government contributions. It seems doubtful that any equity would be added to the program by government contributions financed through a sales tax.

Create Unemployment. The final argument against the payroll taxes, that they tend to create unemployment, is used against all labor legislation and with some validity. Most labor legislation makes the employment of labor less desirable and the employment of machinery more desirable. Labor legislation is sustained despite this objectionable tendency, partly because minimum standards are thought to outweigh it in importance and partly because the better distribution of purchasing power or other advantages resulting from governmental interference may help to sustain production and employment indirectly.

The case for payroll taxes as support for the social security program offers no defense for them as support for the general services of government. Like the gasoline tax, they become an entirely different species when diverted from the special use for which they were intended. Wages are not a measure of capital employed in business or volume of business transacted, and thus a business tax based on payroll is quite objectionable. As an income tax, collected at the source, the payroll tax is more defensible, but it is neither suffi-

[11] See Eveline M. Burns, *Toward Social Security*, Whittlesey House, McGraw-Hill, New York, 1936, pp. 153-176; also Abraham Epstein, *Insecurity: A Challenge to America*, 3rd ed. rev., Random House, New York, 1936, pp. 669-785; Paul H. Douglas, *Social Security in the United States*, Whittlesey House, McGraw-Hill, New York, 1936, pp. 3-68.

ciently integrated with the general income tax nor adequately differentiated according to payers to be acceptable in this capacity.

EXPERIENCE RATING AND PAYROLL TAXES

In the case of payroll taxes for unemployment compensation, states can and some do differentiate among employers, favoring those with the best record as to unemployment. This "experience-rating" feature of some state acts is one of the most controversial points in the existing program. Among the opposing arguments are the contentions that favorably situated firms ought not to profit at the expense of the less fortunate and that the system makes employers too conservative in expanding payrolls. On the other side of the issue it is argued that employers can prevent at least some types of unemployment to some extent and that they should be given an incentive to do so. If employers are expected to bear all or a large part of the cost of unemployment compensation, the cost should be distributed according to its source and in a manner most conducive to the maintenance of morale in private business.[12]

It is also argued that employees as well as employers should contribute to unemployment compensation funds. The existing arrangement is defended on the ground that employees bear the uncompensated costs of unemployment. Moreover, the states can and some do provide for employee contributions in addition to those prescribed for employers by federal law.

SOCIAL SECURITY RESERVES

During the first few years of experience with the social security system, much argument centered upon reserves for the old-age insurance program. The original plan contemplated a very large reserve to be built up in the early years of the program. It was thought that the reserve would make the system actuarily sound and that it would ease the load of support in the future. Experience with life insurance and with retirement systems pointed to this financial pattern. However, the reserve plan was later revised to reduce the size of the reserve to contingency proportions. The Board of Trustees is required to report to Congress when its estimates indicate that during the ensuing five fiscal years the trust fund will exceed three times the highest annual expenditure anticipated and when in the opinion of the Board the fund is unduly small.

[12] Emerson P. Schmidt, "Incentive Taxation with Special Reference to Unemployment," *Proceedings of the National Tax Association*, 1941, pp. 464-477; K. Pribram, "Employment Stabilization Through Payroll Taxation," *Quarterly Journal of Economics*, Vol. LVII, Nov. 1942, pp. 142-152.

Arguments Against a Reserve Program. Principal arguments against the reserve program are (1) that it encourages extravagance; (2) that it is deflationary; and (3) that it is meaningless. As to the first, the contention is that an excess of collections over outlays for social security tempts the government to balance the budget on a cash basis only and to use excess collections not to retire existing debt but to enlarge current expenditures.

The alleged deflationary effect of a reserve is based on the assumption that the government will take the opposite course of that stated above and will use the reserve to retire debt. Retirement of debt may be deflationary if it takes purchasing power from those who have a high propensity to spend and distributes it to bondholders who have less propensity to spend.

The contention that a reserve is meaningless is based on the notion that a closed economy can neither borrow from itself nor build a credit for itself in any true sense. Double-entry bookkeeping is involved. A credit simply means that future taxpayers will pay taxes to the social security fund indirectly through the interest they are obliged to pay on the assets of the fund.

Arguments for a Reserve Program. Proponents of a reserve program argue that present old-age costs are in reality much larger than present old-age disbursements and that, with our present tax schedule, we are "placing all confidence in the taxing power of the future." A reserve program, it is said, would at least serve to keep the record clear.

It is argued, moreover, that the reserve system serves to keep the social security program on a contributory basis. At present many general taxpayers, such as farmers, professional persons, independent businessmen, and government employees, are not involved in the benefit program; and, although their inclusion has been contemplated and proposed, the feasibility of such expansion has not been entirely demonstrated. If the future program is financed as largely from general taxes as present procedure anticipates, the system will fall far short of the original goal of self-support. It is not meaningless for one part of the economy to borrow from another.

Conclusion. On the score that the actuarial reserve for social security might be deflationary and that due precautions should be taken against deflationary influences in the postwar era, the contingency reserve program is probably justified. But the price paid for the abandonment of the actuarial reserve should be recognized and counted.

FUTURE OF SOCIAL SECURITY

During 1942 in Great Britain the impressive Beveridge Report [13] was issued. It called for a very comprehensive social security program covering a wide range of contingencies and virtually all British citizens. Included was

[13] Sir William Beveridge, *Social Insurance and Allied Services*, published by arrangement with H. M. Stationery Office. London, Macmillan, New York, 1942.

an extension of the health insurance program and family allowances for children. Finances were to be provided by flat weekly personal payments, employers' contributions based on payroll, and general government support through the tax system. That the cost of this program would be very high was admitted, but it was pointed out that present outlays for public and private insurance and other means of meeting contingencies would go far to cover the cost. The report was followed by documents issued by the National Resources Planning Board [14] and the Social Security Board [15] calling for a more comprehensive and more closely integrated program in the United States. So far these reports have received no serious attention in Congress. It can be said, however, that our present social security program is but a beginning and that the vital interest in collective protection against the many contingencies which arise in a dynamic industrial economy will ensure further development in this field.

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[14] National Resources Planning Board, *Security, Work, and Relief Policies*, 78th Congress, 1st Session, House Document No. 128, Washington, 1943.

[15] Social Security Board, *7th Annual Report of the Social Security Board*, 1942.

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CHAPTER XVII

The Taxation of Natural Resources

INTRODUCTION

Natural resources are the economically useful products of nature, the presence of which is not due to the expenditure of either labor or capital by man. They are usually of ancient origin and are frequently conceived as "the common heritage" of all. The term "natural resources" includes a wide field not easily classified. Some natural resources, perhaps more accurately called natural advantages, are seldom subject to ownership and exchange. These include a favorable climate, access to natural waterways (such as the oceans), and beautiful scenery, as well as an intelligent, industrious, and dependable people. Such advantages do not enter directly into the problem of taxation at all. Some resources are both destructible and reproducible, as forests and soil fertility; others are destructible but not reproducible, as minerals and petroleum; still others are neither destructible nor reproducible, such as urban land sites. These peculiarities complicate the tax problem and warrant some special consideration for the taxation of natural resources.

In dealing with natural resources which are destructible and not reproducible, such as minerals, and to a lesser extent with resources which are destructible but also reproducible, such as forests, conservation is a major interest. The depletion of forests cannot soon be replaced, while the depletion of minerals means an irreparable loss. It is sometimes thought that certain taxes (particularly severance or yield taxes) imposed upon such resources tend to conserve them by decreasing their rate of exploitation. On the other hand, certain other taxes (such as ad valorem taxes) are thought to have the opposite influence; the rate of exploitation is increased in order to sell out from under the tax.

Mention should be made of the fact that taxation is only one among the many means of conservation. The police power can be used to prevent the wasteful exploitation of minerals, oil, and forests. When it is deemed to be in the social interest, the government can retain or acquire ownership of these resources. Sweden is an example of a country which has extensively

followed this later policy. The Swedish government owns a substantial share of the Swedish forests and the mining rights to the largest iron ore deposits in the country.[1]

Of course, the taxation of natural resources has as much to do with obtaining revenue as with preserving the resources. Particularly in the case of indestructible resources, such as urban land, the fiscal interest is the principal one. High taxes on destructible resources are advocated on the ground that they are a common heritage and can be taxed but once. Where a single district or a few districts have a monopoly upon an important resource, large sums may be collected from outsiders by the imposition of taxes before materials are exported.

TAXATION OF FORESTS

Nature and Importance of Forest Resources

Forests are a resource which is continually being built up by nature, a process that is both helped and hindered by human beings; helped through conservation work of various sorts and hindered by man-made fire and too early cutting. Because the development of forest resources in the United States is substantially less rapid than their depletion, an interest has been created in conserving and developing forests. Forest products have many important uses for consumers. In addition, forests reduce soil erosion, which does great damage to agriculture, and prevent floods, which destroy large amounts of property. There is both a social and an economic interest in the attractive scenery and recreational facilities which forests afford. Finally, and perhaps most important, forests constitute the best use of large quantities of land and offer hope of renewed economic independence to large sections of many states.

Problems Created by Deforestation

Decadent Communities. The rapid deforestation of the United States creates not only a problem of conservation but also a problem of territorial maladjustment. The industries and cities which were built because of the accessibility of forest raw materials become decadent when the supply of the latter is exhausted. In order to maintain an adequate standard of public services in these denuded areas, local taxes are often supplemented with state aids, which, if long continued, become a serious financial problem for the rest of the state.

Unproductive Land. A large part of the problem of these cut-over regions is the uncertainty of their adaptability to other productive purposes. Until

[1] Marquis W. Childs, *Sweden: The Middle Way*, Yale University Press, New Haven, 1936, pp. 66-74.

the early twenties, these regions faced the future with confidence in the tradition that "the plow follows the ax." It was supposed that agriculture would supersede lumbering as the major industry in most of the wooded areas. However, the market for farm products ceased to expand at the end of the First World War. A general belief arose that too much land was being cultivated. Moreover, much first-rate forest land will never be good for agricultural purposes.

Tax Delinquency. The condition of the denuded areas is reflected in huge amounts of tax delinquency. In Northern Wisconsin, in 1927, over 3,000,000 acres (about $\frac{1}{10}$ of the land in the state) had one or more tax certificates against them.[2] In the same year, about one-quarter of the cut-over area of Wisconsin was offered for tax sale, but only 18 percent of it found private buyers.[3] On January 1, 1931, 44 percent of the taxable area of 16 Minnesota counties was tax delinquent.[4] Much of this land is gradually being taken over by the counties in some states (as in Wisconsin) and by the state in others (as in Minnesota). This process has been described as the development of a new public domain.

Tax delinquency is both a cause and a result of the financial difficulties of these problem areas. As a cause, it reduces the tax base and thus makes the taxes higher on the property remaining in private hands. High taxes produce tax delinquency; and so it goes, in a vicious circle. The tax base is substantially reduced also, in many places, by the development of state and federal forests and the reservation of land for Indians. As a result of all these factors, in some counties less than 45 percent of the land is taxable.

Bad Assessment of Property. The financial problem of these communities is augmented by other causes as well. Usually they have the poorest property assessments to be found in the states. Property is often assessed according to what the traffic will bear. Cut-over land is generally overassessed. This may be due to the fact that certain value for land on the basis of its agricultural prospects still lingers. Much cut-over land is owned by absentees who, lacking voting rights in the election of assessors, are often discriminated against by the latter. In Wisconsin, where the county credits the town with unpaid taxes, excessive assessments are occasionally deliberate; that is, they are imposed in order to reduce the town's share of cash payments to the county.

Overdevelopment. Some of these frontier towns suffer from the general overoptimism of an earlier period. Lands unsuited for agriculture were sold to prospective farmers, with the result that many of these communities were oversettled. Public improvements, particularly highways, were overdeveloped

[2] B. H. Hibbard, John Swenehart, W. A. Hartman, and B. W. Allin, *Tax Delinquency in Northern Wisconsin*, Bul. No. 399, Agricultural Experiment Station, Madison, 1928, p. 20. The figures include delinquency for the 7 previous tax sales.

[3] *Ibid.*, p. 11.

[4] Roy G. Blakey and Associates, *Taxation in Minnesota*, p. 117.

at public expense. Real estate companies in some cases deliberately fostered road building by scattering sales to settlers, who would immediately demand that the town or county build them a road for ingress and egress. The realtors called this "opening up the country."

These developments and difficulties added impetus to the demand for reforestation programs. The latter, however, were confronted, among other things, with a system of taxation which was alleged to discourage conservation and forest development.

Criticism of Property Tax as Applied to Growing Forests

The tax receiving most criticism was the general property tax. As applied to forests and prospective forests, it was contended, first, that the tax was inconvenient for the forest-owner as to time. The forest-owner is expected to pay taxes for many years [5] before his ability to pay is realized. Forests may be regarded as similar to agricultural crops. The latter, however, are annual and are not usually included in property tax assessments. Forests, because of their slow maturity, are the exception. Farm crops bring an annual income to the landowner whereas the owner of timber land receives no regular income except in the unusual case of rotation cutting. Forests involve substantial risk, particularly from fire; under the property tax this risk is practically all assumed by the owner and very little by the government. Because of the slow maturity of the forest crop, an inequity as well as an inconvenience is said to arise in the application of the general property tax to forests. The owner is thought to be unfairly burdened by a tax which is based upon values arising from remote expectations.[6] This includes the allegation that he must pay interest and taxes upon taxes. Those paid in the early years are capitalized and become part of the land value upon which taxes are paid in subsequent years.

A second objection to the property tax, closely related to the first, is that its future burden is unpredictable. The speculative element in a long investment is great enough without an additional uncertainty as to governmental obligations.

Finally, it is said that the property tax encourages the premature cutting of forests because the owner will harvest early in order to avoid further impositions of the tax. Good forestry may require two cuttings of a forest, the first to take out the mature trees only. If the first cutting is done with care, the smaller trees will have a better opportunity to develop rapidly to permit another cutting. The property tax encourages harvesting all at once to minimize taxes.

[5] In Minnesota a minimum of fifty years is required for jack pine or white spruce pulpwood and a maximum of one hundred years for good quality Norway pine saw logs (Roy G. Blakey and Associates, *Taxation in Minnesota*, p. 147).

[6] See Chap. III.

Requisites of Good Forest Taxation

Critics of the general property tax as applied to forests have sought a forest tax which would meet the following conditions:

1. Impose a burden on the forest-owner which involves neither subsidy nor discrimination;
2. Eliminate the uncertainty in future governmental burdens which a forest-owner may be called upon to meet;
3. Provide local communities with the means necessary to maintain minimum standards in such local government during the period of forest development;
4. Time the tax burden, as far as possible, to fall when the forest yields an income;
5. Impose no obstacles to the best use of, or to new investment in, forests.

Special Forest Taxation Measures

Wisconsin's Forest Crop Law. A large number of states now have legislation which puts forest property in a separate class for taxation purposes and gives it special treatment adapted to its peculiar characteristics.[7] The Wisconsin forest crop law will serve as an example of one type of special legislation. Under the Wisconsin law, a yield tax is combined with an annual levy and an annual contribution by the state to the local government in which the property is located. It should be observed, however, that the application of this law is optional with the owners of forest land. Before the law comes into operation with respect to his land, the owner makes application for its inclusion under the scheme, after which the relationship between him and the state is contractual. Once his land is listed, he pays to his local government ten cents per acre, which the state matches with an equal amount. The latter, however, must be shared by the town with the county and the school districts. These contributions are designed to help municipalities maintain services while the forest crops are growing. In case the land listed is county-owned, there is no local payment by the landowner, but the state contributes an additional ten cents to the county to be used by it for forestry purposes only. The yield tax, all of which goes to the state, consists of 10 percent of the value of the products harvested from privately owned lands and 50 percent of that harvested from county-owned lands. Four-fifths of the latter yield goes to the state forestry fund.

Other provisions of the law specify that land may be listed only in lots of at least 40 acres and that it must be "suitable" for forestry.[8] Moreover,

[7] In some states it was necessary to adopt a constitutional amendment before this could be done.

[8] Farm wood lots not to exceed 40 acres meeting certain requirements are exempt entirely from property taxation under another Act.

the owner must make a reasonable indication that he is getting a forest under way and must, to a reasonable extent, practice the rules of forestry. The law provides for an inspection by the state both when the property is listed and five years thereafter. The property may be withdrawn from its forest-crop status on the initiative of the owner or the state, the latter only in case of the owner's failure to practice forestry. When withdrawing, the individual is required to pay the property taxes (plus interest) which would have been levied upon it had the property not been listed. Mature timber may be listed as forest crop land under an arrangement which affects a gradual transition from general property taxation to the acreage and yield tax.

Land Included Under Wisconsin Forest Crop Law. Over 2,036,000 acres have been entered under the Wisconsin forest crop law (1942), an amount which is well in excess of that included under any other similar state law. In Oregon, where classification is compulsory and made by a state board with no option by the landowner, the special classification includes about 800,000 acres. Louisiana has about 500,000 acres specially classified [9] and Minnesota none. In Wisconsin most of the listed land is county-owned. In 1942 private owners had only 152,000 acres included and the amount was not increasing as was that of the county-owned land. Thus, the forest crop law in Wisconsin has developed into more of a public than a private program.

Administration of Forest Crop Law. It has been the policy of the State Conservation Commission, which administers the Wisconsin law, to admit and retain under it only land which has a fairly good prospect of a timber crop and which may be expected to recompense the state for its immediate outlays. An attempt is made to list lands which will form, together, a fairly large block of territory and thus to facilitate the local zoning of land with resulting economies in local government. Some encouragement and aid have been given in the replanting of land, particularly that owned by the counties. The additional ten cents returned to the counties in the case of county land is devoted in large part to that purpose. Some attention (probably inadequate) has been given to the proper location of forests so as to meet the needs of state industries.

Financial Results. Thus far, after about fifteen years' experience with it, the State of Wisconsin has made a net outlay of about $1,000,000 under the law. All calculations of eventual results are necessarily based on many assumptions and are, therefore, not too reliable; but it seems quite probable that in the long run the state will at least "break even" financially. Local units gain substantially in the early years because of state payments on county-owned land which otherwise would bring in no income. Private owners derive enough advantage from the plan so that most of those who anticipate the development of a forest crop prefer to have their land listed under the state law rather than subject to the property tax. However, except for

[9] *Tax Systems*, 1942, pp. 174-175.

corporations which can afford to develop raw materials as an assurance of an available supply for an established industry (such as the paper industry), the financial incentives of the law are insufficient to justify investment in forest development as a commercial proposition. The real advantages of the law for all concerned consist in (1) better care of forest land; (2) better rural plannning and land use; (3) increased local interest in forestry; and (4) better prospects for a replenished resource which eventually will help to support the industries and government of the state.

Local Interest in Forests and Scientific Land Use. Probably the outstanding achievement under the Wisconsin law has been the psychological effect which it has had upon deforested communities. Formerly they regarded forests as a resource to be "mined," but now many have come to show genuine enthusiasm for a program of scientific forest development. The successful operation of the law has been facilitated by rural zoning, which in turn has been extended a great deal under its influence. Both the forest crop law and rural zoning have become accepted institutions in Wisconsin and are particularly popular throughout the cut-over areas.

Criticism of the Wisconsin Forest Crop Law

The type of law now in operation in Wisconsin has been vigorously criticized by many students of forest taxation. Among the criticisms and rejoinders the following may be mentioned.

Payment to Local Government Abused. It is contended that the payments by the states to local governments (which has stimulated local interest more than any other feature) might be subject to abuses. Local pressures, it is said, may result in increasing the outlays, which, therefore, may become very burdensome. Local pressures might also be exerted to include unsuitable land under the law. State aids for specific functions are a better form of state assistance.[10] None of the anticipated abuses seem to have been realized in Wisconsin. However, they might be an important factor under bad administration. As a matter of fact, in recent years appropriations have been inadequate on occasions to pay the full ten cents per acre to the towns in which land has been listed under the law. A more important danger appears to be that state assistance may, in some cases, go to municipalities which, because of forest zoning and resettlement, may be in a position to economize and thus need no outside assistance. Very rarely as yet, however, has more than half of a town been entered under the forest crop law. Several suggestions have been made to meet this possible waste of public money. Among the most promising is a proposed statute which would require a minimum population and taxable value as a condition for the retention of a separate town unit. If the forest crop law could be used to bring about some governmental

[10] Roy G. Blakey and Associates, *Taxation in Minnesota*, pp. 168-169.

consolidation, it might result in considerable economies in local government. It is probably because of the state's contribution to local finances that the local opposition to private listing of forest crop land has been far less important in Wisconsin than in Minnesota.

It is true, perhaps, that state aids would constitute a form of state support which might afford a better adjustment of state outlays to local needs. On the other hand, they would give the communities less assurance of future support than the forest crop payments, less independence in the use of their income, and less feeling of self-sufficiency.

Flat Rate Per Acre Arbitrary and Inflexible. The flat rate per acre is criticized as arbitrary and inflexible. It takes no account of the prevailing property tax rates and values in the different sections and periods. This is true, of course, and must be offset against the greater certainty of his obligations to the government which a flat tax imposes upon a prospective forest investor.

The Optional Feature. Optional classification as provided by the Wisconsin law has been criticized as raising "serious questions of inequality and favoritism, not to say illegality." [11] The special treatment accorded under any classification of property for property taxation is justified, usually in part at least, by social expediency. It is true that the contractual basis of the relation between the landowner and the state commits the latter for a long period during which important changes may occur in tax rates and prices. On the other hand, the contractual basis affords important advantages in creating assurance, arousing interest, and obtaining practical results.

Forests Should Be Public Rather Than Private. It is said that if we are to develop forests, it should be under public rather than private ownership. Regardless of any decision in the matter, experience appears to indicate that under present conditions no very large amounts of private capital can be attracted into forest development. Perhaps the more important issue is: which level of government should take the lead in reforestation. Local participation in a conservation program is important. It is the local units which are closest to the land. Under our present system of local government, planning land use falls most naturally to local governments. Some weight should be given to the sustenance to local morale resulting from participation in a local program which offers some hope for the future. Privately owned forests, even on a small scale, may have a proper place in the picture if for no other purpose than as a yardstick for public management.

Taxation Unimportant in Reforestation. Doubt is expressed concerning the importance of taxation as an element in the will to reforest. Probably other factors, such as the hazard of fire, uncertainties as to the future market, and particularly the long period of waiting for a return are more important. But this is no adequate reason why tax institutions should not be adjusted to

[11] Forest Taxation Inquiry, *Progress Reports*, No. 18, U. S. Department of Agriculture, Forest Service, 1932, p. 4.

facilitate rather than obstruct what is conceived to be a desirable social objective.[12]

Treatment of Forests in the Tax Laws of Other States

Over half the states have special provisions in their statutes for the application of the property tax law to forests. Most of them make concessions to growing forests and recoup with a yield tax. In some of them, trees or land and trees meeting certain specifications are exempt for a certain number of years without any yield tax feature. Others have an exemption plus a yield tax. Still others, such as Wisconsin, Minnesota, and Michigan, have a flat acreage tax plus a yield tax. In these states, listing is voluntary and contractual. In some other states, as in Oregon, special classification is at the discretion of the state and is not optional with the owners. Wisconsin and Michigan are the only two states authorizing, as part of the forest tax system, state payments to local units of government. Just how far these several measures have been successful in "bringing back the forests" is not easy to determine, but the very small acreage listed for special classification in most states would indicate that these laws have had a fairly limited application.

TAXATION OF MINES

Special Taxation of Mines and Minerals

The question arises as to whether the mining industry may properly be singled out among the industries and occupations for special taxation. This matter has long been the subject of heated debate in Minnesota, where the iron mines are subjected to the top rate of assessment under the classified property tax and pay an occupational or severance tax besides. It is urged by those who defend exceptionally heavy taxation for the mines that the latter

[12] An exhaustive study of forest taxation by the Forest Taxation Inquiry opposed the yield tax as a method of forest taxation and recommended either an adjusted property tax or a partial exemption as a solution of the problem. The adjusted property tax would be based upon the theory that taxation of capitalized anticipations before their realization produces a heavier burden than the taxation of capitalized current income. The property tax applied each year to the capitalized value of an income 20 years hence will add up to a higher percentage of the income than a similar tax upon the same value based upon a steady annual income. Granting the correctness of the mathematics involved in arriving at this conclusion, the proposal to adjust the property tax to allow for the discrimination has several limitations as a basis for forest taxation policy. The first is that the same discrimination, if it exists, holds equally for many other applications of the property tax (in the case of idle lots, for example). The second is that any attempt at manipulating the property tax base to take account of this alleged discrimination would be so complicated and incomprehensible to the layman that it would be impracticable. The partial exemption of forest values would be a more practical solution, but it would afford the investor in forest development less assurance as to the future, less concession as to timing the tax burden, and less freedom from pressure to harvest "out from under the tax" than a yield tax.

are a gift of nature to all the people of the state and that they represent a disappearing asset which will not always be available as a tax base. The fact that many of the mines are owned by absentees and that the mining interests have only a small representation in the legislature may also have a bearing on Minnesota's mine tax policy.

In opposition to the policy of exceptionally heavy taxation, it is alleged that mines are not the sole gift of nature but that urban land, soil fertility, and even inherited talents must be placed in the same category. Even the fact that mines are a "gift" of nature is often belittled; rather, it is stressed that they are a business which requires investment and one in which the risks and hazards are exceedingly great.[13] In answer to the proposition that mines are a diminishing asset, it is said that their products are not destroyed (not immediately at least) but are converted into manufactured goods which, when added to the tax rolls, become a taxable asset of the state. Finally, and most important of all, it is alleged that excessive taxation kills the "goose which lays the golden [or the iron] egg"; that is, high taxation discourages investment in mines, prospecting for new mines, and development of old ones. This contention, offered by the mine-owners, has been supported in Minnesota by the tax commission [14] and other highly competent critics.[15]

Deterrent Effects of Heavy Taxes on Mines. The question whether taxation has a deterrent effect upon mining depends in the last analysis on whether the tax is imposed on a cost or a surplus. A tax imposed on the mere ownership of nonreproducible gifts of nature has a different effect than one imposed on their exploitation and preparation for consumption. But these two aspects, ownership and exploitation, blend into each other in a very elusive way. Obviously, a tax on a clear find will not hinder anyone from making the find. If A finds a pocketbook containing valuable notes, as long as this windfall carries a tax less than 100 percent, he will not hesitate to pick it up. Nor will *B*, to whom he offers his find for sale, hesitate to invest in it because part of its contents will have to be turned over to the government. The tax simply will cause *B* to offer A less for his treasure.

However, suppose *A* is regularly engaged in the process of hunting lost pocketbooks but finds only one every six months and that one is only lightly stocked with valuables, may he not get discouraged if the government deprives him of half his findings? And is not this latter supposition quite analogous to the situation in mining, where extensive outlays are often required to discover so-called "gifts" of nature and even more to uncover and bring them to the surface?

It is clear that in the mining business there is an element of "surplus value," "pure site value," or "scarcity value," whatever one may wish to call it, which is not capable of discouragement by any degree of taxation short

[13] See next several paragraphs for a discussion of this point.
[14] *Eleventh Biennial Report of the Minnesota Tax Commission*, 1928, Chap. XI.
[15] Roy G. Blakey and Associates, *Taxation in Minnesota*, Chap. IX.

of confiscation. If mining as a business is exempt from taxation, there is no danger of discouraging it as an ownership of the scarce gifts of nature. In practice, however, it may be quite difficult to separate the values which are created by nature and those which are created by man. Gross value of produce minus necessary costs of production, including necessary outlays for prospecting, should give "a true surplus." However, there may be some difficulty in determining what is necessary cost. The problem in mine taxation is one of framing and administering the law so that it is the surplus element which will be taxed and not the cost element.

Whether in practice it is possible to separate these two elements with tolerable accuracy is not a matter for dogmatic conclusion by one unfamiliar with the practice of mine taxation. The weight of authority seems to support the view that mine taxes discourage mining. Nevertheless, the common failure to recognize the element of surplus existing in mine property values and incomes makes one skeptical about the prevailing conclusion.

Taxing the "Foreigner." The argument is sometimes advanced that taxes levied on natural resources in a particular state can be collected from out-of-state purchasers who, as a result of these taxes, must pay higher prices for the resources they buy. If a particular state has a monopoly of a resource and the latter is one for which there is a relatively inelastic demand, the state might "hold up the world" with such a tax. While a net value tax tends to rest on the owner, a gross production tax or a tonnage tax is likely to enter into the price which purchasers and eventually consumers must pay. The South American export duties in some cases have been little more than severance taxes on the gross production of certain resources. Probably part of these taxes have been paid by "foreigners."

Relation of Mine Taxes to Conservation. Instead of discouraging mining, it seems more plausible to conclude that an ad valorem property tax on the value of mines and minerals will have the opposite effect; that is, it will encourage the owners to mine out from under the tax. If this is the result, then the ad valorem tax is open to some objection from the standpoint of conservation. If the tax stimulates current production, it will tend to depress rather than increase prices. This in turn may stimulate demand, which again may be undesirable from the standpoint of conservation. The annual harvest of natural resources is kept in check to some extent by the inability of the public to buy more at tolerable prices. This check "puts the brakes" on any tendency to produce and market all available resources within a short period. A tax such as the gross production tax or one like the gasoline tax tends to be passed on to the consumer and thus cuts down demand, which in turn has advantages from a conservation standpoint.

Incidence of Mine Taxation. According to the commonly accepted rules of shifting, a gross production tax should be passed on to the consumer, at least in part. Insofar as it is universally imposed by the governmental units in which production takes place, it applies to all mines and all production

and thus meets one of the main conditions of shifting. Net production taxes and ad valorem taxes, on the other hand, are aimed at a surplus: presumably they do not extend to mines which afford no profits above the cost of production. Insofar as they accomplish in practice what they aim at in theory, they will not be shifted.

Mine Taxation and the Balance of Political Power. Mine taxation has often become a very intense political issue, with the result determined by the balance of power of interest groups.[16] Where a mining company is large, prosperous, and absentee-owned, it is especially vulnerable to political exploitation. Illustrations are cited of mining towns where the property tax base is largely mine property and where the majority of voters have no direct stake in the prosperity of the mines. This situation leads quite naturally to extravagance, a tendency which Minnesota has sought to check by a per capita limitation on local public expenditures. The clash of political forces often includes the rivalry between city and state for the public revenue from the mines. Oddly enough, the political weakness of mine-owners in state legislatures is associated with exceptional strength in Congress. Income tax favors (depletion) for mine and oil companies have been maintained in the law despite the recommendations of the Treasury and repeated attacks of the critics. Congressional balance of power on this question is influenced by log-rolling factors much like those that appear in the tariff issue.

Forms of Mine Taxation

The Ad Valorem Tax. The direct application of the general property tax to mines and minerals is called the ad valorem tax. It is the clearest means of equating the tax burden on mines with that on property. It provides the state and local governments more stable revenue than any other form of mine taxation, and it is less arbitrary than its rivals.

The principal difficulty with the ad valorem tax is administrative. It is no simple task to evaluate a mine of any kind. The valuation must depend upon the thickness of the seams of ore, the quality of the mineral, the probable mining costs, the distance from railroads to market, and so on. Obviously this is too technical a task for local assessors. Nevertheless, there are still a few states in which local assessment prevails. The better practice is to turn the valuation over to the state tax commission or some other state agency. In Minnesota, when mines were locally assessed, the mines themselves did most of the assessing; and in Michigan, when state assessment superseded local assessment, the value of mine property on the tax rolls increased over fourfold.[17]

It might seem to the layman that it would be impossible to appraise a

[16] Warren A. Roberts, *State Taxation of Metallic Deposits*, Harvard University Press, 1944.

[17] H. L. Lutz, *The State Tax Commission*, pp. 315, 405-406.

mine with any accuracy under the most favorable circumstances. But such is not the case. The tax commission, with the aid of experts to measure the quality and quantity of ore by drilling for samples, can sometimes assess a mine as accurately as it does most other property.

This is not to say that the ad valorem tax can be administered with tolerable success in the case of all types of mines. It can be successfully applied to coal, iron, copper, and zinc mines. On the other hand, deposits of gold and silver, and usually lead, are too inaccessible and unpredictable to permit their assessment with reasonable accuracy. The extent and value of deposits are frequently a mere speculation to the owners and equally so to appraisers.[18]

Other Types of Mine Taxation. Where mines cannot be assessed efficiently on an ad valorem basis, and sometimes even where they can be so assessed, various types of income or production taxes have been levied. These may be in lieu of the ad valorem tax or supplementary to it, as in the case of the occupational tax on the net value of ore mined in Minnesota. Among the taxes so levied are tonnage taxes, at so much per ton or other units of measurement. Sometimes the attempt is made to apply a classified tonnage tax, that is, to apply different taxes per unit to different grades of product. This tax is difficult to administer. A gross production tax based upon gross value of product is a simple tax to understand and administer and is the nearest equivalent in taxes of this type to the general property tax. Like all gross taxes, it is criticized on the ground that no account is taken of expenses of production. Net product taxes meet this difficulty but afford no revenue at all from mines which are not profitable. As a rule, some of the mines are unprofitable all of the time and all of the mines are unprofitable some of the time, yet it is said that all should pay some taxes. Finally, some of the states have taken the net income from mines and doubled or tripled it in order to get a base for property taxation. This is highly arbitrary, takes little account of the revenue needs of the state, and produces a very fluctuating revenue. The use of a three, five, or seven-year average of income tends to reduce instability, but this assesses the mine-owners on ability to pay which may have grown cold in the lapse of time between earning and payment. A modification of the net production tax is the use of average capitalized income over a period of years as the basis of the property assessment. Arizona made use of this instrument at one time,[19] using rates of capitalization ranging from 15 to 30 percent. Probably no conclusion can be drawn concerning the consensus as to the best system of mine taxation, particularly where the ad valorem system is impractical.

[18] In the case of aluminum and manganese, the technology of mining and refining is undergoing such important and frequent changes that valuation is, to say the least, exceedingly difficult.

[19] More recently the method applied in Arizona is described as the "use of any and all factors which indicate the full cash value of said property" (letter from the Arizona Tax Commission, Jan. 26, 1939); Warren A. Roberts, *State Taxation of Metallic Deposits*, Chaps. XVI-XVIII.

Practice in Mine Taxation

As in most matters of taxation, a wide range of practice prevails among the states in the taxation of mines. Michigan and Minnesota levy a straight ad valorem tax assessed by the tax commission. Minnesota, as previously mentioned, has a supplementary occupational tax based upon net value of product. California apparently has an ad valorem system with assessment by county assessors, a system which seems ill-adapted to that state with its variety of mineral resources. Utah applies a property tax rate, in the case of metalliferous mines, to twice the net annual proceeds from the mines; Idaho uses much the same system but without multiplying the net proceeds; and both states apply production taxes, the former to the gross and the latter to the net value of product. Wyoming and Montana use gross production taxes, the former applying general property tax rates and the latter a special graduated scale.

TAXATION OF OIL AND GAS RESOURCES

The administrative difficulties which the ad valorem system of taxation encounters in its application to certain mines are even greater in the case of its application to oil and gas resources. Not only are these latter properties unpredictable as to output, but in addition they are, in many cases, very short-lived and otherwise unadapted to ordinary property tax treatment. Nevertheless, some states still attempt to tax them under the general property tax. Most states apply to such properties the gross production tax. Thus Oklahoma levies a 5 percent gross production tax on oil in lieu of all other taxes, and Texas levies a specific tax on each barrel of product plus an ad valorem tax locally assessed.[20]

MINES AND OIL WELLS UNDER THE NET INCOME TAX

Mention has been made of the fact that mines and oil wells cause much difficulty in the administration of net income taxes. Theoretically, depletion, or the reduction in capital value as a result of sale of assets, should be a deductible expense. It is allowed as such under the federal law, but administration is difficult and the law now provides for depletion deduction in the case of some resources on the basis of certain percentages of gross income. The system is criticized as arbitrary and the percentages allowed as

[20] The oil interests of Oklahoma and Texas are said to play one state against the other; in Oklahoma they contend that they are overtaxed because Texas has a lower production tax, and in Texas the contention is that they are overtaxed because Oklahoma has no ad valorem tax.

overgenerous. In some cases, taxpayers are still deducting depletion after they have deducted the full cost of their investment.

SPECIAL TAXATION OF NATURAL RESOURCES IN LAND

Of course, the principal natural resource in most countries is land. In some form it is necessary for practically all economic activity. Urban land is essential as a site for the location of labor and capital or for the location of homes; rural land is the ultimate source of most food and much clothing.

It has been contended for many years that land is an economic good especially well-suited for taxation. The basis for this contention can be seen in the common analysis of the factors and functions of production, whereby the differences between capital and land are disclosed.

Land Among the Factors of Production

Land, labor, capital, and entrepreneurial services are the elements which may be combined to produce economic goods. Each of these factors has a personal contributor—landlord, worker, capitalist, and entrepreneur. Each receives a reward—rent, wages, interest, and profits. Each—except perhaps the landlord—makes a contribution or renders an equivalent for his reward. The worker labors; the capitalist saves; the entrepreneur risks. But it is alleged that the landlord makes no contribution. This is not to say that natural resources are not essential for production. The contention is that the landlord merely appropriates natural resources and does not create them nor their value.

Fundamental Tax Differences of Land and Capital

Many economists make no distinction between land and capital. According to the proponents of special land taxation, however, there are many fundamental differences between these two. Some of the alleged differences are as follows:

1. Natural resources are discovered and appropriated; capital is produced. Man makes the buildings on the earth, but he does not make the sites for them.

2. Land is not capable of reproduction; capital is. The value of capital cannot rise above its cost of reproduction; the value of land can rise indefinitely.

3. Income from capital involves a return from the recipient to the commonwealth; income from land does not.

4. Land cannot migrate; capital can.

5. To a very large extent, land is not reproducible and, therefore, taxes imposed on it are not shifted to the consumer, as are most taxes on capital; the former tend to be capitalized and become a "burdenless" tax upon the purchasers. Taxes on cigarettes make them expensive; taxes on land make it cheap.

Example of Land Value Increment

Proponents of special land taxation have no difficulty in citing cases where landowners have profited immensely as a result of the developing population of a large city. For example, take the financial history of a lot on the southwest corner of State and Madison Streets in Chicago: [21]

> In 1830 when the population of Chicago numbered 50 people, the plot of ground was bought for $20. In 1845, when the city's population had increased to 12,000, the value of the land had risen to $5,000. By 1860 when the population was 109,000, the lot was worth $28,000, or 1,400 times its original value. In 1875 the population of Chicago had increased to 400,000, and the land had risen in value to $92,500. In 1894, with population at 1,500,000, this quarter acre of ground had a value of $1,250,000.

The author who compiled these impressive data concerning one case of land value increment topped off his figures with certain comparisons as follows: [22]

> Six hundred average Illinois farms would not now exchange for this quarter acre of raw prairie land, and nearly three thousand years of labor of one man would be required to buy it. If 500 years before the Christian era, some man had found employment at the equivalent of $1.50 a day; had, like some wandering Jew, been preserved through the vicissitudes of the centuries; had been miraculously sustained without expense for any of the necessities or luxuries of life; had done his work regularly from that day to this, 300 days in the year without losing a day, and had hoarded all his wages, his savings would not yet be enough to buy this quarter acre of prairie land at the mouth of the Chicago River.[23]

[21] Fred R. Fairchild, Edgar S. Furniss and Norman S. Buck, *Elementary Economics*, rev. ed., Vol. II, The Macmillan Co., New York, 1930, p. 149 (quoted from the *Eighth Biennial Report of the Bureau of Labor Statistics of Illinois*, 1894, p. 279).

[22] *Ibid.*

[23] Criticizing ability to pay as a single canon of taxation, Professor John R. Commons has stated the theoretical case for special land taxation as follows:

"But if there is another canon of taxation that may properly be applied, namely, the effects of wealth production, guided by the public purpose of favoring wealth production, then the man who gets his wealth by the 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

The Single Tax on Economic Rent of Land

The most celebrated of all proposals for the special taxation of land is that which usually passes under the name, "The Single Tax." At one time this proposal aroused considerable interest, and even today it has its strong adherents. The following section will be devoted to a discussion of what the proponents of this tax mean by it and how they propose to operate it.

Exposition of Single Tax Proposal. The single-tax advocates propose to base their tax upon economic rent. By economic rent they mean the annual value of a parcel of land. Economic rent is not to be confused with net income from land. Idle land has no net income, but that does not mean that it has no annual value. A bad manager may get no net income from a parcel of land. This does not mean that such land has no economic rent.

What is meant by economic rent can be made clear by two illustrations. *A* and *B* are farmers and neighbors and *A* offers to let *B* have a year's use of 40 acres of land for $400. There is nothing on the land—not even fences. Assuming that this was a fair price for what was being offered, the $400 is economic rent.

Or, again, suppose *C* owns a city lot and building upon which he is able to make $4,000 each year. Part of this net income must be attributed to the capital invested in the improvement on the lot and to the labor of *C* himself. The latter may be determined by appraising the value of *C*'s services were he to offer them on the market. The same applies to the value of the reproducibles or improvements, that is, how much he could earn on his investment in some other line of business. Finally, there is the value of the land, which may be calculated by reference to the market as in the case of labor. If the values of these three deductions do not add up to $4,000, the residue is profits (not to be confused with economic rent). The economic rent, as indicated above, is the market value of the use of the land for one year.

The rate of the single tax according to its most orthodox followers would be 100 percent; some are willing to accept a rate sufficiently high to provide the revenue needed for government.

The tax would be levied annually. In this respect Henry George's single tax is not to be confused with Lloyd George's land value increment tax. The latter was to be collected not annually but only when an exchange of land took place.

The orthodox single-tax proponent urges his tax to the exclusion of all others. Again, some of the less orthodox followers have been willing to give

he contributes directly to an increase in both private wealth and commonwealth. Hence, looking at it from the commonwealth, or social utility, standpoint, there are two kinds of ability to pay: that ability which varies directly with one's additions to the commonwealth, and that which varies inversely with one's additions to the commonwealth. The first we shall name Ability to Serve, the second, Ability to Pay." (John R. Commons, *Institutional Economics*, p. 819.)

ground and accept, along with heavy taxes on land, certain other taxes—perhaps, income and inheritance taxes.

Unsound Criticisms of Single Tax. Some of the superficial criticisms of the single tax are unsound. For example, it is said that a tax system which takes all that a person is able to make on a parcel of land deprives him of all incentive to own or improve the land or to use it to its best advantage. Those who make such assertion either have small understanding of single-tax theory or are claiming that the single tax does not work according to its theory.

No incentive to own? The incentive to own remains because land becomes less expensive—in fact, of nominal cost only.[24] Besides, one must have land as a situs for labor and capital from which one would still be allowed to acquire all economic rewards except rent.

No incentive to improve land? On the contrary, the incentive to improve land would be considerably strengthened by the fact that no taxes would be levied on improvements. One of the principal single-tax arguments is that the proposed tax system would stimulate improvements. The single tax is a developmental tax policy. Take the taxes off from labor and capital, it is said, and these necessary elements of progress will be forthcoming in more generous measure than ever before. Why should a man who paints his garage be penalized by an additional dose of taxes?

No incentive to operate land efficiently? Those who so argue confuse rent with profits. A single tax is not a tax on excess profits. Special efficiency would still be entitled to its reward. As a matter of fact, because of the necessity of paying the tax, the single tax might force some to raise their efficiency.

Valid Criticisms of Single Tax. What seems to the writer to be valid and important criticisms of the single tax are the following:

1. It is too single. Granting it to be true that at least much income from land is unearned, it is also true that much income from many other sources is also frequently unearned. The notion that the landlord is a thief and that all the rest of us are "worthy of our hire" is one which has not and will not find support among most citizens, particularly the ones who have no taste for abstractions. Income in gifts, inheritances, and monopoly profits are commonly cited as examples of unearned income from other sources than land. A considerable part of wages and salaries is also thought by some to be unearned. Why is Mr. X able to command a $100,000 salary? As in the case of income from a choice lot, it is probably due to a combination of circumstances over which he has had scant control. A fortunate endowment of qualities and the proper social environment may have had far more to do

[24] According to the theory under which land values are determined by capitalizing net income, if the net income from land is nothing, its capitalized value is nothing. Under the single tax, the government would have the equivalent of a 100 percent mortgage on all land which would be bought and sold as though it were subject to a 100 percent mortgage.

with X's success than industry and thrift. It is exceedingly difficult to isolate the unearned portion of the national income. It seems highly probable that most of it is in the higher brackets of income, an additional ground in support of a graduated net income tax.

2. The single tax is an attempt to pick up spilled milk. In a young and rapidly developing country, many profit by the social and economic changes taking place in the community. Before long, however, this unearned wealth becomes diffused by exchange, inheritance, and so forth. A, a working man, may have spent his entire life laying up some savings to invest in a little land. Should he then, after his investment, be expropriated by the single tax?

3. The single tax flagrantly disregards the principle of ability to pay. The time was, perhaps, when concentrated wealth was mainly in real estate, but this has ceased to be true. Most of the largest estates show a relatively small percentage of real estate. Moreover, it will be found that land constitutes a larger proportion of rural than of urban property. In typical rural communities, as much as four-fifths of real property values are made up of land values; in moderate-sized urban centers, well over half of real property values are in improvements. Thus, an exemption of improvements would reduce the farm tax base far less than the urban tax base. A very large amount of land is owned by relatively poor people, and it is probable that within certain ranges of income there is an inverse correlation between size of fortune and the proportion of it held in real estate.

4. It should be mentioned that the distinctions drawn between land and capital can be nowhere nearly so sharply defined in practice as they are in theory. Agricultural land, for instance, includes fertility, which is an exhaustible and reproducible factor like capital. Fertility is not the only intangible "improvement" concealed in land values. At one time Professor John R. Commons devised legislation which sought to isolate "pure site values" from other elements of land value and single out the former for special taxation.[25] This objective is sound from a theoretical standpoint but not easily managed as a practical matter.

History of Single Tax. Space will not permit an extended discussion of the history of the single tax. Although the idea of special taxes on land was not new with Henry George, he was the first to build a social and economic theory about it and to make his program into a great social reform movement. As editor of the San Francisco *Post* during the seventies, George had the opportunity to observe the effects of what he regarded as a mistaken land policy in a young and rapidly developing country. In his *Progress and Poverty*, published in 1879, he boldly and eloquently presented the philosophy of the single tax. The book was very widely read and captured considerable following. George ran for mayor of New York in 1886; in his plat-

[25] John R. Commons, "A Progressive Tax on Bare Land Value," *Political Science Quarterly*, Vol. XXXVII, No. 1, Mar. 1922, pp. 41-68; the Grimstad Bill introduced in the Wisconsin legislature in 1921 embodied Professor Commons' proposals.

form he asked, "Why should the people pay rent to private parties and taxes to the state rather than rent to the state and no taxes?" Since his death in 1897, a well-financed and ardent movement supporting his philosophy has survived, but it has not been too successful in enlarging its following. The single tax as a reform movement seems to have a very limited popular appeal in the American environment.

Other Special Taxes on Land

Attempts to apply the "Georgian Approach" to taxation have been confined by no means to the single tax. One of the best known is the land value increment tax proposed by Lloyd George in England and adopted in 1909.

Lloyd George proposed to let bygones be bygones and ignore past increments to land. He wished to impose taxes upon future increments to land value only. The base of the tax was to be the gain in value of land between exchanges.[26] This had some resemblance to the capital-gains feature of many income tax statutes except that it applied to land only. The rate was 20 percent of the increment above a certain exemption. Needless to add, this was an additional tax and not designed to replace the whole revenue system. However, the British found the tax expensive to administer and disappointing in its yield, with the result that it was abandoned. On the continent, Germany has employed a land value increment tax as a federal and state tax, and the measure survives in the tax systems of municipalities.

The use of special assessments, which will be discussed in the next chapter, is based largely on the theory that certain services of government are particularly beneficial to land and that land should pay special taxes accordingly.

The city of Pittsburgh has in practice a plan sanctioned by the state of Pennsylvania under which improvements are assessed at only half their true value whereas land is assessed in full. No startling consequences appear to have developed from this practice, possibly because the theory is somewhat nullified by the administration.

Some of the cities of Western Canada have relied heavily upon the taxation of land values as their main or sole source of revenue.

In Australia and New Zealand a graduated land tax has been employed with the nonfiscal purpose of breaking up large estates. A similar measure has been proposed in Oklahoma by the Farmers' Union. Cities of New Zealand apply local property taxes either to unimproved land or to all real estate, according to their option. A substantial number have chosen unimproved land as their tax base.[27]

It is said that the city of Canberra, Australia, new capital of the Australian

[26] To start with, value at the time of the law's enactment was to serve as the original basing point.

[27] James H. Gilbert, *The Tax System of Australasia*, University of Oregon, Eugene, 1943.

commonwealth, is engaged in a novel experiment in land management. The city was and is being built upon land which cost the government nothing or practically nothing. No part of this land is being sold, but is leased instead at 5 percent of its land value. Land will be revalued periodically and leaseholds for various lengths of time auctioned off to the highest bidder.[28] Whether or not one accepts all the philosophy of Henry George, one can applaud this experiment as a sensible city-land policy, an excellent method of financing government, particularly for a young city.

Conclusion. All things considered, it seems that the case for the special taxation of land, particularly urban land, rests on sound ground. It is very doubtful whether cities ever should have allowed the sites within their boundaries to have passed entirely from public ownership. The main sound argument for private property in city sites is that city governments are too corrupt to manage a real estate business. Failing to follow the course taken by the city of Canberra, the next best program is to recapture a large amount of urban [29] economic rent through special taxes on land. The inequalities of such a program would be largely eliminated by the capitalization process over a period of time. Immediately, however, the inequalities resulting from a drastic increase in land taxation would be very important. Moreover, the strong theoretical basis for special land taxation is not generally understood by the lay public, to whom a dollar of income is a dollar of income whether from land or any other source. Consequently, special land taxation must wait upon economic education and, in any event, must proceed gradually.

SUMMARY

Natural resources have special characteristics which justify their special consideration for taxation. In some cases they are so subject to depletion that a strong interest in conservation arises; in others, they are nonreproducible and relatively fixed in supply, factors which are conducive to a program of special taxation of such property.

Both the importance of forest resources and the problems created in certain areas by deforestation (such as tax delinquency) prompt a widespread interest in forest development. It is said that the general property tax is inimical to this program because it is inconvenient (as to time) for the forest-owner to pay and leads to premature harvesting to avoid the tax. Special forest taxation of several varieties is being tried in many states. The Wisconsin Forest Crop Law, one of these experiments, combines a low flat acreage tax, a yield tax, and payment by the state to local communities

[28] *Labor*, Vol. VIII, No. 10, Nov. 6, 1926, p. 4; No. 32, Apr. 9, 1927, p. 4.

[29] Rural land involves somewhat different problems because of the element of soil fertility in land values. Moreover, the imposition of high fixed charges upon the productive assets of farmers may produce undesirable results.

where land is listed. County as well as private land may be entered. This program is subject to much plausible criticism but has been successful in enlisting widespread local interest in forestry. A partial or full exemption for forest values appears more logical but may be less successful in securing local interest and self-reliance.

In the taxation of mines a lively controversy is taking place concerning the question of whether mines should be taxed at a higher rate than other property or business. An important element in this controversy is the alleged deterrent effect of heavy taxes upon mining. Logically, mine values should contain an ingredient of surplus which should bear taxes without discouraging mine operation, but whether the surplus can be distinguished from necessary costs for taxation is not established. Certain mines can be successfully taxed ad valorem, but others require special taxation. Tonnage taxes, gross production taxes, net production taxes, and property taxes applied to multiples of net proceeds are other varieties of mine taxation in use. Oil wells offer much the same problem of taxation as mines, except that the former are less well adapted to ad valorem property taxation.

Natural resources in land are said to differ from most other property in several respects which make them a specially apt subject for taxation. One expression of this point of view is the single-tax proposal which advocates placing all taxes upon the economic rent of land. Many unsound criticisms are leveled at this proposal. However, it is open to valid objection in its singleness, its refusal to recognize the diffusion of past land values, its flagrant disregard for the ability-to-pay principle, and its assumption that site values can always be distinguished from other elements of value in land. Special taxes on land of various sorts have been applied quite extensively in other countries and to a more limited extent in the United States. Particularly at a time when property tax limitation, homestead exemption, and gross income and sales taxes are quite the vogue, the large element of truth in the old-fashioned notion that land values invite taxation should be emphasized.

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CHAPTER XVIII

Nontax Revenues

INTRODUCTION

Many people think of taxation as the sole source of public support. There are several other governmental sources of revenue, however, some of which have been, at certain times and places, very important. The Cameralists, writing in the seventeenth and eighteenth centuries, "regarded taxation as the last and least of the sources of public revenue." [1] Even as recently as the late 1920's, there were cities which derived more revenue from special assessments than from general property taxes. And at present there are sizable cities which secure more revenue from the earnings of public service enterprises than from property taxes. On the whole, however, nontax revenues are of far less importance now than formerly.

DISTINGUISHING CHARACTERISTICS OF VARIOUS SOURCES OF REVENUE

Enumeration of Sources. In addition to taxes, the government may collect commercial revenue in its capacity as landlord or entrepreneur. Charges of this sort are usually referred to as *public prices*. It may also collect certain charges for special services to the individual, such as in the grant of patents; or for special costs which the government incurs on his account, such as in the issuance of hunting licenses, the funds from which help maintain the upkeep of game preserves. The former costs are usually called *fees* and the latter, *license fees*. Further, it may impose charges as a penalty, or *fines*, for violating the rules established by government. Occasionally the government also receives gratuitous funds, which are referred to as *gifts*. And finally, it may impose special levies for certain services rendered specific property owners. Such charges are called *special assessments*.[2]

[1] H. L. Lutz, *Public Finance*, 3rd ed., p. 189.

[2] Beside the sources enumerated above, governments also secure revenue from interest on public money. This source grew to be of substantial importance during the twenties,

Special Benefit. Considerable attention has been given to the definitions and distinguishing characteristics of these various sources of revenue. A principal distinction among them and between them and taxes is the degree of special as contrasted with general benefit. In the case of public prices, the special benefit is the main feature of the transaction. As in a private commercial transaction, the government and its customers engage in an exchange of equivalents, and the relation between the two is essentially contractual. In the case of fees, the special benefit or cost element predominates, but there is usually a larger factor of general interest in the transaction. Students may pay required special fees for courses of extraordinary expense even in an otherwise free state university. The students receive a special benefit, but the public, too, has considerable interest in the service. The same holds true in the case of public improvements (such as street paving) which are financed out of special assessments. Where general benefit is especially important and the special benefit less significant and less measurable, the charges made are called taxes. This is not a hard and fast rule, however. For example, the motor vehicle and social security levies are usually called taxes even though they are imposed according to more or less measurable benefits.[3] Moreover, the factor of benefit is not entirely absent nor ignored even in the distribution of other taxes, especially general property and business taxes. At best, the difference between these categories is a matter of degree, and boundaries between them are not very distinct.

Degree of Compulsion. Another possible criterion for classification of these various kinds of governmental receipts is the degree of compulsion involved. Public gifts are entirely gratuitous payments to the government. Public prices are contractual in character but are not compulsory except in the sense that one must make a payment if he wishes to procure a service. Certain taxes appear to be only slightly less optional; one can avoid the tobacco tax by giving up tobacco. A greater degree of constraint appears in the income and property taxes, which can be avoided only by going without these essentials. Apparently only the poll tax involves absolute compulsion and even this could be avoided by committing suicide or "skipping the country." Any valid distinction among these revenue sources on the ground of their compulsion is certainly very much a matter of degree.

when the federal government was collecting substantial sums in interest on its loans to its war allies. With the onslaught of the world-wide depression, this largely ceased to be a source of revenue, but in its place was developed a system of large-scale governmental loans to municipalities and private corporations (e.g., through Reconstruction Finance Corporation) as well as to individuals (e.g., through Home Owners' Loan Corporation, etc.). On its Reconstruction Finance Corporation loans alone the federal government collected over $22,000,000 in interest in 1937. Occasionally governments also receive property by escheat (when a property owner dies without heirs and leaves no will).

[3] When motor vehicle license charges were of sufficient magnitude to pay only for cost of administration, they were fees in all certainty. When they were extended to yield a revenue far beyond these administrative expenses, they became taxes even though there remained an element of special benefit to justify their imposition.

Purpose and Legal Basis. Some of these categories may be distinguished by their special purpose and the power under which they are levied. Thus, fines are a form of administrative revenue levied under the penal power and are a means of enforcing laws rather than raising revenue. Licenses usually involve an element of privilege and, like fines, are imposed partly for the purpose of regulation under the police power. Special assessments are sometimes used to abate nuisances, in which case they too are levied under the police power. On the other hand, taxes and fees, as well as most special assessments, are imposed under the taxing power.[4]

Special Procedures. These categories are further distinguished in practice by certain special procedures. License payments are usually made a condition for continuing in business or some other enjoyment. Special assessments are imposed at irregular intervals and need not conform to rules of uniformity which apply to property taxes; furthermore, they are usually excluded from the application of certain statutory provisions, such as property tax exemption and tax and debt limitations. As a rule they are confined to land and are associated with public improvements.

It will be seen that each of these categories of nontax revenue differ from the others in many respects, but usually the difference is one of degree. The boundary lines are not obvious, and the terms are used rather loosely in practice. The motor vehicle registration tax, as well as many occupational taxes, are often termed fees. Not infrequently even gross income taxes are included under this designation. The social security taxes represent a high degree of compulsion, but they are somewhat commercial in nature and involve a measurable special benefit. It is as logical to call them public prices, premiums, or contributions, as taxes. In general, the classification of these sources of revenue into various categories is useful and often important, but the boundary lines between them must always be somewhat obscure.

THE PUBLIC DOMAIN AND PUBLIC INDUSTRIES

Public Domain

The historical importance of the public domain as a source of public income has already been mentioned. Under the feudal system the government was practically synonymous with the king, who was the principal landowner in a country. Ordinarily this land provided all the revenue the king required. During the early parts of its history, the federal government of the United States also relied to some extent on the public lands for its income. Its

[4] However, it has been said by good authority that "a tax is no less a tax because its purpose is regulation or destruction." E. R. A. Seligman, *Essays in Taxation*, 10th ed., p. 406.

revenue might have been much greater had it not placed, as an objective of public land policy, "opening up the country" ahead of revenue, and had graft and fraud been kept out of the administration. The federal government made huge grants of land to the states for the purpose, among others, of aiding public education; but the record of the states in managing and disposing of public lands was no more creditable than that of the federal government. According to F. H. Swift, the domain granted specifically for schools by our federal government to its 30 public-land states amounted to 114,000 square miles, an area larger than Italy, more than twice as large as England, more than nine times as large as Maryland, and 23 times as large as Connecticut.[5] To show for all of this generosity most of the states have a meager permanent school fund. Wisconsin, for example, has a fund of less than $11,000,000 and Minnesota, with one of the largest funds, less than $74,000,000.[6] The public domain was also used extensively to subsidize the railroads.

Income from the sale of public land has not been of any importance as a source of public revenue for many years. Although in 1930 there were 178,979,446 acres of federal lands subject to entry under homestead and other land settlement laws, little of this land has much value for crop production.[7] In recent years, public interest has turned to the acquisition of a new public domain rather than to the disposition of the old one. The interest has been motivated in part by the desire to conserve timber resources and outdoor recreational facilities. During the depression of the thirties the counties and states have, in many cases, been forced to acquire large tracts of unredeemed tax-delinquent land.

As stated in the previous chapter, a strong defense can be made for the proposition that cities should never have parted with any of their lands but should have let them instead, with long leases subject to frequent revision of rent. By this policy, large increments could have been preserved for public use. True, many city governments have shown scant qualifications for an administrative responsibility of this kind. But the large waste and cost which the practically uncontrolled private ownership of urban land has entailed could hardly have been excelled from the public point of view had public ownership of city land prevailed. Even today, there are excellent opportunities for municipalities to conserve revenue and provide service through the acquisition and management of real estate. Many European cities have made good use of this practice by purchasing large amounts of land on their outskirts to provide cheap housing as their population developed.

[5] Fletcher Harper Swift, *Federal Aid to Public Schools*, Bul. No. 47, U. S. Department of the Interior, Bureau of Education, 1922, p. 34.

[6] *Statistics of State School Systems*, 1933-34. Bul. No. 2, U. S. Department of the Interior, Office of Education, 1935, p. 72.

[7] W. A. Hartman, *State Land-Settlement Problems and Policies in the United States*, Technical Bul. No. 357, U. S. Department of Agriculture, Washington, 1933, p. 14.

Public Industries

Public Pricing and the Profits of Public Enterprises. The government may play a commercial role not only as landlord but also as entrepreneur. When successful in such a venture, it receives public revenue in the form of profits of the public enterprise. If its venture is a failure, the result may be public expenditure rather than revenue. The matter of profit and deficit in public enterprise, however, depend not only on the success or failure of management but also upon the policy of public pricing, which in turn depends in some degree upon the purpose for which the government undertakes the particular function. If its purpose is to encourage the consumption of certain services, it may deliberately set their price below cost and point of maximum profit. For many years the federal government in the United States has provided mail service for newspapers and periodicals on this principle. Public housing is undertaken largely with the view of bringing better houses within the range of low income groups, and a deficit in the program is deliberate. At the other extreme are the "fiscal monopolies," such as the tobacco and lottery monopolies of European countries, which are undertaken to secure for the government the maximum revenue from certain businesses.[8] The typical municipally owned utility, the municipal water, gas and electricity works, ordinarily seeks to charge the same prices which a privately owned utility would and attempts to make for the local treasury at least the equivalent of the taxes the latter would pay plus a normal profit. When it succeeds beyond this point, the issue arises as to whether the taxpayers or the consumers of utility services should enjoy the benefits. In some states where municipal utilities are subject to regulation by a state public utility commission, the policy has been to order a reduction in rates as soon as a utility earns the taxpayers more than a modest profit. However, where public ownership and operation are so successful as to yield a surplus above the equivalent of taxes and a fair return upon investment, with rates no higher than those prevailing in comparable situations under private ownership and management, it seems that the city itself (or other governmental unit) might well be allowed to determine the disposition of the fruits of its success.

Other Problems in Public Pricing. The benefit and cost principles have their clearest application in the field of public prices. But even here it is extremely difficult to determine the cost of the service (cost) or the value of the service (benefit), and it is not always practical to apply the results once they are determined. The problem of differential rates in the public utility field is not confined to publicly owned utilities but applies to regulated private ones as well. In the case of railroads the problem involves differentiation between the long and short haul, between carload and less than carload quantities, and between valuable and light commodities and cheap and

[8] M. C. Mills and G. W. Starr, *Readings in Public Finance and Taxation*, pp. 168-170.

heavy ones. The problem is complicated by the fact of joint costs, as in the hauling of passengers, mail, baggage, and express, all in one train. It is further complicated by the existence of overhead or constant costs which may be distributed over all or only part of the business. In the electrical utility field, differentiation among domestic, commercial, and industrial users is necessary, and the peak-load service is frequently allotted a higher cost than service at other times.[9] In the strictly public field of postal service, a flat rate is allowed for letters below a certain weight regardless of distance to destination within the country. An exception has at times prevailed in the lower rate allowed for letters destined for delivery within the municipality in which they originate. Parcel post charges are classified according to weight and zones of distance. Rate-making is a large and intricate field, but here the few above suggestions of its nature must suffice.

When Should Governments Go into Commercial Ventures? Treatises on public finance frequently devote considerable space to the pros and cons of public ownership and to an appraisal of its successes and failures in practice. These matters perhaps more properly belong in the field of public utility economics and are probably best left for specialists in that field to present. For this reason and because of limitations of space, a few general observations concerning this very broad subject are all that will be attempted here.

There is no categorical rule to apply in deciding where and when governments should "go into business." An often-stated rule is that governments should carry on those ventures which they can do more efficiently than private enterprise, leaving to the latter the field in which it has an advantage. In other words, we should seek maximum social utility—the greatest good to the greatest number. We are told that we must be scientific and open-minded in approaching the problem, that we should avoid judgments rendered as "an article of faith." Many fear any expansion of public enterprise as an entering wedge for socialism, under which all means of production would be owned by the government. On the other hand, many advocate government ownership in the belief that it paves the way to the eventual collective ownership of all means of production. It is neither possible nor desirable to ignore entirely the effect of specific acts upon a general trend. Nor can decisions of this kind be made to the utter disregard of a general philosophy of life and values. But major weight no doubt should be given to the evidence concerning the relative efficiency and serviceability of public and private ownership in specific places, at specific times, and in specific fields. In any event, some weight must be given to the existing difficulties and legal obstructions in maintaining effective regulation, which, in more monopolistic fields, is the necessary alternative to public ownership and operation. Weight must be given also to the apparent inability of certain essential industries to operate without a subsidy. And finally, the inability

[9] Martin G. Glaeser, *Outlines of Public Utility Economics*, The Macmillan Co., New York, 1927, Chaps. XXIX and XXX.

or unwillingness of private industry to absorb available capital and labor must be taken into account. At the present time a major advantage of municipal ownership is that it results in the avoidance of the federal income tax. However doubtful this privilege may be on social grounds, there can be no question of its advantage to municipalities.

Certainly, the taboos against public enterprise found in many state constitutions or read into them by court interpretations [10] are unfortunate. The legislature should have full discretion to determine what the government should and should not undertake.

Success or Failure of Government Enterprise. Most of the attempts to generalize on experience with public ownership and operation show a decided influence of the author's bias. Nevertheless, and subject to this limitation, a few comments on the issue will be ventured.[11] It is generally agreed that public ownership has been successful almost universally in the field of water supply.[12] In certain other services, such as electricity, it has been an impressive success in the province of Ontario, Canada,[13] in many municipalities in the United States,[14] and in some European countries.[15] In the United States an ambitious federal power, flood control, and regional development project—the Tennessee Valley Authority—is recognized as an outstanding success.[16] Considerable interest in promoting other projects of a similar character is now apparent.

On the other hand, from the fiscal standpoint the North Dakota ventures into public ownership (including a state mill, elevator, bank, and insurance company) have been an expense rather than a source of revenue to the state.[17] There are plenty of cases where government enterprise has been characterized by lethargy and inefficiency.[18] But there are also many cases where the same is true of private industry, and, contrary to some interpretations, the public is involved and concerned in these failures also. In a sense all business,

[10] See Chap. XIX.

[11] See G. L. Wilson, J. M. Herring, and R. B. Eutsler, *Public Utility Regulation*, McGraw-Hill Book Co., New York, 1938, Chap. XIX, for an excellent discussion of this subject.

[12] In the case of water in the United States about 90 percent is supplied through municipal systems (*Encyclopedia of the Social Sciences*, Vol. XII, 1934, p. 677).

[13] In the province of Ontario, electrical utilities are almost entirely publicly owned and operated. See article by John Bauer, "Public Utilities," in the *Encyclopedia of the Social Sciences*, Vol. XII, 1934, pp. 677-683; also W. E. Mosher and others, *Electrical Utilities: The Crisis in Public Control*, Harper and Bros., New York, 1929, Chap. IX.

[14] See the article in the *Encyclopedia of the Social Sciences* mentioned in the previous note; also Francis A. Staten, *State Control of Public Utilities*, League of Wisconsin Municipalities, Madison, 1931.

[15] See an excellent article by Carl Brinkmann, "Public Utilities," in the *Encyclopedia of the Social Sciences*, Vol. XII, 1934, pp. 683-686; also Marquis Childs, *Sweden the Middle Way*, Yale University Press, New Haven, 1936.

[16] David Lilienthal, *TVA; Democracy on the March*, Harper and Bros., 1944.

[17] Gilbert W. Cooke, "The North Dakota State Mill and Elevator," *Journal of Political Economy*, Vol. XLVI, Feb. 1938, pp. 23-51.

[18] H. L. Lutz, *Public Finance*, 3rd ed., Chaps. XI-XIII.

particularly corporate business, is more or less public. It is doubtful if there is anything in the annals of public business which approaches the graft and abuses found in the financing of the private American railroads.[19]

Use of Government Corporations to Improve Administration of Public Enterprises. Much interest has attended the use of the public corporation as an administrative device to facilitate public administration of enterprises more or less commercial in character. The public corporation allows more speed and flexibility in managerial decisions than the traditional departmental organizations. The Panama Railroad Company, a public corporate organization, has made a creditable record. The Tennessee Valley Authority is one of the more ambitious contemporary experiments in government organization through the corporate device. Freedom from usual checks and restraints in expenditure which corporate control allows is warranted on the expectation that competent and nonpolitical directors will be appointed to head corporate government agencies. Thus far, most of the federal appointments have fulfilled this expectation.[20]

Extent of Governmental Revenue from Public Service Enterprises. Governments range widely in the extent of their commercial undertakings. At least one country, Russia, is so highly socialized that the problems of public prices and public revenue are almost identical. European countries generally have considerably more public enterprises than the United States. In the latter, they are an important source of revenue principally for municipal governments. In 1942, according to United States Census Bureau data, cities of over 100,000 population received from public service enterprises the equivalent of 13.9 percent of their tax revenue; cities with populations between 25,000 and 100,000 received 15 percent from this source.[21] The trend is distinctly upward. Cities differ widely in their revenue support from public service enterprises. Some, such as Jacksonville and Tacoma, receive from one and one-half to two times as much from this source as from taxes; whereas others, such as Gary, Indiana, get practically no revenue from this source.

On the whole, it seems fair to conclude that a municipality with a civic-minded population and the competent administration of public affairs which goes with it can provide for itself a considerable source of public revenue through the wise choice and efficient development of public service enterprises. In times like the present, when municipalities are hard pressed for additional sources of revenue, here is a potentiality which might well be given consideration.

[19] *Hearings, Investigation of Railroad Financing*, U. S. Senate Committee on Interstate Commerce, U. S. 74th Congress, 1st Session, 1935; this gives an interesting and revealing discussion of recent railroad financial manipulation.

[20] John McDiarmid, *Government Corporations and Federal Funds*, University of Chicago Press, Chicago, 1938; Terence H. O'Brien, *British Experiments in Public Ownership and Control*, G. Allen and Unwin, Ltd., London, 1937.

[21] Computed from *City Finances*, U. S. Bureau of Census, Washington, 1942.

FEES AND FINES

Licenses and fees have never constituted an important source of revenue, but they are widely used by governments at all levels in connection with different services and to different degrees. The use of fees requires certain conditions, particularly the presence of discernible special benefits. They could hardly be used to pay for government services which provide a strictly general benefit, as in the case of the outlays for the legislature and the general administrative officers of a state. But the vast majority of public outlays provide some element of special benefit for particular persons or groups, and these may be the occasion for the imposition of fees. Such charges have been imposed for a great variety of services, ranging from the marriage ceremony by the justice of the peace to the consular and passport fees collected by the State Department of the federal government.[22] The judicial process, particularly, is characterized by much fee-taking.

One of the best known and most lucrative application of fees is in the financing of education, particularly in the case of colleges and universities. Tuition is a major source of income for private schools of higher learning, and a fairly important one in public schools at the same level, especially during recent years when the fees charged students have shown a strong upward tendency. The fee system as a support for higher education encounters the objection that it creates a financial qualification upon educational opportunities. The cost of maintenance for a student during his college period is something of a financial qualification even without fees. The objection can be met in part with a generous provision for scholarships. The fee seems most defensible in the case of professional courses, which usually add greatly to the students' earning power, or in the case of certain special services, such as medical care or special recreational facilities, provided by the educational institution.

In recent years many cities have placed disposal of sewage upon a "public utility basis." The movement has been stimulated in large measure by property tax limitation laws. The cost of service is measured in various ways, one of the simplest of which is water consumption. The benefit of sewage disposal is usually quite general and the service is one that is quite appropriately supported by a general tax. The impact of a cost charge differs considerably from that of a general property levy. In the case of vacant property, the property tax applies and the service charge does not; the reverse is true in the case of tax-exempt property.

The service charge measures benefits to industry with considerably more

[22] Formerly the State Department was largely self-supporting because of the consular and passport fees it collected. In recent years, however, this has not been true, although substantial sums are still collected from this source.

precision than the property tax. However, it is much more practicable and equitable for application to sewage disposal than to some other services, such as, for instance, garbage disposal, where a precise measure of benefits would be difficult. On the whole, the service charge for sewage disposal has considerable merit.

Although fees are a relatively minor source of revenue, it has been thought by many critics that their use could be considerably expanded. Industries which are subject to regulation of one sort or another might well be charged directly with more of the administrative costs they create. The cost of special recreational facilities, such as tennis courts, can be paid at least in part by charging users a small fee. The charge may also help to restrict the demand to the supply in case the municipality is not in financial position to provide sufficient free facilities.

Less frequently than formerly, though still quite often, a public official is allowed to keep all the fees he collects in lieu of a salary. This has worked very badly, particularly in the case of county sheriffs. The office may become so lucrative that it is entirely out of line in this respect with other county offices and the object of desperate political rivalry. Moreover, the fee system may encourage a public officer to undue activity. This occurs where sheriffs are paid a fee for feeding and housing tramps. The fee system as a support for justices of the peace is particularly vicious. The justices are local officers empowered to decide petty cases of dispute. In general, each town, village, and city ward may have one and the plaintiff in a dispute can frequently select any justice of the peace in the county. Justices which are favorable to plaintiffs get the most business and the most fees. The office is not always exploited, but the system is an open invitation to abuse. Impartial and efficient public service require that officials be paid salaries and that fees be paid into the public treasury.

Fines are not of any importance as a source of revenue and are usually levied with no regard for filling the public treasury. The "speed traps" of some municipalities are a notorious exception. Many a motorist has had to contribute handsomely to the coffers of some small village (or worse still to the private account of some constable or justice of the peace) into whose clutches he unfortunately fell. In 1907 Judge K. M. Landis probably set an all-time record in the imposition of fines when he imposed a penalty of $29,240,000 on the Standard Oil Company for violation of the antitrust laws.[23] But his ruling was set aside and this munificent sum was lost to the public treasury. It has been suggested that "it is probable that in many cases a pecuniary penalty will have as satisfactory penological results as any other form of penalty" and that, "if the finance minister were also the administrator of justice . . . the revenue from fines would show a marked in-

[23] United States v. Standard Oil Co., 155 Fed. 305 (1907).

crease." [24] It is highly questionable whether at least the second part of this suggestion would merit any consideration for practical application.

SPECIAL ASSESSMENTS

Special assessments are an American institution. There are traces of their use in Rome and in Great Britain as early as 1427, and several European countries have also made some use of them in recent years. But by far the greatest use of special assessments and the most discussion of the subject has been in America. The Massachusetts Bay Colony employed this device as early as 1658, when the General Court of the Colony authorized the imposition of charges to pay for a public way upon "all such as shall have benefit of the way." [25]

Theory of Special Assessments

Special Benefit. As previously indicated, special assessments are compulsory levies upon property owners to pay for special services to their property. They are distinguished from general property taxes mainly by the element of special benefit involved. However, the special benefit does not exclude the possibility of general benefit. The taxing power may not be exercised except for a public purpose; thus the government cannot construct strictly private driveways for the sole convenience of property owners, but it can extend the private driveways, once built, to form a street which gives ingress and egress to the abutting property, both for the owners and for the general public.

Increment to Land Values. Most special assessments are in payment for services which make the land more desirable to own. It is not true, as has often been assumed, that these services always raise the value of the land. The repaving or repair of a street may not result in any increase in values over those previously held, and under such conditions several states do not allow special assessments.[26] Many states, however, apply the contrary rule, and it seems quite proper, in supporting a levy, to regard the maintenance of existing values as of equal importance to the creation of new values. The value of a site depends upon its desirability as compared with alternative sites. If the latter also entail occasional expenditure for special improvements, the value of the particular site may not rise as a result of the service provided for it by the government. In spite of these facts, however, many courts insist that it is only the equivalent increment to land value which justifies a special

[24] Jens P. Jensen, "Sources of Public Revenue Other than Taxes," *Readings in Public Finance and Taxation*, edited by M. C. Mills and G. W. Starr, p. 167.

[25] Philip Nichols, *Taxation in Massachusetts*, 3rd ed., Financial Publishing Co., Boston, 1938, pp. 751-752.

[26] Eugene McQuillin, *The Law of Municipal Corporations*, 2nd ed., Vol. V, Callaghan and Co., Chicago, 1928, pp. 615-616.

assessment. Actually, administrators are forced to presume many increments which may or may not materialize.

Police-Power Assessments. Assessments are sometimes used to abate a nuisance, such as draining a stagnant pool, cutting weeds from idle lots, removing snow from sidewalks, and so forth. In this case the benefit provided is the negative one of relieving the owner of an obligation he might otherwise be expected to perform. Special assessments are sometimes used to pay for special services such as garbage removal or street sprinkling.[27] In all such instances, though a case can be made for the proposition that a special benefit is provided, it is idle to seek an equivalent in an increase in land values. The fact that such levies are made under the police power removes the legal necessity to prove either an increment or a special benefit.

A Special Land Tax. Special assessments not only localize payments according to benefits, but they also shift the basis of payment from general property to land and sometimes from an ad valorem to some other measure, such as frontage or square feet.[28]

A case can be made for the proposition that land is superior to improvements as a base for taxation, and the case is even stronger when applied to the financing of certain so-called land-service expenditures. Just what should be classed as land-service expenditure is not entirely clear. But the types of improvement which are usually financed through special assessment, such as paving and sewer construction, would be included. These land-service expenditures, it is argued, should be conceived as principally beneficial in making land inhabitable and attractive. An idle lot may get as much benefit from such services as a highly improved one. Special assessments have the virtue, from this point of view, that they collect for the land-service expenditures a special tax from the land.

The fact that land exempt from other taxes is usually subject to special assessments is also in the latter's favor. Some have advocated special classification of property with the view of levying a small tax upon churches, lodges, and the like, to pay for land-service benefits. Special assessments provide the technique by which this may readily be done.

Special Assessments and Land Value Increment Taxes. Special assessments have often been compared and contrasted with land value increment taxes. There are several important differences between the two. Mention has already been made of the fact that special services to land do not necessarily result in an increment. Moreover, increments may arise from a number of causes, such as increases in population, which are not due to governmental services. Land values may even decrease in spite of the fact that the land is

[27] In some states assessments for sewers are also sustained under the police power.

[28] It is sometimes said that this is shifting over from an ability-to-pay basis to that of the benefits. But this is not necessarily true. General property may be a measure of benefits, even though a very imperfect one, just as it may be a measure of ability, though, again, a very imperfect measure of it. There are a few instances where special assessments have included buildings and even personal property, but this procedure is quite exceptional.

provided with special governmental services. This does not mean that the services result in no benefit to the landowner. Attempts to check actual increments over a period of years against special assessments show that the two are frequently badly correlated.[29]

Of course, increments often do accompany public improvements and afford a high degree of plausibility to a special assessment levy. For example, it has been calculated[30] that, following the acquisition of Central Park in New York, land around it enjoyed an increment of 800 percent during a period in which land values in the rest of Manhattan increased only by 100 percent. The increase in land values represented many times over the entire cost of the park. The special assessment actually made, amounting to 32 percent of the cost of the park, seems exceedingly conservative.

Legal Aspects of Special Assessments

Special Assessments and Special Benefits and Cost. Special assessments have been a prolific source of litigation. Among the contested points of greatest interest is the question of whether a special assessment may go beyond the special benefit enjoyed by the taxpayer. This matter has gone to the United States Supreme Court many times. In its Norwood v. Baker decision in 1898, the Court said, "The principle underlying special assessments to meet the cost of public improvements is that the property upon which they are imposed is peculiarly benefited, and, therefore, the owners do not in fact, pay anything in excess of what they receive by reason of such improvement."[31] The Court went on to declare unconstitutional an assessment for street construction which was assessed on a frontage basis and "excluded any inquiry as to special benefits."

This decision has never been overruled, but it has been qualified in later opinions which generally hold that, while special assessments are based upon the theory of special benefit, the latter as to the area covered and the distribution are matters for the legislature (including city councils) to determine. Unless the legislature's determination is palpably unjust and cannot possibly bear any relation to benefits, it will not be disturbed by the Court. Thus, in recent decisions, distribution of the cost of improvements among abutting lots according to frontage, without any judicial inquiry as to benefits,

[29] Edwin Spengler, "The Increment Tax versus Special Assessments," *Bulletin of National Tax Association*, Vol. XX, No. 9, June 1935, pp. 258-261; Vol. XXI, No. 1, Oct. 1935, pp. 14-17; Vol. XXI, No. 6 and 8, March, May 1936, pp. 163-167, 240-244. See also, Herbert D. Simpson, "The Influence of Public Improvements on Land Values," *Annals of the American Academy of Political and Social Science*, Vol. CXLVIII, No. 237, Mar. 1930, p. 120. Professor Simpson shows that values may be diverted rather than created by public improvements; such improvements may result in both increments and decrements and both in unexpected places.

[30] National Municipal League, *Special Assessments*, 3rd ed., New York, 1929, p. 14.

[31] Norwood v. Baker, 172 U. S. 269, 278-279 (1898).

has been sustained.[32] The Court has also held that an assessment will not be ruled out because no opportunity for a hearing has been allowed the taxpayer.[33] The distribution may be based on area or valuation as well as frontage. The fact that a taxpayer receives no benefit at all will not render a special assessment invalid.[34] The fact that the special assessment is greater than the market value of the property does not make a case for interference by a court of equity.[35] Whatever hardship this position may involve "must be borne as one of the imperfections of human things." [36]

It is by no means the universal rule that the property owner has no defense against the legislature in case it sets up rules for measuring benefit which result in greater charges than the value of his special benefits. In Massachusetts, for instance, the opposite principle is well established; that is, any taxpayer who can prove that an assessment exceeds his benefit will be sustained in a suit against the levy. A party who cannot possibly profit by an improvement is immune from assessment. The owner must be given an opportunity for a hearing concerning the benefit he may derive from the improvement.[37] The Massachusetts rule is followed in a considerable number of states, though in practice, except for extreme cases, its results are not very different from those under the rule of the United States Supreme Court. Practically, the difficulty lies in the fact that the degree of special benefit is not susceptible to proof. Theories aside, most special assessments are more or less arbitrary distributions of cost among limited groups of taxpayers without much success in establishing actual benefit.

[32] Eugene McQuillin, *The Law of Municipal Corporations*, Vol. V, p. 579.

[33] *Ibid.* But see position of certain state courts below.

[34] At least one case has arisen in which it was established than an improvement for which an assessment had been made actually damaged the property of the party upon whom the assessment was levied. In this case—where the grading of a street left a property 14 feet above the street level—the court relieved the property owner by allowing damages, but held nevertheless that the special assessment was legal and must be paid [McQuiddy v. Smith, 67 Mo. App. 205 (1896)].

[35] Eugene McQuillin, *The Law of Municipal Corporations*, Vol. V, p. 580.

[36] Louisville and Nashville R. R. Co. v. Barber Asphalt Paving Co., 197 U. S. 430, 434 (1905).

The position of the Supreme Court on special assessments puts these levies in much the same category as general taxes. It is well established that a tax cannot be imposed which is a gross and palpable violation of the benefit principle (such as the imposition of taxes upon an individual to pay for services in a district where he does not reside or hold property). But if the general plan of distribution is at all plausible, it will not be disturbed. Thus, taxing the property of a railroad company with other property to pay for the construction of a highway which will harm the railroad through its competition is valid [Wight v. Police Jury, 264 Fed. 705 (1919)]. The same rule holds in most jurisdictions for special assessments, though attempts to establish special benefit in these cases are not very convincing. And taxes levied by a municipality upon farm land within its borders, where the property is in no position to benefit from most city services, are valid [Kelly v. Pittsburgh, 104 U. S. 78 (1881)]. The Supreme Court in this respect follows the rule of "rough justice." It should be said, however, that special assessments are frequently very heavy, sometimes as much as or more than the value of the property itself. A poor distribution of the levy may result in very important injustice.

[37] Philip Nichols, *Taxation in Massachusetts*, pp. 753-763.

Many courts have given lip service to the doctrine that special assessments must be correlated not only with benefits but also with increment; that is, these charges are justified by the fact that the value of the taxpayer's property rises or will rise by the amount of the assessment. Actually, factual demonstration of the correlation between increment and special assessment is rarely, if ever, made.

The courts as a rule insist that assessments be limited to the cost of the project even though benefits may be in excess of such cost.[38] This is an illustration of the fact that special assessment practice tends more toward cost than benefit ideology. Actually, of course, benefits may greatly exceed costs. It has been calculated, for instance, that the extension by half a mile of one New York subway costing about $5,700,000 was accompanied by land value increments of $31,300,000 to land within a range of a half mile on either side of the extension. The normal increment would have been $13,500,000.[39]

Tax-Exempt Property Subject to Special Assessment. As a rule, properties which are exempt from other taxation, such as churches, cemeteries, and lodges, are not freed thereby from special assessment and, in the absence of special statutory exemptions, they must pay these special levies. The same rule does not always hold for property owned by public bodies, but in some states these also are required to pay special assessments.[40] Wisconsin specifically includes "the property of every county, city, village, town, and school district" as "in all respects subject to all special assessments for local improvements."[41] Only the state and federal government are exempt. Collection from these larger units, even if they were assessed, would be impossible except through voluntary payment.

Replacements and Repairs Ground for Special Assessment. The legislature has the power to make special assessment applicable to replacement and repair as well as original construction of improvements, but in several states it has not done so.[42] The practice of confining special assessments to original improvement tends greatly to restrict the use of this instrument. Once a city has been developed, maintenance and reconstruction are the important improvement outlays, and, as a result, special assessments largely disappear. Actually, as has been previously explained, the latter practice is due to the fallacious notion that special assessments must be justified by the creation of a land value increment.

[38] *Ibid.*, pp. 757-758.
[39] National Municipal League, *Special Assessments*, p. 18.
[40] Eugene McQuillin, *The Law of Municipal Corporations*, Vol. V, pp. 695-704.
[41] *Wisconsin Statutes*, 1935, Chap. 75, Sec. 65.
[42] Eugene McQuillin, *The Law of Municipal Corporations*, Vol. V, p. 615.

Special Assessments in Practice

Purposes. Legislation in the various states establishes a variety of purposes for which special assessments may be levied. Among the more important are the following: grading, paving, sidewalks, bridges, sanitary sewers, storm sewers, parks, extension of municipal utilities, high-pressure fire protection, ornamental street lighting, sidewalk snow removal, sprinkling and oiling the streets.

Procedure. Special assessments may be initiated either by petition of the property holders or the city council. The approval of a majority of the property owners may or may not be necessary, and the same is true of approval by the council.[43] To give the council the final authority independent of the wishes of the property owners represents a high degree of compulsion, but it is defended on the ground that continuity of projects and good general city planning may require it. Procedure usually includes notice[44] of the prospective levy and a hearing at which property owners may at least sound a protest. Many state courts require these procedures as a condition for the validity of the assessments. Whether or not required, the hearing provides a desirable opportunity for giving the concerned parties full information concerning the contemplated program. In certain states which limit assessments to actual benefit, the opportunity and machinery for appeal on the grounds of insufficient benefit must be provided.[45]

Limitations. Mention has been made of the fact that in some states special assessments are limited either by the legislature or the courts to the benefits and cost of improvements. In addition, some cities specify other limits, for example, that the levy may not exceed one-half the value of any parcel. Other jurisdictions specify a certain portion of the improvement cost as the limit. Occasionally, two levies for the same purpose cannot be made within a certain period of time.

Finances. Many problems arise in financing special assessments to which only the most general attention can be given here. Public improvements involve an arrangement for paying the contractor who does the improving. He may be paid in special assessment warrants. This procedure delegates to the contractor the collection of the special assessments as the installments become due and leaves to him the assumption of risk of nonpayment. These two impositions upon contractors result in higher bids by them, and it has usually been found more economical for a city to undertake its own collection (along with the property tax) and assume its own risks of nonpayment.

[43] Approval of the property owners may take the form of majority approval by areas or by value of property. Arthur R. Burnstan, *Special Assessment Procedure*, Special Report No. 1, New York State Tax Commission, Albany, 1929, pp. 29-35.

[44] Notice may take the form of publication, mail, or personal service, depending on the jurisdiction. It is by no means always effective in reaching absentee owners. *Ibid.*, pp. 37-46.

[45] Philip Nichols, *Taxation in Massachusetts*, pp. 762-763.

The city issues special assessment bonds to provide cash with which to pay the contractor. The special assessment bonds may be secured by the "full faith and credit" of the city or only by special assessment obligation. The former provides an easier market for the bonds and lower rates of interest, but the latter, as a rule, avoids debt limitations. A third method of finance, used in New York City, provides a revolving fund from which initial payments for improvements are made.[46] The revolving fund involves the sale of bonds to create the fund. It has been criticized as open to abuses associated with sinking funds.[47]

Difficulty of Measuring Benefits. The principal difficulty in the use of special assessments is in the measurement of benefit. The measurement involves decision as to what portion of an improvement or service should be paid for from general taxes and what portion from special assessments; what territory should be included in the special assessment district; and what method should be used to distribute the cost among the properties within the district. Actually, all three judgments must be approximations and, in practice, often are "guesswork." If benefit is conceived in terms of increment to land value, the increment must be estimated in advance of its realization. It is impossible to estimate with much accuracy what the trend in land values will be or what effect the improvement will have. Moreover, the increment may be defeated by other extraneous influences. And even if there were no extraneous influences and no increment, these facts would not be complete proof of no special benefit.

General v. Special Benefit. First of all it is necessary for someone to decide what proportion of the cost of an improvement should be allotted to special assessments and what to general taxes. This is no easy task and in practice is frequently performed in a quite arbitrary manner. In 1929 it was reported that, of the cities with more than 30,000 population, one-quarter charged the cost of paving streets to general taxes, another quarter (frequently controlled by charter provisions) charged various percentages of the cost to special assessments, and one-half charged the entire cost to those specially benefited.[48] Of course, a plausible decision on this matter must take into account the nature and use of the improvement. A through or arterial street which is of service mainly to people at or beyond the ends of the street ought not to be financed mainly by abutting property owners. The same is true of a trunk sewer. On the other hand, a street or sewer which serves mainly the abutting properties can more properly be charged to them. It seems, too, that once a city has been built up and everybody is served with suitable streets and sewage facilities, it is not improper to charge all the

[46] Philip Cornick, "Special Assessments," *Municipal Finance*, edited by A. E. Buck, The Macmillan Co., New York, 1926, pp. 432-437; A. R. Burnstan, *Special Assessment Procedure*, Chap. IX.

[47] See Chap. XXVI.

[48] National Municipal League, *Special Assessments*, p. 9.

cost of improvement of these facilities to the general taxpayer. Some may receive no special benefit from this year's improvements, but they may expect to get their "inning" next year. The use of the automobile (increasing the general interest in good streets) and the completion of much original improvement probably accounts to a considerable extent for the declining importance of special assessments in municipal finance.

Zone of Benefit. The next problem of measurement is that of determining the size of the area to be included in the special benefit charges. Frequently the cost of street paving is assessed to the abutting property owners only, a procedure which may be tolerably appropriate in the case of a street used almost exclusively by the residents upon it, but which is obviously inappropriate for arterial streets. It may be more sound in the latter case to include a wider area in the zone of special benefit. In the case of a park or the extension of a subway, a considerable range of territory should be included in the zone of special benefit. In such case the degree of benefit may be presumed to vary with distance from the improvement. In financing the acquisition of a park at Dayton, Ohio, 15 zones were set up, with variation in the assessments from zone to zone according to proximity.[49] This appears to have been a rough but proper approach to the problem of dividing benefits territorially.

Distribution Among Taxpayers. If the problems of division and measurement just discussed are difficult, that of distributing the cost or benefit among particular individuals or properties is even more so. Here again, arbitrariness of procedure is the rule. In the case of streets and lateral sanitary sewers, the most usual procedure probably is that of assessing the special cost according to frontage. Sometimes the value of the land is taken into account, and sometimes area is used as the basis of division. In the case of storm sewers, division according to area is the rule. Distribution of the cost of paving according to frontage is criticized as favoring the deeper lots; that according to area as favoring the shallow lots; and that according to value as favoring the cheaper land. Probably the consensus of expert opinion favors the use of proximity as the measure, with each foot of area assigned a corresponding value and all area included as far distant at least as the rear line of lots abutting the improvement. This approach resembles that used to calculate depth-factor influence under the general property tax.

Some cities exempt the cost of paving street intersections from special assessment on the ground that these do not benefit abutting owners. This is a fallacy, however, for it is apparent that a street with intersections left unpaved would be quite unacceptable to either the special-assessment payer or the general public.

Excessive Special Assessments. Granting that special assessments are sound in theory and assuming that they can be successfully administered, they

[49] National Municipal League, *Special Assessments*, pp. 14-16.

can still be abused by loading onto property more services than it needs, or at least more charges than it can pay at a given time and place. The special assessment is a favorite device of the land speculator and a familiar feature of suburban development in the boom areas.[50] Speculators take advantage of this instrument to force public improvements ahead of their need, leaving the city with land that could meet assessments only on the realization of the boom the speculators hoped for and sought to create. Not infrequently, special assessments against property have accumulated to and above the point of confiscation. The temptation to levy excessive special assessments has been strengthened by the fact that these assessments are usually exempt from tax limitation statutes and special assessment bonds from debt limitations. The exemption lessens the effectiveness of these limitations and creates an artificial and unfortunate pressure to use special assessments.[51]

Volume of Special Assessments

A study of property taxes by the United States Census Bureau as of 1941, for cities with population of more than 100,000, describes the trend of special assessments as "showing a substantial falling off between 1932 and 1941, from $99.5 million to $25.0 million or 74.9 percent in total revenue from this source." [52] Some of this trend may be cyclical rather than secular. There is a correlation, obviously, between special assessments and the volume of municipal public works. The range in the ratios of special assessment to general property tax collection was from 26.7 percent in Spokane, Washington, to no collections from special assessments at all in San Francisco and several other cities.[53]

Conclusion

Special assessments, like several other uses of the taxing power, have strong theoretical justification but frequently bad practical consequences. It is entirely sound to distribute the cost of certain governmental services

[50] See Chap. XXVI.

[51] The indictment of special assessments by Chief Justice Church, presented below, is too sweeping, no doubt, but contains some element of validity.

"The few are powerless against the legislative encroachments of the many. The 'constituents' under this system, are attacked in detail, a few only selected at a time, and they have no power to enforce accountability, or to punish for a violation of duty on the part of the representative. The majority are never backward in consenting to, and even demanding, improvements which they may enjoy without expense to themselves. The inevitable consequence is, to induce improvements in advance of public necessity, to cause extravagant expenditures, fraudulent practices, and ruinous taxation. The system operates unequally and unjustly, and leads to oppression and confiscation. It is difficult to discover in it a single redeeming feature which ought to commend it to public favor" [Guest v. Brooklyn, 69 N. Y. 506, 517 (1877)].

[52] *Property Taxation 1941*, U. S. Department of Commerce, Bureau of Census, 1942, pp. 44-49.

[53] *Ibid.*, Table 13.

mostly to those who secure the greatest benefit from them. It is entirely sound to place more of the cost of government upon land than upon buildings and other property. In fact, there is grave doubt as to the wisdom of allowing unlimited private ownership of city sites and private appropriation of increments which are the result of growing population and community improvement. But the special assessment instrument is used to poor advantage in practice because of the difficulty of measuring special benefits.

One of the valuable features of special assessments is the classification of land and improvements, with special charge upon the former. This feature might be further developed as follows: Certain services of government, such as street construction and maintenance, water supply, and so forth, might be designated as "land-service expenditures." The cost of these services might then be distributed over all the land of the city according to value. This would avoid, except between land and other property, difficult problems of apportioning benefit. Some landowners might have to pay for certain improvements from which they receive relatively little benefit. On the other hand, at some future date they would be the beneficiaries and at the expense of those who now enjoy special benefits. This procedure would probably violate the uniformity clauses of state constitutions.[54] It would also ignore the territorial localization feature of special assessments. But it would extend the use of these levies and further apply one of their soundest features.

It has been argued[55] that the land value increment tax is superior to the special assessment as a tax measure and should be substituted for it. The increment tax would assess increments after, rather than before, they arise and include increases in land values due to social as distinguished from public improvements. The increment tax has a great deal of merit in its own right but it is hardly a substitute for special assessment, which rests more logically, as has been explained, upon the idea of special benefit than upon land value increments.

Special assessments as now conceived will probably continue to play a fairly important role in municipal finance. It is often argued that if a group of people want and need certain public improvements, "let them pay for it." It cannot be doubted that the principle of territorial localization of charges has legitimate application and that some instrument for applying it should be available. The improvement of this means of raising revenue is largely a matter of better administration. More care and scientific procedure can be exercised in the ascertainment of benefits. Debt and tax limits, if we are to have them, should include special assessments in their scope. Certainly, full and regular reporting of receipts from this source should be required. More safeguards against excessive subdivision and greater moderation in the authorization of speculative improvements can be heartily recommended.

[54] Philip Nichols, *Taxation in Massachusetts*, p. 756.

[55] Edwin H. Spengler, "The Increment Tax versus Special Assessments," *Bulletin of the National Tax Association*, Vol. XXI, No. 8, May 1936, p. 240.

The public might well give increased attention to this badly neglected source of public revenue. The results thus far achieved with this instrument, however, are hardly such as to recommend its more extensive use.

EXCESS CONDEMNATION

Excess condemnation is the taking of more land, under the power of eminent domain,[56] than is needed for an improvement. This device is much more commonly used in Europe than in the United States. Not all states have this power. The courts have quite universally held that, in the absence of constitutional provision to the contrary, excess condemnation even of remnants[57] is an invasion of private rights and unconstitutional. Amendments have clearly established its constitutionality in several states (including New York, Massachusetts, Ohio, and Wisconsin), but even in those states its use has been quite limited.

Excess condemnation generally has been used in the United States to wipe out uneconomic property lines resulting from the widening of a street or the construction of a diagonal thoroughfare. Occasionally it has been used to ensure some improvement against having its beauty and enjoyment marred by objectionable uses of adjoining land. Odd remnants of territory left after a relocation of a highway may be useful in private hands only for shoe-shining, rubbish piles, or other undesirable purposes. If such land is purchased by the public, it can at least be landscaped. Undesirable uses can be barred in the government's contract of sale or lease. In the case of a street widening, private owners may resent a special assessment because they are left with remnants of land which are valueless except when combined with other units. Sale at a fair price is not always possible, and certain lots may be held in trust and cannot be sold. Sometimes owners insist on an unreasonable price and thus hold up a desirable rearrangement. On such occasions the coercive power of the government may be of a benevolent nature to all concerned.

It is reported that Worcester, Massachusetts, used excess condemnation to finance the widening of a street and sold the excess land condemned at three times what it cost the city. In Europe the use for recoupment has been much more general and in a few cases has resulted in a net profit from improvements.

Excess condemnation is undoubtedly a valuable instrument, at least to

[56] Eminent domain is defined as the superior right of property subsisting in a sovereignty, by which private property may in certain cases be taken or its use controlled for the public benefit, without regard to the wishes of the owner. It is also defined as the right of every government to appropriate otherwise than by taxation and its police authority (which are distinct powers), private property for public use.

[57] Remnants are fractions of lots which remain in private hands after a public improvement, necessitating purchase of parts of the lots, has been made.

accomplish the limited objectives for which it usually has been applied in the United States. Whether it can and should be used to help finance needed improvements, as in Europe, is more debatable.

It has been claimed that either the special assessment or the unearned increment tax afford better means of reaching socially created increments than excess condemnation. Certainly, the latter has the limitation that it is not available for use in financing most drainage, sewer, or street-paving projects. In addition, it is objected to because it is said to involve the city in land speculation. The least that may be said is that the use of this instrument should be freely available to any city which wishes to use it.[58]

SUMMARY

Taxes are by no means the only source of public revenue. Others include income from the public domain and public enterprises, fees, and special assessments. These are distinguished from taxes and from each other by various criteria, such as the special benefit involved, but the differences are only ones of degree.

Income from the public domain was once very important in public finance, but in most countries this is no longer true. Public industries may be a source of revenue, depending upon their success and the pricing policy pursued by the government in selling the services of the enterprise. Some municipalities derive a very substantial revenue from governmntal undertakings. This represents a fruitful field of revenue for a municipality or state with a civic-minded population and competent administration.

Fees are widely applied in payment for public services but are only a minor source of public revenue. They might be expanded considerably. Payment of fees to public officials in lieu of salaries has been, and continues to be, a major evil in the fee system; such payment frequently results in excessive compensation and develops objectionable attitudes in public officials.

Of considerable interest and importance, from both the theoretical and practical standpoints, is the field of special assessments. These levies receive theoretical support because they are related to special benefits (both individual and territorial) and constitute a special tax on city land values. They are frequently compared with land value increment taxes, but they differ substantially in following benefit rather than increment and in disregarding entirely increments due to causes other than government improvements.

Legally the courts pay lip service to the rule that special assessments must correlate with benefits; however, in most cases rather arbitrary divisions of

[58] If the power of condemnation for slum clearance and the acquisition of land for public housing is eventually established, excess condemnation might be used to help finance a public housing program.

cost are sanctioned. In practice, special assessments present many grave difficulties of administration, particularly in dividing burdens between special beneficiaries and the general taxpayer, among zones of benefited territory, and among the individual properties benefited. Often the techniques employed are crude and the standards arbitrary. This and the not infrequent excessive use of special assessments results in considerable injustice.

The use of special assessments is a cyclical phenomenon, varying substantially from city to city. In the years of rapid expansion immediately preceding the depression of the thirties, some cities collected more from special assessments than from general property. Special assessments might be used to impose a special land tax for "land-service expenditures." Beyond this, the principal recommendations for improvement are better administration and moderate application. Excess condemnation also has a place in financing and planning public improvements and should be given more liberal sanction by constitutions and courts.

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CHAPTER XIX

The Power to Tax

INTRODUCTION

One of the attributes of any sovereign government is the power to tax, without which its existence would be impossible. In the words of Chief Justice Marshall, this power "may be legitimately exercised on the objects to which it is applicable, to the utmost extent to which the government may choose to carry it." [1] Nevertheless, it is by no means an absolute power. By resolution, by formal agreement (as in constitution making), and by custom, the people have imposed limitations upon it. In the United States most of these limitations may be found in state and federal constitutions.

The constitutional status of taxation in the United States is considerably complicated by the fact that it must conform to the rules, not of one sovereign government, but rather of many sovereign state governments within a sovereign federal government. Some of the states were in existence when the federal government was established and did not surrender the general powers that are customarily associated with sovereignty. Naturally, equal powers were accorded the states entering the Union after the formation of the federal government. However, not all of the peculiarly sovereign powers were retained by the states. The constitutional convention of 1787, following a sad experience under a loose confederacy of states, chose to create a strong, independent federal government with sovereign powers. The new constitution required the states to yield some and share others of their original powers with the new government. But, in order to avoid conflict and safeguard local independence, the new government was given sovereignty only within a limited field. Thus, the federal government is said to have only designated powers, some of which, however, are also held concurrently by the states except insofar as they are limited either by the federal constitutions or by their own.

The municipalities are not sovereign but are merely subdivisions of the

[1] McCulloch v. Maryland, 4 Wheaton 316, 428 (1819).

states and depend for such power as they have upon grants from the former.

Thus, the taxing powers, like other powers of government, may be inherent, designated, or delegated. The states have inherent powers; the federal government has designated powers; and the counties, towns, villages, cities, and other political subdivisions have delegated powers. The latter may be granted by the state legislatures, but only to the legislative branch of a subdivision of states.[2]

GENERAL LIMITATIONS ON THE POWER TO TAX

Taxation Must Be for a Public Purpose

A general limitation on the power to tax, existing usually by authority of custom and legal precedent rather than by constitutional mandate, is that taxation must be for a public purpose. What constitutes public purpose depends upon time and place and also, perhaps, upon the disposition of the courts.

Thus, in the case of Citizen's Saving and Loan Association v. Topeka,[3] the Court declared invalid a Kansas statute which permitted municipalities to loan money or credit to aid private industrial concerns. The question involved arose frequently when states allowed their municipalities to grant or loan money to railroads in the era of railroad construction, but the preponderance of legal opinion permitted such practice in the absence of constitutional provisions to the contrary.

In a Wisconsin case[4] a municipality borrowed $100,000 to aid a new (private) industry, the creditors to be repaid out of taxes. The industry agreed to provide a payroll of $1,000,000 over a 10-year period and offered a bond to secure its faithful performance. The company defaulted upon its contract and the municipality sued the surety company. The state supreme court denied the right to collect on the bond. It held that the municipality's procedure was "permeated with illegality," that the contract was opposed to public policy, and that to assist the municipality to collect would encourage dishonest transactions. In somewhat similar circumstances, however, an Ohio court compelled a private corporation which had benefited by a contract with a municipality to fulfill its end of the agreement.[5]

Considerable interest attended the recent move of Mississippi sanctioning public borrowing and expenditure of public money to buy or build industrial plants for leasing to private industries on terms approved by the state industrial commission and in accord with the public welfare.[6] The preamble stated

[2] W. J. Shultz, *American Public Finance and Taxation*, 1st ed., pp. 250-252.
[3] 20 Wall. 655 (1875).
[4] Wendlandt v. Hartford Accident and Indemnity Co., 222 Wis. 204 (1936).
[5] New York Central Rd. Co. v. City of Bucyrus, 126 Ohio 558 (1933).
[6] *Laws of Mississippi*, First Extraordinary Session, 1936, Chap. I.

as the major purpose of this legislation the importance to the state of providing wealth-creating work for unemployed citizens and a balance between agriculture and industry. The law was sustained by the supreme court of Mississippi in spite of the following provision in the state constitution: "The credit of the state shall not be pledged or loaned in aid of any person, association, or corporation. . . ." The court emphasized that Mississippi, in comparison with other states, has few manufacturing enterprises, "and it has long sought in vain to procure them by offering them special inducements, e.g., exemption from taxation." A positive incentive, therefore, seemed no less appropriate to the court than a negative one.[7] The program has since been abandoned.

Even if the decision in Loan Association v. Topeka were consistently applied, it would hardly support the view that state subsidies to private industry are always unconstitutional. There are many precedents for public subsidies to private business, at least where such subsidies are indirect. The protective tariff is, of course, the classic example. Reconstruction Finance Corporation loans probably carry some element of subsidy in them. And there are many other cases of this kind. These aids can be defended on the ground that they serve the public interest. What does and does not serve the public interest is usually a matter of opinion; the dividing line between the two is often scarcely visible.

There is ample precedent for ruling out special government aid to private persons on grounds similar to those used to invalidate the Kansas statute. Just two years previous to this decision, a Massachusetts court declared invalid an attempt to provide relief through public loans for the victims of a fire.[8] In 1902, however, a similar case in Wisconsin resulted in a different decision,[9] but one year later another Wisconsin case ruled out a public appropriation to provide an institution for the care and cure of drunken persons.[10] On the other hand, the soldiers' bonus acts have been generally sustained and, of course, the relief of personal destitution has always been regarded as a legitimate function of government.

The rule that taxation must be used for a public purpose has also been employed to prevent public undertakings in business and industry. Several years ago the legislature of South Dakota passed an act which permitted certain state officers, if they found that gasoline prices were excessive, to buy gasoline and sell it at retail. They were permitted to use a certain portion of gasoline tax money for capital. The court, in declaring the statute void, quoted from a decision of the Kansas Supreme Court as follows: [11]

[7] Albritton v. City of Winona, 181 Miss. 75, 99 (1938).
[8] Lowell v. Boston, 111 Mass. 454 (1873).
[9] State ex rel. New Richmond v. Davidson, 114 Wis. 563 (1902).
[10] State ex rel. Garrett v. Frochlich, 118 Wis. 129 (1903).
[11] White Eagle Oil & Refining Co. v. Gunderson, 48 S. D. 608 (1925).

> It has been the policy of our government to exalt the individual rather than the state, and this has contributed more largely to our rapid national development than any other single cause. Our Constitution was framed, and our laws enacted, with the idea of protecting, encouraging and developing individual enterprise and if we now intend to reverse this policy, and to enter the state as a competitor against the individual in all lines of trade and commerce, we must amend our Constitution and adopt an entirely different system of government.

On the other hand, several state as well as federal court decisions have disallowed the contention that use of public money to participate in business, usually private, is taxation for a nonpublic purpose. Thus, in the leading case of Green v. Frazier,[12] the industrial program of the State of North Dakota, which included the establishment of a state mill, bank, grain elevator, and housing corporation, all to be financed by tax-supported bond issues, was sustained. The decision rested on the grounds that inasmuch as North Dakota was predominantly an agricultural state, and this program aimed to augment its prosperity, and because the legislature, the people, and the state supreme court had all held this to be for a public purpose and for the state's welfare, the Supreme Court, in the absence of a clear violation of the Fourteenth Amendment, could not but uphold the legislation.[13]

Reasonable Classification

It is settled that classification in tax legislation is not contrary to the federal constitution, whether such classification is used by the federal government or the states. However, it is important that the classification be *reasonable* and not arbitrary; otherwise it may be contrary to the Fourteenth or Fifth Amendments of the federal Constitution. Thus a state "may, if it chooses, exempt certain classes of property from any taxation at all, such as churches, libraries, and the property of charitable institutions. It may impose different specific taxes upon different trades and professions, and may vary the rates of excise upon various products. . . . But clear and hostile discriminations against particular persons and classes . . . might be obnoxious to the constitutional prohibition." [14] In one case the Court held that taxing surface but not underground railways was a proper classification.[15] In a more recent case, a graduated tax on the gross income of merchants has been held unreasonable classification and therefore unconstitutional.[16] The Court admitted that there may be a relationship between gross income and net

[12] 253 U. S. 233 (1920).

[13] An excellent discussion of the subject will be found in an article by B. P. McAllister, "Public Purpose in Taxation," 18 *California Law Review*, 137 and 241 (1930).

[14] Bell's Gap R. Co. v. Pennsylvania, 134 U. S. 232 (1890).

[15] Metropolitan St. Ry. Co. v. New York, 199 U. S. 1 (1905).

[16] Stewart Dry Goods Co. v. Lewis, 294 U. S. 550 (1935).

income (measure of ability to pay), but "denied that the graduation adopted was a 'reasonable approximation' to that increase so that the classification could be upheld." [17]

Use of Taxation for a Nonfiscal Purpose

Taxation is usually primarily for revenue, but nonfiscal considerations often play a part, and may be the major objective, in tax legislation. The use of taxation to regulate rather than raise revenue may or may not be valid, depending on the circumstances. The boundary line between what is and what is not acceptable in this field is quite obscure.

Since the federal government's powers are confined to those enumerated in the Constitution, and since economic development is in the direction of more centralized institutions, Congress has been under constant pressure to legislate on matters for which it has no specific authorization. Regulatory powers granted to the federal government are limited, and this accounts for the numerous attempts to accomplish regulatory objectives under the clearly established taxing power. If the federal government had powers suited to the present economic era, or if the "general welfare clause" [18] of the Constitution were sufficiently broadened by interpretation, such subterfuge would be unnecessary. Recent broadening of the concept of interstate commerce (over which the regulatory power of the federal government does extend) has partially solved the problem.

The use of the taxing power by the federal government, with an apparent major or collateral purpose to regulate in fields which are beyond its regulatory power, has afforded an extremely difficult and interesting field of adjudication for the courts.

Veazie Bank v. Fenno. In an early case after the Civil War the Supreme Court was called to pass upon the legality of an attempt to tax the circulation of state bank notes out of existence. It was contended by the bank that the tax was so excessive as to indicate a purpose to destroy. In reference to this point, Justice Chase, who read the Court's decision, said: "The first answer to this is that the judicial cannot prescribe to the legislative departments of the government limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons, but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected." [19] The Court also relied on the fact that Congress had the power to provide and regulate coinage; that it could, if it chose, prohibit state coinage altogether; that the federal tax was thus only an attempt to do indirectly what could have been done directly.

[17] J. B. Sholley, "Equal Protection in Tax Legislation," 24 *Virginia Law Review*, 229 and 388 (1938).

[18] Art. 1, Sec. 8, Par. 1: "The Congress shall have power to lay and collect taxes . . . to . . . provide for the . . . general welfare of the United States."

[19] Veazie Bank v. Fenno, 8 Wall. 533, 548 (1869).

One of the most obvious instances where the federal government used the taxing power to regulate and destroy was its legislation against white phosphorus matches. The manufacture of matches with white phosphorus ingredients was extremely injurious to the employees in the industry. The federal government imposed a tax of 2 cents per 100 on such matches and by this means entirely eliminated their manufacture.[20]

McCray v. U. S. The phosphorus match tax was never carried to court, but in a somewhat similar case—McCray v. U. S.[21]—an act of Congress was sustained. This involved the imposition of a heavy differential tax on the manufacture and sale of oleomargarine colored to look like butter (one-quarter of a cent per pound if uncolored and 10 cents per pound if colored). Legislation frankly regulating the manufacture and sale of oleomargarine along these lines might lie within the police power of the states, which could have justified it on the ground that they protected the public from fraud. However, the federal government has no such sustaining authority for this type of legislation and must need resort, when necessary, to its taxing power. It was argued that Congress could not, under the guise of raising revenue, impose a tax so onerous as to make it manifest that the real objective sought was suppression of the manufacture of the taxed article. This view, however, was rejected by the Court. Justice White, in delivering the opinion of the Court, quoted with approval an earlier case as follows: "The act before us is on its face an act for levying taxes, and although it may operate in so doing to prevent deception in the sale of oleomargarine as and for butter, its primary object must be assumed to be the raising of revenue." [22] He added, "The decisions of this court from the beginning lend no support whatever to the assumption that the judiciary may restrain the exercise of lawful power on the assumption that a wrongful purpose or motive has caused the power to be exerted." [23]

This decision apparently gave Congress the power to levy any excise tax which appears on its face to be such, regardless of the incidental effect which the tax might have on the sale of the object taxed or on a particular business or practice related to such sale.

Similarly, the Court upheld an excise imposed upon the manufacture and sale of opium, a tax that was very clearly designed to give the federal government an effective means of regulation and control of the opium traffic.[24]

Child Labor Tax Case. That there is a limit to what may pass as "an excise on its face" was established in the Child Labor Tax Case. In 1916 the federal government attempted to outlaw child labor under its power to regu-

[20] John M. Mathews and Clarence A. Berdahl, *Documents and Readings in American Government*, The Macmillan Co., New York, 1928, p. 405.
[21] 195 U. S. 27 (1904).
[22] *Ibid.*, p. 51.
[23] *Ibid.*, p. 56.
[24] U. S. v. Doremus, 249 U. S. 86 (1919).

late and control commerce, but this was declared to be an invasion of a power reserved to the states.[25] In 1919 an act was passed imposing a tax of ten percent on net profits of firms knowingly employing children below the ages of 14-16 years. To enforce the law, inspection by both the Treasury Department and the Labor Department was provided. Justice Taft, for the Court, said: "It [the law] provides a heavy exaction for a departure from a detailed and specified course of conduct in business." He went on to add that it was only where the employer knowingly departed from the prescribed course that payment was to be exacted, and concluded that, "In the light of these features of the act, a court must be blind not to see that the so-called tax is imposed to stop the employment of children within the age limits prescribed." [26]

"Grant the validity of this law, and all that Congress would need to do hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the States have never parted with and which are reserved to them by the Tenth Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word "tax" would be to break down all constitutional limitation of the powers of Congress, and completely wipe out the sovereignty of the States." [27]

Magnano Co. v. Hamilton. It is still not entirely clear whether the states (as distinguished from the federal government) are permitted to regulate under the guise of taxation where they could not regulate directly. This issue came close to being presented in a recent oleomargarine case,[28] wherein the Supreme Court sustained a tax of 15 cents per pound, laid by the State of Washington upon all butter substitutes sold within the state. It was apparent that the purpose of this tax was to prevent the sale of oleomargarine in the State of Washington. The Court would have been blind indeed not to have perceived as much. In this case it stated that the due process clause could be invoked to rule out a state tax law only if the law were so arbitrary as to compel the conclusion that it was not an exercise of the taxing power, but rather that of another and forbidden power. The fact that a tax has the effect of imposing a burden upon one class of business enterprise in such a way as to benefit another is not a ground for declaring it unconstitutional. Nor can it be inferred that a prohibition instead of a tax was intended, solely because of its heavy burden.

In a case involving somewhat similar issues, the Supreme Court sustained a heavy chain store tax levied by the State of West Virginia. The Court said

[25] Hammer v. Dagenhart, 247 U. S. 251 (1918).
[26] Child Labor Tax Case, 259 U. S. 20, 36-37 (1922).
[27] *Ibid.*, p. 38.
[28] Magnano Co. v. Hamilton, 292 U. S. 40 (1934).

that, "When the power to tax exists, the extent of the burden is a matter for the discretion of the lawmakers." [29]

United States v. Butler. From the analysis of the above cases, it can be seen that the Supreme Court has allowed the use of taxation for nonfiscal purposes quite freely and that, with the one exception of the rule laid down in the child labor case, legislative bodies appear to have much discretion in the matter. In some later cases, however, the Court seems to have somewhat circumscribed this power. The first of these is the case of United States v. Butler,[30] wherein the Court declared the Agricultural Adjustment Act of 1933 unconstitutional. This Act provided for a processing tax levied on certain commodities and benefit payments under which the government gave bonuses to farmers for acreage temporarily and voluntarily taken out of cultivation.

Judging by previous decisions of the Court, it would seem that, inasmuch as this tax was on its face for revenue only, it should have been sustained The Court pointed out, however, that the tax was an indispensable part of a plan of regulating agriculture, a view supported by the fact that the revenue was appropriated to facilitate crop control. "The tax, the appropriation of the funds raised, and the direction for their disbursement are," said the Court, ". . . but means to an unconstitutional end," [31] namely, regulation of a local matter (agriculture) over which only the states have control. The dissent argued that if there were any regulation involved in the legislation, it was not accomplished by the tax, as the majority opinion declared, but rather "by the methods by which its proceeds are expended, and would equally be accomplished by any like use of public funds, regardless of their source." Congress is specifically authorized to spend for the public welfare. The dissent contended that, "It is a contradiction in terms to say that there is power to spend for the national welfare, while rejecting any power to impose conditions reasonably adapted to the attainment of the end which alone would justify the expenditure." [32] The dissent further cited the precedent of expenditure by the federal government to make conditional grants-in-aid for education and other functions, regulation of which is reserved to the states. Whether such expenditures were ruled out by the Butler decision was not clear. Benefits to farmers who follow certain prescribed patterns of procedure in the use of land have continued although the processing tax feature was dropped. The conservation (of soil) has been stressed as the objective of these programs. These measures have not been challenged on the score of constitutionality.

In a case similar to that of United States v. Butler, the Court overruled an attempt to impose a code of fair practices upon the bituminous coal in-

[29] Fox v. Standard Oil Company of New Jersey, 294 U. S. 87, 99 (1935).
[30] 297 U. S. 1 (1936).
[31] *Ibid.*, p. 68.
[32] *Ibid.*, pp. 80, 85.

dustry. The Act imposed a tax on the sale price of coal at the mines and allowed a 90 percent credit if the code were complied with.[33]

Grosjean v. American Press Company. Limitation upon a state's power to regulate by means of a tax, "on its face, an excise," was pronounced in Grosjean v. American Press Company.[34] A Louisiana statute imposed upon all publishers of newspapers with a circulation of more than 20,000 a license tax for the privilege of selling advertising. The rate of the tax was 2 percent, and the measure was the gross receipts derived from advertisements. The act was held unconstitutional under the due process clause of the Constitution on the ground that it abridged freedom of speech.[35]

Social Security Cases. In May 1937, the Court, in sustaining the federal Social Security Act and the Unemployment Compensation Act of Alabama,[36] turned in the direction of a liberal interpretation of the federal taxing powers. In the Social Security Act, a tax had been levied upon payroll with a 90 percent credit for similar payments made to a state unemployment compensation system. The Act prescribed in some detail the sort of state compensation system which would entitle taxpayers to the credit. It was alleged that this was coercive and an attempt to exceed federal powers. The Court held that Congress could seek to influence state action without exceeding its constitutional powers and that the conditions imposed were designed to protect the national treasury and were well within federal fiscal powers. Whether similar reasoning would have sustained the Agricultural Adjustment Act is not certain, however, since the agricultural program was an attempt of the federal government to control the individual conduct of farmers directly rather than through the action of the states.

SPECIAL LIMITATIONS ON FEDERAL TAXING POWER

Introduction

Under the Continental Congress and the Articles of Confederation, the "United States" incurred such great financial difficulties that the credit and prestige of the new union went from bad to worse. The Congress and the Confederacy had no independent powers of taxation and had to get such

[33] Carter v. Carter Coal Co., 298 U. S. 238 (1936).

[34] 297 U. S. 232 (1936).

[35] This was alleged to be an attack by certain Louisiana office holders upon the newspapers which opposed them.

[36] Steward Machine Co. v. Davis, 301 U. S. 548 (1937). The Court also sustained the old age insurance taxes and the Labor Relations Act. The latter decision considerably broadens previous interpretations of the power to regulate interstate commerce [Helvering v. Davis, 301 U. S. 619 (1937); National Labor Relations Board v. Jones and Laughlin Steel Corporation, 301 U. S. 1 (1937)]. Production destined for and indirectly affecting interstate commerce is now included within this power.

revenue as they could by begging or coercing the states to levy taxes on its behalf.

It is curious to observe how the situation has reversed itself in a century and a half. As a practical matter, the federal government now has far more effective powers of taxation and borrowing than the states. This lies at the bottom of a developing system of federal grants-in-aid to states for meeting their responsibilities. It was mainly financial necessity which motivated the Constitutional Convention of 1787, and it was to be expected that any proposed constitution would contain much more adequate taxing powers than the federal government had theretofore possessed. Although the powers granted were very extensive compared with previous ones, and although these powers have been substantially extended, notably by the Sixteenth Amendment, they are still far from being all-inclusive. The features of the federal Constitution which impose limitations on the federal taxing power will now be briefly discussed.

No Tax on Exports

No tax or duty may be laid on articles exported from any state.[37] This limits the taxing power on articles of commerce to imports. The rule is by no means universal throughout the world. Many countries tax exports and several South American countries derive considerable revenue from this source.

The clause has been sensibly interpreted by the Court as follows:

"The true construction of the constitutional provision is that no burden by way of tax or duty can be cast upon the exportation of articles, and does not mean that articles exported are relieved from the prior ordinary burdens of taxation which rest upon all property similarly situated. The exemption attaches to the export and not to the article before its exportation." [38] In a case involving the 1913 federal income tax, as applied to the income of an industry engaged in exporting, the Court held that "at most, exportation is affected only indirectly and remotely." [39] On the other hand, a general excise tax on exporting cannot be applied to sales made to a commission merchant for a foreign consignee. Such sales are regarded by the Court as a step in exportation.[40]

Direct Taxes Must Be Apportioned

The apportionment clause in the federal Constitution provides that ". . . direct taxes shall be apportioned among the several states which may be included within this Union, according to their respective numbers . . ."

[37] *United States Constitution*, Art. 1, Sec. 9, Par. 5.
[38] Cornell v. Coyne, 192 U. S. 418, 427 (1904).
[39] Peck and Co. v. Lowe, 247 U. S. 165, 175 (1918).
[40] Spalding and Brothers v. Edwards, 262 U. S. 66 (1923).

and "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken." [41]

This clause raises the question as to what constitutes a direct tax. As previously explained, the phrase has frequently been defined to describe taxes which cannot be shifted. But there is no clear consensus concerning the shiftability of many taxes. The property tax particularly is in doubt; probably some parts of it can be shifted and others not.

In an early case a tax on carriages assessed according to value was sustained, and the Court seemed to accept the view that the term "direct" as used in the Constitution covered only poll taxes and taxes upon real estate.[42] Thus, the Civil War income tax laws were sustained as not contrary to the apportionment clause. After a full review of the proceedings of the constitutional convention and of the writings of Hamilton, Madison, Story, and Kent, the Court said: "Our conclusions are, that *direct taxes*, within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate; and that the tax of which the plaintiff in error complains is within the category of an excise or duty." [43]

However, the income tax law of 1894 was held unconstitutional.[44] The Court attempted to distinguish the issue from that involved in the Civil War income tax case on the ground that the income from real estate was involved in the 1895 case and not in the earlier one. The income tax as applied to the income from real estate was held to be equivalent to a tax upon real estate itself and thus subject to the apportionment clause as a direct tax. On rehearing, the majority also extended this rule to include the income from personal property. Admitting that a tax which was confined to professional income might still be valid, the Court nevertheless concluded that, since so much of the 1894 law had been ruled invalid, the whole Act should be declared unconstitutional.[45] Some fifteen years later, an attempt to impose a tax on the income of corporations under the guise of an excise on corporation franchises, measured by net income, was sustained by the Court. The tax was distinguished from that involved in the 1894 law as follows: "The difference between the acts is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way." [46] But to the layman the difference is likely to simmer down to that between calling something "twiddledeedee" rather than "twiddledeedum."

In 1913 the Sixteenth Amendment brought the income tax within the power of Congress by providing that Congress might tax income "from what-

[41] *United States Constitution*, Art. 1, Sec. 2, Par. 3, and Sec. 9, Par. 4.
[42] Hylton v. United States, 3 Dall. 171 (1796).
[43] Springer v. United States, 102 U. S. 586, 602 (1880).
[44] Pollock v. Farmers' Loan and Trust Co., 157 U. S. 429; on rehearing 158 U. S. 601 (1895).
[45] For further discussion of this decision, see Chap. VII.
[46] Flint v. Stone Tracy Co., 220 U. S. 107, 150 (1911).

ever source derived" without regard to apportionment. However, the amendment did not entirely end the controversy over apportionment of taxes aimed at net income. Subsequent decisions of the Court have made it clear that any tax which is aimed at income, but which is not upon net income as the Court interprets the latter, is still subject to the apportionment clause. This interpretation of the Court makes its definition of income a matter of first-rate importance. As has been observed, stock dividends were excluded from the Court's definition.[47] This makes them immune from federal taxation, but it does not prevent a state or territory from calling a stock dividend income and taxing it as such.[48]

In 1929, in a case involving the constitutionality of the federal gift tax, the Court held "that a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership" is an excise and therefore need not be apportioned. A dissenting opinion contended "that a tax imposed upon an ordinary gift, to be measured by the value of the property given and without regard to any qualifying circumstances, is a tax by indirection upon the property, as much, for example, as a tax upon the mere possession by the owner of a farm, measured by the value of the land possessed, would be a tax on the land. To call either of them an excise is to sacrifice substance to a mere form of words." [49]

Certain Federal Compensation Excluded?

The Constitution provides that the President and federal judges be paid a salary which "shall not be diminished during their continuance in office." On the authority of this provision it has been held that a federal tax on the salary of a United States district judge is invalid.[50] In the Revenue Act of 1932 Congress attempted to circumvent this interpretation with an amendment to the Act pertaining to salaries. The amendment as finally stated in the Revenue Act of 1934, Section 22(a), provided: "In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly."

There was some doubt as to whether this attempt to bring these officers under the federal income tax would be successful. It can be plausibly argued that every change in the income tax rates is a change in salary. At any rate, the decision prompting the amendment appears to grant a quite unnecessary special privilege. The rule laid down in the case involving the application of the income tax to exports could have been followed; that is, that only a

[47] Eisner v. Macomber, 252 U. S. 189 (1920).
[48] Pasados v. Warner, Barnes and Co., 279 U. S. 340 (1929).
[49] Bromley v. McCaughn, 280 U. S. 124, 136, 141 (1929).
[50] Evans v. Gore, 253 U. S. 245 (1920).

discriminatory, or special tax, not a universal tax including the subject "along with all the rest of the world," should be banned. The decision and a number of other similar ones are quite unfortunate, to say the least, and have caused considerable discrimination in the application of the income tax laws.

The Requirement of Uniformity in Indirect Taxes

The rule of apportionment previously discussed does not apply to indirect taxes; "but all duties, imposts, and excises shall be uniform throughout the United States." [51] Interpreting this uniformity, the Court declared that "The uniformity of taxation throughout the United States enjoined by Article I, § 8, is geographic, not intrinsic. A graduated tax, on legacies, granting exemptions . . . or on incomes, . . . does not violate this clause of the Constitution . . ." [52] and even geographic uniformity means only that the tax law shall be generally applicable, not that it shall be uniform in its effect. Thus, a federal tax may be imposed on objects which exist in some states and not in others.[53]

Due Process of Law

The Fifth Amendment to the Constitution provides that no person shall be "deprived of life, liberty, or property, without due process of law." As applied to the tax field, this clause means that taxes must not be arbitrary or discriminatory. Classification is permitted but it must be reasonable.

The due process clause might also be invoked in the event the taxpayer is denied "a fair opportunity to assert his substantive rights before a proper judicial tribunal." [54]

Taxation of State Instrumentalities

Introduction. There is no specific provision in the federal Constitution prohibiting the federal government from taxing state instrumentalities or the states from taxing federal instrumentalities. The prohibitions have developed as a result of court decisions which rest upon the philosophy and theory of governmental systems existing in the United States rather than upon specific mandate. The theory upon which they are especially based is that of dual sovereignty, under which fully sovereign state governments operate within a fully sovereign government.

The following discussion of some of the more important cases pertaining

[51] *United States Constitution*, Art. I, Sec. 8, Par. 1.
[52] Bromley v. McCaughn, 280 U. S. 124, 138 (1929).
[53] *Head Money Cases*, 112 U. S. 580 (1884).
[54] W. J. Shultz, *American Public Finance and Taxation*, 1st ed., pp. 264-265.

to governmental instrumentalities includes state taxation of federal instrumentalities as well as federal taxation of state instrumentalities.

McCulloch v. Maryland. The prohibition on the taxation of federal instrumentalities by states goes back to McCulloch v. Maryland,[55] decided in 1819. Specifically, the issue in this case was the constitutionality of a tax imposed by Maryland "on all banks or branches thereof" not chartered by Maryland. The law required the notes of such banks to be issued upon stamped paper and in certain denominations or the payment of a lump sum in order to be absolved from this obligation. The Court declared this law unconstitutional. Justice Marshall, in delivering the opinion of the Court, stated that "the power to tax involves the power to destroy," and added: "If the States may tax one instrument, employed by the government [federal] in the execution of its powers, they may tax any and every other instrument. They may tax the mail; they may tax the mint; they may tax patent rights; they may tax the papers of the customhouse; they may tax judicial process; they may tax all the means employed by the government, to an excess which would defeat all the ends of government. This was not intended by the American people. They did not design to make their government dependent on the States." [56] He made the reservation that the limitations imposed upon state powers by the Constitution as interpreted in the decision "does not extend to a tax paid by the real property of the bank, in common with the other real property within the State, nor to a tax imposed on the interest which the citizens of Maryland may hold in this institution, in common with other property of the same description throughout the State." [57]

In other words, the decision appeared to mean that the states may impose general and nondiscriminatory taxes, but not special and discriminatory taxes, on federal instrumentalities. If the decision means this, no one can quarrel with it. But subsequent opinions of the courts extended this prohibition to include all taxation by states of federal instrumentalities (subject to certain exceptions) and all taxation by the federal government of state instrumentalities (again with some exceptions).

Immunity Doctrine Extended. In the case of Collector v. Day,[58] the United States Supreme Court ruled that the federal government could not impose and collect a general income tax upon the salary of a judicial officer of a state. This extended the limitation imposed in McCulloch v. Maryland to include the federal government as well as the states and a general tax as well as a specific one. A dissenting opinion aptly commented that "no man ceases to be a citizen of the United States by being an officer under the State

[55] McCulloch v. Maryland, 4 Wheaton 316 (1819).
[56] *Ibid.*, p. 432.
[57] *Ibid.*, p. 436.
[58] 11 Wall. 113 (1870). An earlier opinion, Dobbins v. Commissioners of Erie Co., 16 Peters 435 (1842), had already granted immunity to federal employees from taxation (by states) on their compensation.

government," [59] and wondered where the doctrine of the majority opinion would end.

In a later case [60] a federal court held the earnings of employees of the publicly owned street railway of Detroit exempt from federal income taxation.

In Pollock v. Farmers Loan and Trust Co. the Court unanimously ruled out the application of the federal income tax to the interest upon municipal bonds.[61] The courts have made it clear in many cases that the Sixteenth Amendment did not alter pre-existing immunities of this kind.

The exemption doctrine was carried to greater lengths in Panhandle Oil Co. v. Knox,[62] which banned a state gasoline tax on gasoline sold for use by the federal government. The Court held that the state could not exact tribute for its support on federal transactions. Justice Holmes, in his dissenting opinion, suggested that instrumentalities could be adequately protected as long as discriminatory taxation were prohibited. "The power to tax is not the power to destroy," he said, "while this Court sits." [63] Justice McReynolds added that he was "unable to think that every man who sells a gallon of gasoline to be used by the United States thereby becomes a federal instrumentality. . . ." [64]

Similarly, an attempt to apply a federal tax on manufactured goods to motorcycles sold to a Massachusetts municipality was declared invalid.[65] The majority opinion ignored the question of incidence involved on the theory that it was the transaction which was taxed. A dissenting opinion argued that the matter of incidence was an important issue and one which involved "considerations so various and complex as to preclude the assumption a priori that any particular tax at any particular time is passed on." [66] The exact status of the immunity of sales is in great confusion, since they are made by, as well as to, governments. It remains to be seen whether the rule set up in the motorcycle case will be applied to work both ways.[67]

The taxability of sales made to cost-plus-fixed-fee contractors working on government contracts became an important issue during the early years of the Second World War. In the case of Alabama v. King and Boozer,[68] the Court decided that in the absence of action by Congress the state sales tax could be applied to the purchases by the contractor. "So far as such a nondiscriminatory state tax upon the contractors enters into the cost of the

[59] 11 Wall. 113, 128 (1870).
[60] Frey v. Woodworth, 2 Fed. (2nd) 725 (1924).
[61] 157 U. S. 429; on rehearing, 185 U. S. 601 (1895).
[62] 277 U. S. 218 (1928).
[63] *Ibid.*, p. 223.
[64] *Ibid.*, p. 225.
[65] Indian Motorcycle Co. v. U. S., 283 U. S. 570 (1931).
[66] *Ibid.*, p. 581.
[67] Robert Murray Haig and Carl Shoup, *The Sales Tax in the American States*, pp. 646-650.
[68] 314 U. S. 1 (1941).

materials to the Government, that is but the normal incident of the organization within the same territory of the two taxing sovereignties." [69] The case seems to make "legal incidence" a determining factor of constitutionality in sales tax situations. This would mean that a vendor's sales tax would be unconstitutional as applied to sales by the government and a vendee's sales tax would be outlawed as to sales to the government.

In this and other cases dealing with the state taxation of federal instrumentalities (national banks, for instance), the recent decisions make it clear that a tax by the states would not be valid unless imposed in such a way as to come within the authority granted by Congress. It is not recognized at all that the states have any right to tax federal instrumentalities if Congress chooses to exempt them.[70] Whether the reverse would be true (no federal taxation of state instrumentalities without consent) is doubtful. However, the Court, as late as 1944, decided that federally owned machinery leased to private concerns was not taxable, even in the absence of a congressional prohibition.[71]

The legal opinion in Canada concerning instrumentalities is an interesting contrast to that in the United States. The income derived from a state security or salary is taxable under the federal (Canadian) income tax.[72] The Canadian defense against attacks on sovereignty rests upon the rule that there must be no discrimination against the instrumentalities of another sovereign government with concurrent jurisdiction. This is the solution suggested in McCulloch v. Maryland and in many dissenting opinions in the instrumentality cases decided in the United States. Recent opinions of the Court indicate some inclination to move toward a similar rule.[73]

The rather extreme limitations placed upon the taxing power by the decisions discussed above have been subject to qualifications in others.

Limitations on the Immunity Doctrine. In the case of South Carolina v. U. S.,[74] the Court ruled, with three dissents, that a state is not exempt from paying federal liquor taxes when it engages in the liquor business. Here the Court distinguished between two types of functions in which the government may engage; one is strictly governmental and the other, proprietary. Instrumentalities incidental to the performance of proprietary functions, of which the liquor business is one, are not immune from taxation. The Court may have been influenced by the possibility that, if it decided otherwise, the

[69] *Ibid.*, pp. 8 and 9.

[70] Federal Land Bank v. Bismarck Lumber Co., 314 U. S. 95 (1941); see also Northwest Airlines v. Minnesota, 322 U. S. 292 (1944).

[71] United States and the Mesta Machine Co. v. County of Allegheny, 322 U. S. 174 (1944).

[72] Abbott v. St. John, 40 S. C. R. 597 (1908).

[73] Helvering v. Gerhardt, 304 U. S. 405 (1938); Graves v. O'Keefe, 306 U. S. 466 (1939). These decisions are discussed later.

[74] South Carolina v. United States, 199 U. S. 437 (1905).

door would be wide open for the avoidance of much internal revenue taxation.

The criteria to be used in drawing the line between essential governmental functions and proprietary functions are: the importance of the function, the time during which governments have performed it, and the exclusiveness of government performance. In a recent case the Court held that, ". . . the State cannot withdraw sources of revenue from the federal taxing power by engaging in businesses which constitute a departure from usual governmental functions and to which, by reason of their nature, the federal taxing power would normally extend." [75]

The distinction between proprietary and governmental functions as a dividing line between that which is taxable and that which is not taxable is extremely unsatisfactory and has involved the Court and taxpayers in a maze of uncertainty and confusion. Functions which were not essential fifty years ago may be indispensable today. Essentiality of governmental functions is always a matter of opinion and no proper issue for the Supreme Court to decide.

In a series of further cases the Court added to the confusion; it held the compensation paid to the general counsel for the Panama Railroad Company [76] and to the chief engineer of a city's bureau of water supply [77] non-taxable, although in the cases of salaries paid to the trustees of a municipally owned railway [78] and employees of the New York Port Authority it reached a contrary conclusion.[79] Needless to say, the question of immunity remained more uncertain than ever.

[75] Helvering v. Powers, 293 U. S. 214 (1934).

[76] Rogers v. Graves, 299 U. S. 401 (1937). A recent article dealing with "State Taxation and the New Federal Instrumentalities," by Harold W. Stoke will be found in 22 *Iowa Law Review*, 39 (1937).

[77] Brush v. Commissioner, 300 U. S. 352 (1937).

[78] Helvering v. Powers, 293 U. S. 214 (1934).

As an exhibit of the confusion and fine distinctions formerly prevailing in this field, witness an opinion by the Attorney General of Wisconsin. Employees of the Agricultural Adjustment Administration and the National Industrial Recovery Administration were held taxable under state income tax legislation because these Acts have been declared unconstitutional and the employees were clearly not "discharging a governmental sovereign function." Employees of nine federal credit agencies organized as corporations were held taxable on the ground that they were engaged in the banking business (proprietary); those of three other agencies were held to be engaged in the insurance business (proprietary). On the other hand, employees of the Emergency Crop and Feed Loan Office were held exempt on the basis that their lending operations were "more in the nature of relief" (sovereign), and those of the Farm Credit Administration on the ground that it is mainly administrative (sovereign); other agencies, such as the Public Works Administration, were held immune for similar reasons.

In the case of interest on bonds, for no very clear reason the opinion holds that a different rule must be followed from that applied to salaries; interests on the obligations of federal agencies are held immune from state taxes [*Opinions of Attorney General*, Wisconsin, Vol. XXVI, pp. 68-76 (1937)].

[79] Helvering v. Gerhardt, 304 U. S. 405 (1938). Football games conducted under the auspices of a state university have been held to be proprietary and subject to tax under the

Another qualification to the immunity doctrine is that compensation received from the government by those who are employed under special contract and take no oath of office is taxable. Thus, immunity does not extend to the compensation of a consulting engineer whose work for the government is neither permanent nor continuous.[80]

A third qualification to the immunity doctrine is that no exemption will be allowed where the tax would constitute only an indirect burden upon the functioning of government. Income from patents and copyrights, once immune, is now by a reversed decision held taxable.[81] A capital gain from the sale of a government bond is taxable on the ground that ". . . neither the Federal Government nor the States have found a tax on the profits of the sales of their securities to be a burden on their power to borrow money." [82] Interest on government securities held by banks may be taxed under a corporate franchise tax which is measured by net income.[83] At one time the immunity allowed governmental instrumentalities was extended to include the lessee's profits on land owned by the government. Such income is now taxable.[84]

A fourth limitation to the freedom of governmental instrumentalities from taxation, one which appears to represent a fundamental change in philosophy and opens the way for a complete overthrow of the whole immunity doctrine, is that a nondiscriminatory tax creates a burden so indirect and conjectural that its application to governmental instrumentalities is permissible. This new approach has been sanctioned recently, but it is impossible to say how far the Court will apply it. In two cases involving the salaries of government employees, the Court held that the application of a nondiscriminatory tax to such income was valid. The first decision was said in the dissenting opinion to overrule by implication "a century of precedents." [85] The second specifically overruled Collector v. Day.[86] This leaves the exemption of municipal utilities and securities as the outstanding remaining strongholds of immunity among state instrumentalities.

federal excise on admission [Allen v. Regents of University System of Georgia, 304 U. S. 439 (1938)].

[80] Metcalf and Eddy v. Mitchell, 269 U. S. 514 (1925).

Among those who qualify for exemption under this doctrine are: public school teachers, persons serving on the jury, county surveyors, deputy sheriffs, employees of state agricultural colleges (unless part or all of the compensation of such employees is paid, directly or indirectly, by the United States, in which case, such part is taxable). Those who do not qualify include: state witnesses in criminal action, paving contractors, physicians serving under workmen's compensation acts, security dealers dealing in municipal bonds, notary publics, receivers appointed by state courts (Treasury Department, Regulations 94, Income Tax Revenue Act of 1936, Art. 116-2; Prentice-Hall, *Federal Tax Course*, 1936 Edition).

[81] Fox Film Co. v. Doyal, 286 U. S. 123 (1932).

[82] Wilcutts v. Bunn, 282 U. S. 216, 232 (1931).

[83] Pacific Co. v. Johnson, 285 U. S. 480 (1932).

[84] Helvering v. Mountain Producers Corporation, 303 U. S. 376 (1938).

[85] Helvering v. Gerhardt, 304 U. S. 405 (1938), p. 430.

[86] Graves v. O'Keefe, 306 U. S. 466 (1939).

Conclusion. It is too early to say where the Court's change of direction will lead. The entire doctrine of immunity from nondiscriminatory taxation has never been necessary for the preservation of sovereignty and has served only to vex the tax system with confusion and special privileges. Developed for well over a century, in almost every case with a divided Court, the doctrine has become less and less defensible. It is to be hoped that the Court will continue on its present course until it has completely overthrown this legal Frankenstein. If any limitation on the power to tax instrumentalities along with other tax bases is needed, it can safely be left to the discretion of Congress. This would give legislative bodies a chance to construct a fair tax system.

FEDERAL LIMITATIONS ON STATE TAX POWERS

Limitations on the Power to Tax Commerce. Several of the limitations under this heading have already been discussed or closely parallel those discussed. Like the federal government, the states may not levy export duties, but unlike the former, they are also excluded from the taxation of imports. In addition, the states cannot impose tonnage taxes [87] (upon vessels, according to their size or capacity). Both limitations are qualified by the provision "without the consent of Congress." Finally, the states are excluded from taxing interstate and foreign commerce. This last prohibition is not specific, but it is inferred from the prohibition on export and import taxes and the commerce clause which gives Congress power "to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." [88]

The distinction between interstate and intrastate commerce has been a prolific source of litigation. It is clear that it is within the power of the states to tax property used in the transaction of interstate commerce—as, for example, the property of an interstate railroad. Such property may be included along with other wealth in a general tax, but it must not be singled out for discriminatory taxation. A state may tax the gross income of a railroad in lieu of a property tax, but it is questionable if it may impose a gross income tax in addition to a property tax.[89] The state must confine its tax on railroad property to such part as can reasonably be apportioned to its jurisdiction.[90]

A state may tax the net income of corporations doing an interstate business, unless the income is derived exclusively from interstate commerce. In

[87] *United States Constitution*, Art. I, Sec. 10, Par. 3.

[88] *United States Constitution*, Art. I, Sec. 8, Par. 3.

[89] Oklahoma v. Wells, Fargo and Co., 223 U. S. 298 (1912); United States Express Co. v. Minnesota, 223 U. S. 335 (1912); Nashville, Chatanooga & St. Louis Ry. v. Browning, 310 U. S. 362 (1940).

[90] Wallace v. Hines, 253 U. S. 66 (1920); Fargo v. Hart, 193 U. S. 490 (1904).

the case of the United States Glue Co. v. Town of Oak Creek, the Court said: "The difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. . . ." [91] As suggested, the opposite rule holds for a gross income tax, of which the Court has said: "That portion of the tax which is measured by the receipts from foreign commerce necessarily varies in proportion to the volume of that commerce, and hence is a direct burden upon it." [92]

It has been held that where a corporation does both an interstate and an intrastate business, it may be taxed on its net income, fairly apportioned, or on its capital stock; but if the corporation does no intrastate business, its interstate business alone cannot be subjected to a corporate tax of this character.[93]

A state may not impose a sales tax on the exports and imports over its borders even though such a tax is a part of a general sales tax which strikes equally sales made within the borders of the taxing state. On the other hand, the so-called state "use" taxes, levied upon the first use within the state of commodities purchased at retail outside the state and so not subject to the sales tax, have been sustained on the ground that no attempt to discriminate against interstate commerce was involved.[94] Going further, the Court has upheld the collection of a sales tax levied upon goods moving in across the border when the seller maintained a place of business in the taxing state.[95]

The Supremacy of Federal Treaties over State Tax Powers. The treaties of the United States with foreign countries are a part of the supreme law of the land, and if the federal government enters into a treaty with a foreign power providing for mutual nondiscrimination as to taxation or the property rights of the citizens of the two countries, then any state tax which conflicts with such treaty is invalid. Except for contrary treaty provisions, an alien may be subject to special classification and discrimination even to the point of denying him the right to inherit property within a jurisdiction.[96]

[91] United States Glue Co. v. Town of Oak Creek, 247 U. S. 321, 328-329 (1918).

[92] Crew Levick Co. v. Pennsylvania, 245 U. S. 292, 297-298 (1917).

This decision was recently followed when on May 16, 1938, the Court held the Indiana gross income tax, insofar as it applied to business carried on in interstate commerce, unconstitutional [Adams Manufacturing Co. v. Storen, 304 U. S. 307 (1938)].

[93] Alpha Portland Cement Co. v. Massachusetts, 268 U. S. 203 (1925); Cheney Brothers Co. v. Massachusetts, 246 U. S. 147 (1918).

[94] Henneford v. Silas Mason Co., 300 U. S. 577 (1937).

[95] McGoldrick v. Berwind White Coal Mining Co., 309 U. S. 33 (1940); Nelson v Sears, Roebuck & Co., 312 U. S. 359 (1941).

[96] Philip Nichols, *Taxation in Massachusetts*, p. 36.

Impairment of the Obligation of Contract. The federal constitution provides that no state shall pass any law impairing the obligation of contracts.[97] Thus, if a state or municipal bond containing a tax-exemption clause has been issued, the state may not subsequently change its mind and decide to tax the bond or the interest therefrom.[98] Similarly, if a local government issues bonds under legislation which requires it to levy taxes sufficient to meet its bond obligation, the tax is irrevocable and may not be lifted by either local or state action.[99] However, state obligations of contract have been impaired and sustained when they came in conflict with other of its powers, such as police or eminent domain.

Discrimination Against Citizens of Other States. The citizens of each state are entitled to all the privileges and immunities of the citizens of the several states.[100] This rules out any attempt to discriminate against the citizens of other states, whether resident or nonresident. Thus, assessors may not assess the property of nonresidents on a standard different from that used for the property of residents. Actually, this discrimination is a common practice. Evidence sufficient to prove intent to discriminate, or a well-settled practice of discrimination, is required to invalidate such an assessment.[101] This protection does not extend to corporations, however, since they are not counted as citizens. Thus, as a rule, the states are free to levy heavier burdens on foreign than upon domestic corporations.[102] But there are decisions which declare such discrimination invalid, particularly when applied to a corporation after it has built up a large business and valuable connections within the state.[103]

Due Process of Law. Mention has been made of the requirements that taxes must not be imposed so as to take property without due process of law. This limitation in the Fourteenth Amendment is applied to the states and is the same in substance as that in the Fifth Amendment, which restricts the federal government. Thus, a chain store tax graduated according to the number of units in the chain has been held not contrary to due process.[104] But one graduated according to the total volume of sales has been held to violate the Fourteenth Amendment.[105] The rule is that where classification is reasonable, the Court will not interfere with the legislature's discretion to

[97] *United States Constitution*, Art. I, Sec. 10, Par. 1.
[98] McCallen v. Massachusetts, 279 U. S. 620 (1929).
[99] Van Hoffman v. City of Quincy, 4 Wall. 535 (1866).
[100] *United States Constitution*, Art. IV, Sec. 2.
[101] Beeson v. Johns, 124 U. S. 56 (1888).
[102] Philip Nichols, *Taxation in Massachusetts*, pp. 35, 43-47. The corporation cannot be required to surrender its rights under the federal constitution, such as freedom from excise taxation on interstate business and from extra-territorial taxation.
[103] Hanover Fire Insurance Co. v. Harding, 272 U. S. 494 (1926); Southern Railway Co. v. Greene, 216 U. S. 400 (1910).
[104] Tax Commissioners v. Jackson, 283 U. S. 527 (1931).
[105] Stewart Dry Goods Co. v. Lewis, 294 U. S. 550 (1935).

set a top limit to the tax. This is true even though the tax may be confiscatory and destructive of the business itself.[106]

The United States Supreme Court has overruled an attempt to tax the income of husband and wife as though received by one person. The Court pointed out that one person's tax cannot be determined by reference to the income of another person. The attempt to collect from the husband on the combined income of himself and wife was held to violate the Fourteenth Amendment.[107]

A clause in a state inheritance tax law under which substantial gifts within six years before death were presumed to be in contemplation of death was held to contravene due process of law.[108]

The main difference in the application of the Fourteenth as contrasted with the Fifth Amendment is that the limitation upon the states may be invoked to invalidate a tax levied on a base beyond the jurisdiction of the taxing authority. In the case of the property tax, tangible property, as a rule, is taxable only where located or customarily kept.[109] Intangible property is usually taxable only at the domicile of the owner. Debts secured by property are not subject to property taxation in the state where the supporting property has its situs, though it has been held that a nonresident mortgagee can be required to pay taxes upon his interest in local real estate.[110] Intangible property is said to have a business situs that makes it taxable in the state in which it is regularly employed in a business.[111]

As has been observed, the situs of shares of stock for death taxes may be at the domicile of the decedent or in the state where the corporation whose shares are passed on is incorporated.[112] In general, jurisdiction in death taxes follows the rule for property taxation stated above.

The jurisdiction in the case of income taxes is a troublesome problem. It is well established that income derived by a nonresident from a source within a state is taxable by that state.[113] On the other hand, it is also well established that all the income received by a resident taxpayer, regardless of its derivation, may be taxed by the state in which he resides.[114]

In the recent Louisiana chain store tax case, the Court held that the state was not going beyond its boundaries when it levied a graduated tax upon

[106] Fox v. Standard Oil Company of New Jersey, 294 U. S. 87 (1935).
[107] Hoeper v. Tax Commission of Wisconsin, 284 U. S. 206 (1931).
[108] Schlesinger v. State of Wisconsin, 270 U. S. 230 (1926).
[109] Union Refrigerator Transit Co. v. Kentucky, 199 U. S. 194 (1905); Delaware, L. and W. Railroad Co. v. Pennsylvania, 198 U. S. 341 (1905); Frick v. Pennsylvania, 268 U. S. 473 (1925).
[110] Savings and Loan Society v. Multnomah Co., 169 U. S. 421 (1898).
[111] Metropolitan Life Insurance Co. v. New Orleans, 205 U. S. 395 (1907).
[112] State Tax Commission of Utah v. Aldrich, 316 U. S. 174 (1942).
[113] Shaffer v. Carter, 252 U. S. 37 (1920).
[114] Maguire v. Trefry, 253 U. S. 12 (1920).

the units of a chain of stores in Louisiana but measured the tax according to the length of the chain throughout the country.[115]

The state has "plenary power" over corporations of its own creation and can impose a franchise tax measured by all the capital stock of such corporations whether or not employed exclusively within the state's borders.[116] On foreign corporations, the state probably must confine such a tax to as much of the capital stock as is employed within its boundaries.[117]

Equal Protection of the Laws. In addition to the due process clause, the equal protection clause is often cited for the invalidation of unreasonable classification.

STATE LIMITATIONS ON STATE TAXATION

There is little uniformity among state constitutions in the rules and limitations they set up for state taxation. In his discussion of this point, Professor Shultz makes the following comment:

> In a few states no constitutional restrictions whatsoever are imposed on state or local taxing power, full discretion being allowed to the legislature in its enactment of tax statutes. At the other extreme is Louisiana, where the entire tax system of the state and local governments is embodied in the state constitution. Occasionally a state constitution will prohibit outright the levy of some particular form of tax; thus the Florida constitution prior to 1930 prohibited the levy of state income or death taxes. More often state constitutions merely prescribe or limit the bases or method of levying state and local taxes.[118]

Summarizing the history of state constitutional provisions, Professor Shultz points out that the earliest documents, written in the eighteenth century, provided only that taxes should not be levied without the consent of the people or their representatives, a provision that sprang from colonial and British experience. Constitutions of the early 1800's ignored the earlier provisions (fear of tyranny having subsided) and provided that taxes must be "equal and uniform." Later constitutions still feature "uniformity clauses" but also contain many additional details concerning such matters as exemptions, property tax limitations, occupation taxes, and so on. The trend during the twentieth century is away from numerous and rigid restrictions; witness the tendency to permit classification as opposed to complete uniformity. More and stricter property tax limitation and anti-gasoline-tax-diversion clauses are a partial counter-tendency, however.

[115] Great Atlantic and Pacific Tea Co. v. Grosjean, 301 U. S. 412 (1937).
[116] Kansas City Railway Co. v. Botkin, 240 U. S. 227 (1916).
[117] Cudahy Packing Co. v. Hinkle, 278 U. S. 460 (1929).
[118] W. J. Shultz, *American Public Finance and Taxation*, 1st ed., p. 271.

The most general of all state constitutional limitations is that which requires that taxes be equal, or uniform, or both. Frequently the clause applies only to property taxes, but in some states by stipulation (Texas) or court interpretation (Georgia) the uniformity provision is applied to other taxes as well. And not infrequently, state courts have held that many taxes, such as income and death taxes, are property taxes.

Uniformity provisions usually require the application of a uniform rate and assessment standard for all taxable property within the same jurisdiction. Differences of procedure based upon plausible grounds, however, are not repugnant to this provision. A few states allow almost any degree of reasonable classification even under a uniformity clause, but this is exceptional. As a rule, classification by complete exemption is permissible.

SUMMARY

Although both the states and the federal government have broad powers of taxation, the latter have certain limitations. Among the general limitations is that taxes must be levied for a public purpose. This is sometimes used to rule out direct government aid to private corporations and individuals and at other times to prevent the states from engaging in commercial enterprises. The lack of clear definition of public purpose has resulted in conflicting court decisions.

Taxation for nonfiscal purposes involves many troublesome legal questions. The difficulty here arises principally because the power of Congress to tax is much more ample than its power to regulate, and sometimes it attempts regulation in the guise of taxation. A federal tax which on its face is an excise, even though its purpose may be regulatory, is permitted, but there are limits in the degree to which this doctrine may be applied. In the Child Labor Tax Case the degree was held excessive and the tax was declared invalid. The processing taxes levied as part of the New Deal recovery measures were also declared invalid on the ground that they were part of a plan of regulation. On the other hand, the social security taxes were sustained, although they are also regulatory. Here, again, the boundary lines of what is and what is not legal are rather hazy.

The federal Constitution includes a number of limitations upon the taxing power of the federal government, of which one of the most important is that direct taxes must be apportioned among the states according to population. This limitation was used to block the federal net income tax until the Sixteenth Amendment was adopted in 1913; moreover, it still can invalidate an unapportioned direct tax which is levied on any base other than net income. Another limitation on the federal government is that indirect taxes shall be uniform, but this has been interpreted to mean only that the taxes shall be generally applicable.

A very important limitation on the federal taxing power, based upon court decisions rather than specific constitutional limitations, is the prohibition of federal taxation of state instrumentalities. The rule also covers state taxation of federal instrumentalities. Both applications are subject to several subtle qualifications. The immunity-of-instrumentalities doctrine has created many special privileges in the tax laws, and it is doubtful that it was ever required to protect the sovereignty of governments. The doctrine has a long history, but there are some indications that the Court is moving toward a negation of this unfortunate legal development.

The federal Constitution also imposes several limitations upon the taxing power of state and local governments, including the due process clause which has been interpreted to rule out extraterritorial taxation (beyond the borders of the taxing unit) and arbitrary uses of the taxing power. By implication states are also prohibited from taxing interstate commerce, a restriction which has been difficult to interpret and fruitful of litigation.

Finally, state constitutions frequently impose certain limitations upon state power to tax. By far the most common and important of these is that requiring uniformity in property taxation and occasionally in other taxes. Frequently this eliminates the possibility (without amendment) of state income and classified property taxes.

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CHAPTER XX

Tax Exemptions

INTRODUCTION

Taxation is a "game" in which the exceptions are quite as important as the rules. Having already discussed the rules, we shall in this chapter examine the exceptions which, in the terminology of taxation, are better known as exemptions.

Although exceptions are often warranted, the presumption is in favor of uniformity. It is not always realized that exemptions are but a form of classification. Oddly enough, the uniformity clauses in some state constitutions are not interpreted to restrict exemptions. At any rate, exemption, like other classification, should be reasonable and be based on significant distinctions. The exemption of the French nobles from the taxes of eighteenth-century France is a classic example of unreasonable classification.

The presumption in favor of uniformity rests not only upon considerations of equity but also upon the practical consequences of exemptions. The exemptions reduce the tax base, thus necessitating higher rates upon the remainder. In many cases this creates a high fixed charge upon the taxpayer which may much embarrass him during adverse periods. In addition, special exemptions are likely to lead to unfair competition. This occurs when some competitors are exempt and others are not. All these consequences of exemption generally incite taxpayers to avoid or evade the tax, which considerably complicates its administration.

Exemptions are sometimes defended on the theory that all taxes are shifted anyway—that no matter where the pressure is applied in the economic system, it will be conveyed to other parts and thus the burden completely diffused throughout the system. This diffusion theory of taxation has been discussed in an earlier chapter.[1] Actually, it has never been demonstrated that all taxes are shifted, even in the long run. Moreover, if one were to assume that all taxes are shifted, they would still leave behind so many collateral effects that the presumption in favor of uniformity would still be valid.

[1] See Chap. VI.

What exemptions lack in logical strength may be compensated for by their political appeal. In many cases tax exemptions have much in common with political spoils. Often they result in a very appreciable benefit to a relatively few through a scarcely appreciable addition to the tax burden of a large number. An exemption which benefits lodges, for example, may be supported by an eloquent demand from the Masons and Elks. The small increase in taxes on the property of others is not likely to cause much alarm. The added burden from a single exemption is quite imperceptible. But following this, there are certain to be like requests by similar groups and, if the process is repeated often enough, the taxpayers may find that the cumulative effect of many exemptions is quite perceptible.

Anyone who has observed legislatures in action will support the conclusion that new exemptions of one sort or another are relatively easy to maneuver into the tax laws and that, once on the statute books, they tend to remain there.

GOVERNMENT INSTRUMENTALITIES EXEMPT

Principles Upon Which Such Exemption Is Based

Exemptions may be classified in several ways. The following classification is based upon the purpose of, or reason behind, the exemption. The most common of the classifications is found in the practice of governments to exempt their own property and instrumentalities from taxation. They may also exempt the property and instrumentalities of other governments. Combined, these exemptions run into billions of dollars' worth of property.[2]

Violation of Sovereignty. One of the important principles upon which these exemptions are based is the legal doctrine, long asserted in the United States, that for one government to tax the instrumentalities of another is a violation of the latter's rights of sovereignty. This doctrine applies only between the federal government and the states; the relationship among the states is that of separate political entities; as between the states and their municipalities, the latter are legal creatures of the former and thus in a subordinate position. An account of the origin, development, and many applications of this doctrine will be found in Chapter XIX. Suffice it here to say that this doctrine is responsible for the exemption of the interest on state and municipal bonds from federal income taxation; of interest on federal bonds (including federal corporation bonds) from state and local taxation; of the earnings of municipal enterprises (such as waterworks) from federal income taxes, and of federal enterprises (such as the T.V.A.) from state income and state and local property taxes.

[2] Exemption of publicly owned real property in the State of New York alone for the year 1933 amounted to $4,923,874,821.

The Pocket-to-Pocket Theory. Another theory which leads to the exemption of public property and instrumentalities is that taxing such property and instrumentalities is merely taking money out of one pocket and putting it into another. On this theory many state governments exempt from income taxation the salaries of state and municipal employees and the interest on their own state and municipal bonds. The federal government until 1940 also completely or partially exempted from income taxation the interest on many of its bonds. Thus the interest on the enormous quantity of liberty bonds issued during the First World War was exempted from the normal federal income tax and to a certain extent also from the surtax. With the difficulty of refunding huge amounts during the depression years of the early thirties, the government was loath to limit tax exemption for fear that such action might affect adversely the market for its bonds. It was thought that some change in attitude might be anticipated once the major refunding operations were successfully completed.[3] This expectation failed to materialize until 1940, when newly issued bonds were made fully taxable. The exemption privilege attached to outstanding bonds is protected by contract and can be eliminated only when these bonds are refunded. Fortunately, the amount of federal securities thus exempt is relatively small.

The pocket-to-pocket theory is not legal but economic in character and its authorization is statutory or contractual rather than constitutional. For example, governments seek to improve their credit by issuing tax-free bonds and argue that their saving in interest approximates their loss in taxes as a result of the exemption. It may be argued that it is a useless procedure for the state to tax the salary of a professor paid by its university; that it would be simpler to calculate the annual value of this privilege and pay the professor that much less; that indeed without any calculation the forces of competition, supply, and demand will bring about an equitable result.

Legislature Restricted in Taxing Officers of Co-ordinate Branches of Government. There is still another theory which prescribes some exemption of public property and instrumentalities. This is that one department of government cannot impose a tax upon the compensation of the present officers of a co-ordinate branch of government. Thus, a federal tax on a federal judge was held invalid because it diminished his compensation while in office.[4] Franklin D. Roosevelt was the first United States President to pay an income tax on his presidential salary. Similarly the recent appointees to the Supreme Court are the only justices who have had to pay the federal tax on their salaries as judges.[5]

[3] *Taxation of Government Bondholders and Employees: The Immunity Rule and the Sixteenth Amendment*, U. S. Department of Justice, Washington, 1938, Chap. VII.

[4] Evans v. Gore, 253 U. S. 245 (1920).

[5] Double Taxation, House of Representatives, Preliminary Report of a Subcommittee of the Committee on Ways and Means, U. S. 72nd Congress, 2nd Session, 1933, p. 49. See also Chap. XIX.

These theories form the legal and economic basis of our tax-exempt security and public utility problem, of which so much has been heard in recent years.

Quantitative Aspects of Tax-Exempt Securities

As a result of recent action by the federal government making new issues of federal securities taxable under the federal (but not the state) income tax, the tax-exempt security problem now lies mainly in the exemption of the interest on state and local bonds. Although the total amount of these bonds is much less than that of federal bonds, it is far from negligible. According to recent Treasury testimony, there were about 20 billion dollars' worth of such bonds in existence on June 30, 1941, and of these nearly 6 billion dollars' worth were in the hands of tax-exempt institutions such as mutual savings banks and state and local trust funds. About 7.8 billion dollars' worth were in the hands of individuals. The distribution of these individual holdings is not known. A study of estates compiled from *Statistics of Income* showed that, of estates over $1,100,000, more than 15 percent was in tax-exempt bonds in 1940. The figure does not show the effect of recent increases in income tax rates.[6]

Although tax exemption from state income taxes is less important (due to lower rates and a less universal tax) than that from the federal levy, the enormous increase in federal debt makes the state problem of considerable and growing significance.

Arguments Against Tax-Exempt Securities

Loss of Revenue to the Government. Those who oppose tax exemption of securities argue first of all that it is a "bad bargain" for the government. However, whether governments lose more in taxes than they save in interest by tax exemption has never been definitely established. It is a difficult matter to prove one way or the other. The proof involves assumptions concerning both the ownership of securities and the effect of tax exemption upon bond interest rates, neither of which can at present be definitely established.

A study by a New York legislative committee, after a careful investigation, concluded that the alleged compensatory advantage claimed for the government to offset the loss of revenue through exemption is of very uncertain and questionable validity. The committee was of the opinion that the elimi-

[6] Statement of Randolph E. Paul, before the Ways and Means Committee of the House of Representatives, Apr. 16, 1942. Of the federal public debt outstanding on June 30, 1941, only $4.07 billion was exempt from both normal and surtaxes. Some $26.6 billion of securities in private hands were exempt from the normal tax only, and an additional $1.1 billion of wholly tax-exempt Federal Land Bank and Joint Stock Land Bank bonds were outstanding (*Annual Report of the Secretary of Treasury, Fiscal Year Ended June 30, 1941*, p. 629).

nation of exemption would represent a saving to government.[7] A British Committee, investigating the matter, also concluded that tax exemption is a losing proposition for the government.[8] On the other hand, other studies have concluded that the interest rates on government bonds would need to be materially increased if the income from them were taxed and that the loss to the government might equal or exceed the gain.[9] For instance, it has been claimed that an exemption from $15,000,000 worth of state taxes may save the federal government $30,000,000. Just why the buyers of bonds should pay more for the exemption privilege in reduced interest than it is worth to them in reduced taxes has not been satisfactorily explained, but it has been freely contended to be a fact. It seems more plausible to conclude, as have the Canadians and the British, that tax exemption costs the government some net loss but the amount cannot be stated with any assurance.

As long as a nation borrows internally, it does not impoverish itself. The case is analogous to one member of a family borrowing from another. The financial resources of the family are not weakened by the transaction. For instance, although before the Second World War the British government with its large internal debt spent about 25 cents out of every dollar it collected for debt service, actually the burden was not as heavy as it appeared, for a large part of the national income subject to the British income tax was interest from government securities. Thus a considerable portion of the money paid out as interest comes back as taxes. This circular flow is not as inclusive in the United States because of the large amounts of tax-exempt securities. The decision of the federal authorities to make the interest on new borrowing subject to tax brings our own situation much more in line with the British than has been the case heretofore.

There can be little doubt that the tax exemption of salaries at least is a losing proposition for the government. One must have great faith in the efficacy of competition to accept the view that government employees are paid a lower salary than would otherwise be paid them because of the privilege of exemption.

Incompatibility of Tax Exemption with Graduation of Taxes. The second argument against tax exemption of securities and salaries is that it is incompatible with the principle of a graduated income tax, under which all are supposed to be rated on their full ability to pay. Tax exemption is worth much more to some than to others. To the man who has too small an income to pay an income tax it would have no value at all. To the man whose income falls in the top brackets an investment in government bonds yield-

[7] A Preliminary Report of the Special Joint Committee on Taxation and Retrenchment, *Tax Exemption in New York*, Legislative Document No. 86, Albany, 1927.

[8] *Report of the Committee on National Debt and Taxation*, H. M. Stationery Office, London, 1927, p. 57.

[9] C. O. Hardy, *Tax Exempt Securities and the Surtax*, Chap. IV; H. L. Lutz, "Tax Exempt Securities and Local Financing," an address delivered before the One Hundredth Annual Meeting of the American Statistical Association, 1938.

ing 3 percent may result in as much net income after taxes as an investment in common stocks yielding 25 percent. Thus the exemption creates an attractive loophole for the evasion of high surtaxes. Expressed conversely, a government bond which yields 3 percent to one person may be sold to another upon conditions which make it yield an equivalent to 25 percent. This is criticized on the ground that it constitutes a sort of "class price" in the sale of bonds.

How much of the large fortunes is invested in tax-exempt securities is another disputed matter. During the early twenties, studies revealed that most of the tax-exempt securities were owned by people paying little or no income taxes and that, among taxpayers with incomes over $1,000,000, only 2.2 percent was obtained from tax-exempt securities.[10] In explanation of these facts it was submitted that the ownership of common stock carries with it the control of strategic points in the economic system, control which the wealthy families might hesitate to abandon. However, there is a limit to what one can afford to pay for control, particularly since higher surtaxes, more tax-exempt bonds, and fewer opportunities for profitable private investment have aggravated the problem.

Tax Exemption Produces Objectionable Nonfiscal Effects. The third argument against tax-exempt securities grows out of the second. It is said that the combination of high surtaxes and abundant tax-exempt securities has produced certain undesirable nonfiscal effects. Because of the low rate of interest from government bonds, many who can ill afford to gamble are tempted to invest in more risky securities, including common stocks, whereas others who can and should do the risk-bearing for society are persuaded to invest in the relatively riskless government bonds. The conservative investor of small means, who prefers government securities, suffers a loss of income because the interest, due to tax exemption, is lower than would otherwise be the case. Income from investments may be very important for those who must live upon small savings. Those who seek security through insurance or annuities also suffer since some of their funds are invested by the insurance companies in low-yielding government bonds. On the other end of the scale it is contended that the tax-exemption policy will likely result in a shortage of capital for the very risky investments.[11]

The tax systems of Great Britain and the United States form an interesting contrast in their treatment of the risk-taker as distingished from the nonrisk-investor. The British system affords advantages to the risk-taker in that capital gains and losses under the income tax are ignored and the top surtax rates have been more conservative than those of the United States. In addition, the latter country exempts many nonrisk government securities

[10] C. O. Hardy, *Tax Exempt Securities and the Surtax*, p. 62.

[11] For a more complete statement of this argument see Henry C. Simons, *Personal Income Taxation*, Chap. VIII.

from income taxation whereas Great Britain does not. The British may have overdone their solicitation for the entrepreneur, but on the whole their policy seems wiser than that of the United States.

Tax-Exempt Securities Involve a Subsidy to the States. Finally, insofar as tax-exempt bonds consist of state and municipal securities, it is contended that the exemption feature results in a federal subsidy to the states. The states are able to borrow at reduced rates of interest because of tax exemption and the federal government pays for the advantage with reduced tax receipts.

The states may render some return for this in their exemption of federal securities from state taxes. State net income taxes, however, are not universal and carry very moderate rates compared with the federal schedule. State taxes upon intangible property, which are also affected, are not well administered. The balance of gain and loss from this intergovernmental exchange of privileges is very obscure and depends upon all the vagaries in calculating the effects of tax exemption previously explained. Assuming that the balance is in favor of the states, the subsidy is thought to be particularly unfair because it is distributed to reward those states and municipalities which go in heavily for borrowing. Moreover, while municipal credit has legitimate and important functions, it is doubtful if its use needs encouragement by federal subsidies.

Arguments for Tax-Exempt Securities

Increased Cost of State and Local Credit. Spokesmen for the states and cities argue that the elimination of tax exemption would result in increased cost of borrowing and that this would further aggravate an already acute property tax problem. It is doubtful, however, if the credit of these government units would be seriously impaired by a surrender of a privilege which they have enjoyed for only thirty years and which many other countries do not afford. If a subsidy for state and local borrowing is required, it might well take the form of a direct cash grant.

Interference with State Sovereignty. It is argued that the inclusion of interest on state and local bonds in the federal income tax base would involve a dangerous shift of power from the states to the federal government. Federal control would be enhanced by the fact that it could tax some state and local bonds and not others. This is answered with the proposition that no authority to levy a discriminatory tax is sought.

Breaking Faith with Investors. Finally, it is argued that those who have invested in tax-exempt government securities ought not to be subject to a change in rules in "the middle of the game." But the force of this argument is weakened by the fact that many present owners of bonds acquired their holdings when federal taxes were much lower than they are now.

Means of Eliminating Tax-Exempt Securities

The way to eliminate tax-exempt securities in the case of governments that both issue and exempt securities is for these governments to forego further issuance with the exemption privilege. Exemptions included in existing contracts are unavoidable until such contracts expire.

In the case of state and federal taxation of each other's securities there are long and formidable legal precedents with which to cope. However, the Supreme Court might, in accord with the recent trend of its opinions, reverse these precedents. The Court should be given a favorable opportunity to do this. The alternative is a constitutional amendment, which would be difficult to secure because the states—particularly the non-income tax states —appear to profit by the existing arrangement.

Taxation of Federal and State Enterprises

More difficult, perhaps, than the problem of tax-exempt securities is that of tax-exempt federal and state enterprises. Municipalities would regard any attempt by the federal government to include the earnings of municipal undertakings in the base of the federal income tax as very menacing to their status. But the present exemption is open to grave criticism in that it encourages municipalities to "take over" private enterprises to avoid the federal income tax. On the federal side, projects like that of the Tennessee Valley Authority involve a difficult taxation problem for state and local governments. Congress permits certain "federal payments in lieu of taxes" to compensate state and local units in the Tennessee region for their loss of tax base because of the federal project. The payments take the form of a percentage of annual gross proceeds from commercial power sales. Under the present plan, the percentage is to diminish from 10 in 1940 to 5 in 1948 and subsequent years. The diminishing scale is to permit gradual fiscal adjustment and to keep the distribution more or less at current levels as revenues increase. The program confines payment to the revenue-producing part of the development and aims to replace all actual property tax losses; it does not aim to render a full tax-equivalent payment on the entire project. Some relatively small payments are also made on the Boulder Dam project but not on other federal power developments.[12]

Taxation of Federal Property

Even before the Second World War, the federal government owned extensive amounts of real estate exempt from the property tax. These holdings have greatly increased during the Second World War. Congress may provide for payments in lieu of taxes to compensate local units of govern-

[12] *Federal, State, and Local Government Fiscal Relations*, U. S. Treasury, pp. 290-292

ment for a depleted tax base or for other reasons. The policy of Congress in this respect has been highly opportunistic, inconsistent, and undependable. Some public housing projects pay nothing to the municipality which provides them service; others make substantial payments. A legal aspect of this problem, often overlooked, is that some federal projects involve federal jurisdiction (like the District of Columbia) and that such jurisdiction may relieve state and local governments from any obligation to provide services.

It would be very helpful if a few simple and universally applicable principles could be agreed upon for use in making payments in lieu of taxes, but this is not an easy matter. For instance, in the case of certain public property, like post offices, most critics would probably hold that no useful purpose would be served by placing such property on the tax rolls. On the other hand, were the federal government to acquire the railroads, it would seem quite essential to settle with the states for their loss of tax base. In the case of federal housing, where some local contribution to a semi-philanthropic project is expected, the problem is especially difficult. If the local contribution takes the form of tax exemption, this may result in a prolonged and pronounced hostility from local taxpayers, very prejudicial to the success of the project.

Some recognition must be given for the benefit bestowed on a community by the location of a federal project. But the location of all functions, public and private, is usually beneficial, and it does not follow that the function should be tax-exempt. There may be exceptions, however, where federal programs assume functions which might otherwise have to be performed by state or local public agencies, financed by general taxes or special assessments. Flood control and reclamation activities are examples.

More important by far than any single set of rules and principles for guidance in determining payments in lieu is the development of some machinery by which such rules can be established, revised, and used effectively. In other words, what is needed is a clearing house for payments-in-lieu proposals and an agency to hear complaints. The field of payments in lieu of taxes is one of the least satisfactory in intergovernmental relations. Our own government is more conservative in allowing intergovernmental taxation than most. Properties owned and occupied by the British national government are not subject to local property taxation in England, but the Crown makes a contribution, equivalent to the tax, to the local government.[13] Municipalities in turn are taxed under the British income tax, both upon the earnings of municipal undertakings and the "annual value of municipal buildings." [14]

[13] Frank B. Murdock, "The English Rating System," *Bulletin of The National Tax Association*, Vol. XXI, No. 5, Feb. 1936, pp. 137-143.

[14] See H. B. Spaulding, *The Income Tax in Great Britain and the United States*, P. S King and Son, Ltd., Westminster, 1927, p. 152.

Intergovernmental Taxation of Sales

As indicated in a previous chapter, the status of federal instrumentalities under the sales tax is still in much doubt. There are frequent provisions in the statutes to the effect that "sales or businesses which the state is prohibited from taxing" are exempt. Other state laws exclude sales made to the United States Government or its agencies. By administrative ruling the sales made to a contractor on a government job have been held taxable in Illinois,[15] nontaxable in Mississippi. On the other hand, sales made by (rather than to) a government cafeteria have been held exempt even when to a customer who is not a government employee. The taxability of purchases of government contractors under the state and local sales and use taxes became an issue of considerable moment during the Second World War. The Supreme Court held that, in the absence of congressional declaration to the contrary, purchases by cost-plus-fixed-fee contractors engaged on government contracts are subject to federal and state sales taxes.[16] Apparently much depends on whether the impact (legal incidence) of the tax is on the government either as vendee or vendor.

EXEMPTION OF EDUCATIONAL, RELIGIOUS, AND OTHER SIMILAR ORGANIZATIONS

Most states exempt educational, charitable, benevolent, and religious institutions from property taxation and also allow the deduction of contributions to these institutions in calculating income for income taxes. Sales to these organizations are also sometimes exempt from sales taxation. These exemptions are defended on the ground that these undertakings are nonprofit-making and that they perform services which the state would have to perform were they not in existence.[17] Space will not permit an analysis of the arguments for and against all exemptions of this sort. The quite prevalent exemption of lodges may be cited to exemplify the liberality with which the term "benevolent institution" is sometimes interpreted. It is true that the lodge building may be nonprofit-making. So are the homes which serve as shelter for millions of citizens. It may be true that lodges perform a good and useful function. So do country clubs and grocery stores. It is true that

[15] Robert Murray Haig and Carl Shoup, *The Sales Tax in The American States*, Chap. XIV; this position has also been supported by recent court decisions. See Chap. XIII of this book.

[16] Alabama v. King and Boozer, 314 U. S. 1 (1941).

[17] In addition to religious organizations, educational institutions are: temperance associations, medical associations, bar associations, fraternal organizations, and property of ministers, priests, and other unenumerated groups.

lodges which are mainly social perform some incidental charities. So do the homes, for that matter.[18]

At one time the courts in Wisconsin drew a line between the Masons and Elks, holding the former to be a charitable institution and the latter not.[19] More recently, all fraternal societies operating under the lodge system in that state have been specifically exempted.

In England charitable institutions, hospitals, and the like, are taxable on the theory that this is necessary for equality. These buildings are used by people not living in the district in which the buildings are located, and the district should not have to bear the entire expense of serving these properties.[20]

EXEMPTION TO ENCOURAGE ECONOMIC ACTIVITY

Forms of Special Inducement to Industry

One of the most prevalent forms of tax exemption in the United States is that of new industries. These are exempt in order to attract them to a particular city or state. During recent years this form of exemption has assumed greatly increased importance. States are not allowed to adopt tariffs in order to preserve the home market for their own producers, but they may offer special favors to industry as an inducement for its location or expansion. Tax concessions are only one among the many inducements offered to industry by cities and states. The others include cash bonuses, loans, donations of site and building or their provision at nominal rentals, guarantees of favorable labor conditions, and so on. Sometimes these inducements are offered by municipal governments without legal authorization, which makes the municipal officials personally liable for misappropriation of funds, but usually no great hazard is involved if the action has strong sanction from local public opinion. At least one state, Mississippi, at one time legally sanctioned public borrowing and the expenditure of public money to buy or build industrial

[18] In denying an exemption to the Order of Elks, the Missouri Supreme Court in a classic decision said: "Charity is not a promiscuous mixer. Here she modestly stands outside or goes her way and waits; waits until the plaintiff (Elk's lodge) has finished using the spacious and comfortable rooms for the pleasure of its members; waits until the curtain has fallen upon the last scene of the vaudeville performance on the stage; until the dancers have tired and gone home; until the billiard rooms have been deserted to the markers; until the plaintiff has paid the cost of its own entertainment, and goes out and finds her, and hands her whatever it may have left in its own pocket. She gets not the use of the premises, but what remains of income to the owners after they have used it in carrying out the injunction of their organic law, by promoting their own welfare, enhancing their own happiness, and cultivating their own good fellowship among themselves" [St. Louis Lodge No. 9, B. P. O. E. v. Koeln, 262 Mo. 444, 448 (1914)].

[19] Trustees v. Green Bay, 122 Wis. 452 (1904).

[20] Frank B. Murdock, "The English Rating System," *Bulletin of The National Tax Association*, Vol. XXI, No. 5, Feb. 1936, pp. 137-143.

plants for the purpose of leasing them to private industries on terms approved by the State Industrial Commission and "in accord with the public welfare." This law was sustained by the supreme court of Mississippi.[21]

In the more limited field of tax concessions, several states permit municipalities to exempt new industries for a period of five to fifteen years.[22] The exemption may be from local taxes only but it may include state taxes as well. Exemption may be by contract with the state, or mandatory by state legislation, or by specific action of the municipality, usually with a favorable referendum vote. Exemption may include buildings only, or land and buildings, and may apply only to new construction, or also to old property under new ownership. State laws of this kind are prevalent in New England and in the South. Though nothing new, their use during the depression of the thirties was much more common than formerly. Outside of these areas the practice of granting tax concessions to new industries is not authorized by law and indeed is strictly forbidden in several states. But it is quite widespread in practice, particularly among the smaller cities.[23] The industries which have been most amenable to special inducements are the textile and shoe manufacturing industries.[24]

Motives of Tax Exemption for Industry

The motive behind tax exemption and other special inducements to industry may be negative or positive. The negative motive may appear in a small city with an industrial population which is left in desperate straits by the failure or removal of an important factory. Without the factory in operation the city is badly demoralized. Hundreds or thousands of workmen seek private or public relief; the real estate market collapses as people leave town or lose their homes; the tax rolls suffer from delinquency; and so on. In such circumstances, a subsidy—whether or not legal—which would bring in an industry or keep the present one operating would likely appeal to a city council as a good investment of public money. The threatened removal of a key industrial enterprise tends to extract generous concessions from the city

[21] *Session Laws of Mississippi*, Special Session, 1936, Chap. I; Albritton v. City of Winona, 181 Mississippi 75 (1938).

[22] Following information is from National Association of Assessing Officers, *Exemption of Manufacturing Plants and Machinery from Property Taxation*, Bul. No. 19, Chicago, 1938.

[23] But see National Department of Municipal Finance Officers, *Tax Exemptions and Abatements Offered by Cities to Attract New Industries*, 1936. This survey of some 80 cities with population over 50,000 found 90 percent reporting that no inducements to new industries were offered.

[24] Outside of New England and the southern states, several states exempt industrial machinery from personal property taxation. Wyoming exempts the sugar refining industry specifically. Many exemptions are extended to agricultural personal property. The purpose here may be to favor a politically influential economic group rather than to seek consciously the promotion of industry. *American City* (Vol. LIII, May 1938, p. 101) reports that 19 states exempt manufacturing machinery.

fathers, who often have the approval of a large part of the electorate for their policy.

The positive motives are more complex. A community may wish for new industries as a matter of pride, or as a matter of improving local business and real estate values, or of increasing the local tax base, or of improving the balance between the rural and urban population and offering more diversified employment opportunities to the people. In the South, particularly, the earnings in agriculture are so low that almost any opportunity for industrial employment, even at low wages, seems an important advantage. Here is a case where the arguments for the protective tariff, especially the infant-industries argument, are applied on a small scale.

The Supreme Court, in a famous case,[25] decided that direct subsidies for industry involved expenditure of public money for a private purpose and therefore were illegal. As a matter of fact, in some industrial cities the retention of the local factory may seem a public purpose of the first order.

Consideration of State and Municipal Policy in Granting Tax Exemptions

Nonuniversality of Exemptions. Is it sound policy for states and municipalities to grant tax exemptions? Certainly something will depend here upon the universality of the exemption program. If one merchant keeps his store open on Sundays while others are closed, he can make money by so doing. But if all merchants follow the same policy, none of them are benefited. Similarly, if only one municipality were to offer special favors, perhaps it could attract a considerable number of desirable industries. But when favors are universalized, they cease to be effective. The question then arises as to when and where the competition in subsidies will stop.

Effectiveness of Exemptions Questionable. Actually it is impossible to demonstrate conclusively how effective tax exemptions or concessions are in developing industry. There is considerable evidence that states and counties which have gone in heavily for tax exemption have not outstripped their more conservative rivals in industrial development.[26] A study of taxes and manufacturing costs of the metal manufacturing companies of Wisconsin indicated that in 1927 the ratio of state and local taxes to the cost of manufacturing was only 1.65 percent.[27] This is very small compared with an item like wages. There is also evidence that industry itself considers taxes of secondary importance compared with such matters as availability of raw material, nearness to markets, labor cost, transportation costs, and so forth.[28]

[25] Citizens Savings and Loan Association v. Topeka, 20 Wall. 655 (1874).

[26] Claude W. Stimson, "The Stimulation of Industry Through Tax Exemption," *The Tax Magazine*, Vol. XI, Nos. 5 and 6, May and June 1933; Geo. L. Leffler, *Wisconsin Industry and the Wisconsin Tax System*, Bulletins No. 1 and 3.

[27] Edgar H. Auerswald, *The Importance of Taxes to Wisconsin Metal Manufacturing Corporations*, Madison, Wisconsin, 1929 (unpublished manuscript).

[28] Tax Policy League, "Business Migration and Taxation," *Tax Policy*, Vol. IV, No. 12, Oct. 1937.

On the other hand, the advantages of two alternative locations may come close enough to a balance to make a substantial subsidy the deciding factor. At least there are many city council members who think so.[29]

Suitability of Industry Important to Consider. Whether it is sound policy for a municipality to offer special inducements to industry may also depend to some extent upon the suitability and general desirability of the industry. It would be a losing game for North Dakota to encourage a heavy manufacturing industry. The infant-industries argument usually accepts the proposition that eventually industry will be able to stand entirely on its own feet and pay both satisfactory wages and taxes. Industry will not eventually become self-supporting unless it is reasonably well-suited to its environment. Some industries, called "hobo" industries, have had undesirable leadership and have specialized in very speculative ventures. These industries make a racket out of municipal inducements. Advantages granted to such concerns are likely to prove one-sided arrangements, with the municipality getting the short end.

Exemptions Are at the Expense of the Nonexempt. It should be observed that tax concessions and other inducements are at the expense of the taxpayers who do not receive them. In some cases they may be at the expense of those who compete directly or indirectly with the recipients of favors. In any event they are at the expense of the general taxpayer—the homeowner, wage earner, merchant, professional man and, to a lesser extent, the farmer. These people may all stand to gain in the long run by the industrial development which the inducements seek to foster. At all events, these taxpayers are the ones who meet the immediate cost of concessions to industry.

Finally, municipalities need to consider both sides of the balance sheet when deciding on special inducements. New industries may involve not only tax concessions but also a large amount of additional public expenditure, particularly if a new labor supply must be imported.[30]

Undesirable Social Consequences of Tax Exemptions. From the social and general point of view it can be categorically stated that tax concessions and other special inducements extended to industry by specific municipalities and states are very undesirable. Concessions and inducements might conceivably be supported by the infant-industries argument. But industry has

[29] A small city newspaper editorial expressed its sentiments as follows: "It takes money to attract industry! With cities all over the country holding out large morsels as tempting bait, every industry is an economic sucker, if it does not seek a city which gushes forth alms in order to get the company to locate there" (*South Milwaukee Journal*, Apr. 4, 1938).

[30] Some cities are committed to the policy that special inducements are a losing proposition. This attitude is expressed in a reply to an inquiry concerning inducements sent out by the National Association of Municipal Officers: "Up to the present the local government has taken the position that any enterprise without financial backing enough to enable it to move to a good town, might be undesirable and may, if properly financed, go on the rocks and leave its workers subjects for relief. In plainer words if you can't pay your railroad fare, stay where you are, and if you do come, be prepared to pay your share of the cost of local government" (National Department of Municipal Finance Officers, *Tax Exemptions and Abatements Offered by Cities to Attract New Industries*, p. 2).

had no trouble getting started in new territory in this country where the conditions were favorable to its growth. Exemption tends to provoke retaliation and further exemption in an unending cycle. Migration of industry is likely to leave much human disaster in its trail because in many cases labor cannot follow the factory. Exemptions to particular property owners are demoralizing to those who continue to pay taxes. Tax exemption means a subsidy paid by the entire community and it is very doubtful if all taxpayers have a proportionate stake in the benefits. By and large it would seem reasonable to conclude that natural rather than artificial advantages should be the determinants in locating industries.

Conclusions. If states and municipalities are to follow a program of tax exemption and tax favoritism, they should at least show discrimination in choosing the beneficiaries of such a policy. In making the decision to embark upon such a program they should consider their long-run interests. They might better leave the field of promotion to private organizations, which can be helpful in aiding new concerns raise equity capital and in giving advice to investors. Promotional tax programs, if any, should be confined to the federal government. Such assistance would ensure that new concerns have roots in the local community; it would be clearly within the law; and it would help new small enterprises where they most need aid.

Taxing Land and Exempting Improvements to Encourage Industry

A somewhat different use of the encouragement-to-industry doctrine is made by the "single-tax" advocates who hold that, in order to encourage industry and progress, all personal property and improvements should be exempt from taxation. They regard the economic rent of land as uniquely unearned; its payment to landowners is not required to stimulate useful activity and thus economic rent can be taxed without discouraging production. This proposition was considered in greater detail in an earlier chapter. Here it may be observed that public revenues were undermined by very heavy tax delinquency during the depression of the thirties and it may be asked what the fiscal problem would have been had governments exempted over half the property tax base from all taxation. Nevertheless, as an antidote to migration and as a developmental tax policy, some differentiation in the property tax base favorable to improvements might well be considered.

EXEMPTION OF A MINIMUM TO COVER NECESSITIES

Exemptions based on a minimum standard of living are most common in the income tax field, but they are also found in property and sales taxation. Homestead exemptions in the property tax field are based partly upon

the idea of leaving a minimum free from tax. The exemption of food under the sales tax can be placed in the same category. They are defended on the ground that taxpayers with very low incomes have no ability to pay and that levies upon the necessities of life result in unfortunate social and economic effects. Homestead exemption creates some doubtful discrimination as between tenants and homeowners. Exemption of food from the sales tax shifts burdens mainly from one necessity of life to others. Both exemptions are open to important fiscal objections.[31]

Some personal exemption under the income tax is undoubtedly warranted. There would be little point in taxing a relief standard of living when governments are guaranteeing such a standard. However, it seems entirely sound to argue that income tax exemptions in the United States have always been too generous. If it were possible to get enough money to operate all governments by taxing only the higher brackets, much could be said in favor of this policy. Actually, what is done in lieu of reducing exemptions in the income tax and imposing higher taxes on the lower brackets is usually to resort to inferior forms of taxation—notably, the sales tax. It is politically unpopular to reduce exemptions and to tax the lower brackets. This would require large numbers of people to pay the kind of taxes they feel most, that is, direct taxes. Because the people in the United States are not "up to" this kind of tax discipline, they clutter up the tax system with measures that are indefensible on any principle except that of expediency.

EXEMPTIONS FOR ADMINISTRATIVE REASONS

Difficulties of administration account for another class of exemptions. There are certain types of property which constantly evade the property tax or which are grossly underassessed when reached at all. Experience has repeatedly demonstrated that from the administrative standpoint the general property tax without exemptions is a dismal failure. It is said that discretion is the better part of valor. Exemption of what cannot or will not be adequately assessed is defended on the ground that this policy at least salvages some respect for the property tax. It is mainly on this theory that household goods are singled out for property tax exemption.

Inability to assess is one valid consideration in determining what shall be legally exempted from taxation. It is a question of judgment whether more attention should be given to improving administration in the expectation of getting the object on the tax rolls or whether the effort should be abandoned in favor of complete exemption. In making this decision some weight may be given to other elements in the tax system. For example, in the case of

[31] Homestead exemptions are discussed in more detail in Chap. V; sales tax exemptions in Chap. XIII. In lieu of a homestead exemption some partial or complete exemption of housing is possible. This also is discussed in Chap. V.

motor vehicles, property tax assessment of which is generally bad and difficult, the fact that the motor vehicle license tax already reaches all car-owners for some tax may weigh the balance in favor of exemption from the personal property tax. On the other hand, the administration of the tax may be greatly improved by requiring a personal property tax receipt as a condition for granting a license.

EXEMPTIONS TO AVOID DOUBLE TAXATION

Still another class of exemptions is based on the contention that the exemption avoids double taxation. This is the basis for exempting credits in many property tax laws and for exempting dividends received by the stockholder under the income tax. The contention is that the debtor and the corporation pay a tax on certain property and income and that to tax it again amounts to taxing twice the same ability to pay, once in the hands of the creditor or the stockholder and once in those of the debtor or the corporation. This view is widely accepted even among economists, but it raises many perplexing questions, some of which have been considered in the chapters on property and income taxes.

CONCLUSION AND RECOMMENDATIONS

Many jurisdictions appear to be burning the financial candle at both ends. They are constantly spending more money and increasing the public debt at the same time that they generously bestow exemptions on the taxpayer. Sometimes, as a result, they are forced to resort to taxes which are of doubtful soundness and equity. Sometimes they are simply continuing in hopes that their day of reckoning will not come. In either case they will probably come to regret that they did not better conserve their bases of taxation.

By way of recommendation it can be said with assurance that we should have more and better statistics concerning exemptions in taxation. For example, many states never list or estimate the nature and value of property which is legally exempt from assessment. It is important for the legislature and the public to have this information. In addition, it is clear that legislatures should have the power to classify property and apply different rates to different classifications. Instead of exempting certain property, such as real estate owned by lodges, the legislature should have and should consider the alternative of applying a low rate to such property so that it may render some equivalent for the services it undoubtedly receives from government. Finally, the point may once more be stressed that there is a strong presumption in favor of uniformity in the application of taxes. Exceptions and dif-

ferences of treatment are necessary, to be sure, but in our era, when adequacy of revenue is of such great importance, more restraint should be urged in granting exceptions to the tax laws.

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CHAPTER XXI

Intergovernmental Fiscal Relations[1]

DEVELOPMENT OF THE PROBLEM

The growing importance of intergovernmental relations in taxation is easy to explain. The Constitution allowed much overlapping taxation, but this developed slowly. For many years the federal government subsisted largely on customs and then on customs and excises, while the states and municipalities relied for revenue on the general property tax and business taxes. Because of the need for expanded revenues at both levels of government, a wide overlapping of fiscal sources has developed in recent years. All of the states tax alcoholic beverages, motor fuel, and motor vehicles; about two-thirds tax income; and well over half impose excises on tobacco. All these sources are also used by the federal government. This has created many problems, the most obvious of which is overlapping administration by at least two layers of government, and additional cost of compliance to the taxpayer. No major source of tax revenue initiated during peacetime has been relinquished by the federal government to the states, or vice versa.

Problems of valuation, jurisdiction, apportionment, and overlapping business taxation are created by the development of mammoth corporations. A high degree of economic interdependence has developed, taking myriad forms of which the most obvious are interstate trade, travel, communication, migration, and the nationwide circulation of magazines and newspapers. What was once merely a local concern for government has ceased to be so under modern conditions.

THE CO-ORDINATION MOVEMENT IN THE UNITED STATES

History

Although sporadic manifestations of a co-ordination movement could be observed long before 1917, this date may be chosen as the beginning of the

[1] Based in the main on Committee on Intergovernmental Fiscal Relations, *Federal, State and Local Government Fiscal Relations*, U. S. Treasury Dept., 1943.

active co-ordination movement. Federal wartime taxation was the occasion in 1917 for forming and calling a meeting of the National Council of States. At this meeting attention was called to the gradual federal assumption of tax sources developed by the states, and a general warning was sounded of the dire consequences to follow.

During the twenties, principal interest in co-ordination centered about the efforts of state officials and others to induce the federal government to withdraw from the estate tax field. Congress reduced estate tax rates and enacted an estate tax credit, but it did not provide for repeal of the tax.

During the depression and defense preparation periods, from 1931 to 1941, interest in fiscal co-ordination increased rapidly. The President repeatedly expressed his belief that "no really satisfactory tax reform can be achieved without readjusting the federal-state-local fiscal relationship." The period saw the development of interstate organizations, such as the Council of State Governments with headquarters at Chicago. These organizations devoted much research to the subject of conflicting taxation. The National Tax Association appointed committees in 1933 and 1940 to investigate the subject. Out of these efforts the so-called Graves-Edmonds plan developed, suggesting federal administration of certain major taxes with distribution of part of the receipts on an "equitable basis" to the states. An outstanding report by a Canadian Royal Commission on Dominion-Provincial Relations appeared in 1940, calling for action along lines similar to those proposed by Graves and Edmonds. Both Canada and Australia proceeded during the Second World War to monopolize the administration of the personal and corporate income taxes, sharing the revenue with their states. In the United States a National Conference on Interstate Trade Barriers was called in 1939, and the Municipal Finance Officers' Association presented the problem of fiscal relations from the municipal point of view in 1942. The Treasury sponsored an extensive study of the field by a Committee on Intergovernmental Fiscal Relations, whose report was published by Congress in 1943.

During the thirties, the federal government undertook a large new array of functions to cope with the depression, and the Supreme Court, after some hesitation, accepted the view that the Constitution was flexible enough to permit this expansion.

The co-ordination movement has been led mainly by state officials, with less active participation by scholars and businessmen. It has been characterized by much frustration, wishful thinking, and rationalization, but the efforts expended have brought to public attention a set of problems that are real and urgent.

Complaints and Objectives

The conviction that a real cause for action lies behind the co-ordination movement is strengthened by a listing of the complaints lodged against our

present fiscal arrangements: that overlapping taxes tend to become excessive and are costly as to both administration and compliance; that the states and municipalities are left with inadequate tax resources; that the federal government is embarrassed in extending its tax system to meet emergency needs; that state taxation of a national economic system involves impossible problems of jurisdiction and multiple taxation; that state taxation under modern conditions leads to migration of wealth and industry; that economic resources are so unevenly distributed that state taxation must result in malnourishment for certain services in which there is a national interest; that mandatory expenditures imposed from above have dislocated municipal finances; that intergovernmental instrumentalities escape taxation or are taxed to the prejudice of local finances; and that the tax system as a whole is regressive, repressive, and ill-adapted to such important economic ends as full employment and the maximization of national income.

CO-ORDINATION DEVICES AND INSTITUTIONS

Separation of Sources

The idea of separation of sources is that the federal government use certain levies, the states others, and perhaps the municipalities a third independent set of taxes. The Constitution provides for some separation in that the state governments may not tax foreign trade (tariffs) and the federal government cannot practically levy on general property. For many years this provided the basis for independent revenue systems, but the recent tendency has been toward more and more overlapping.

Factors of Suitability. The achievement of separation of sources may be either by constitutional restriction or forbearance. A new constitutional division would require a major operation and would be difficult also because there is disagreement as to which taxes should be monopolized by which governments. The tax system of the United States, if so it may be called, has grown up with little if any planning. This is true of taxation within a particular state, but even more so of the way the tax pattern of a particular state fits into the national pattern. However, if we could begin again and lay out a system of revenue for the federal government and the states, it would not be easy to draw a satisfactory plan. Much attention would be given to the suitability of the various taxes for use by central or local governments.

Administration. There are several elements in this suitability factor. One is the ease and efficiency of administration. Undoubtedly the federal government can collect a tobacco tax far more easily than the states. It can collect the tax by selling stamps to a few manufacturers, who are required to stamp each package sold. The states may use the same technique of ad-

ministration, but they have a much more decentralized group to collect from—usually the wholesalers and in some cases retailers, the number of which runs to hundreds of thousands. Applying stamps to cellophaned packages is an expensive process. Moreover, states have a difficult problem of evasion arising from the fact that they cannot tax shipments over the borders. It is quite probable that state tobacco taxes are only about 75 or 80 percent efficient (counting both cost and evasion as waste). The federal government has the advantage also in the collection of gasoline taxes, but here the difference is relatively slight. In the case of the income tax the federal government has more complete information concerning taxpayers' incomes than is available to the states. Here, however, the information procured by the federal government can be and is made available to the states. In the case of the property tax and motor vehicle taxes, the states and municipalities have advantages over the federal government. The enforcement of the motor vehicle tax is closely associated with state and local policing of traffic.

Jurisdictional Clarity or Confusion. A second element in suitability is jurisdictional clarity or confusion. This may be a matter of multiple taxation to the taxpayer or confusion to the state as to what are the legal and ethical limits of its right to tax. In the avoidance of jurisdictional difficulties, larger units of tax administration and collection have an important advantage over smaller ones, particularly in a highly integrated economy like our own. The advantage is especially great in the case of the net income and inheritance taxes.[2] The sales tax appears to be relatively free from jurisdictional difficulties but has another problem which arises from the inability of a state to tax sales made over its boundary lines. Even the property tax offers some jurisdictional difficulties. Of course, the federal government is not free from any of these difficulties at its own borders; but the international ramifications of wealth, business, and income, as far as they involve the United States, are much less than those in the states. Moreover, the international difficulties cannot be avoided, certainly not by turning over the administration of more taxes to smaller units of government.

The jurisdictional problem also involves the origin of tax bases. Many such bases cannot be adequately labeled as to origin. It can be argued, for instance, that a large mercantile company might properly be taxed by the political units which correspond with its trade area. Actually, state tax laws usually fail to divide tax bases according to economic facts. A large mail-order house in Chicago may draw business from all the Middle West; yet under state taxation only Illinois can tax it. In case an individual resides in one state or district and draws income from another, the claims of the two jurisdictions must be dealt with. The central units encounter problems of conflicting jurisdiction in lesser degree than their subdivisions, except perhaps in the division of surplus revenues.

[2] See Chaps. IX and X.

Dependability. A third element in suitability is steadiness of revenue. An example frequently cited is that the inheritance tax is an unsuitable source of revenue for municipalities because a municipal inheritance tax would yield bountifully in one year and rather meagerly, or not at all, in another. Besides, since the yield cannot be predicted, the budget-makers would be confronted with uncertain estimates. A larger unit does not face the same difficulty, at least not in a like degree. For the latter, due to the operation of the law of large numbers, the death tax base is fairly stable from year to year.

Competition as a Factor in Suitability. Another element in suitability of taxes to units of government is the degree to which their use becomes a factor in business competition or the competition by territories for the location of business. Reference has already been made to this matter. The taxation of land seems peculiarly adapted to local use because land cannot migrate. The land tax is likely to be capitalized and rest as a burden upon the landlord rather than the entrepreneur. On the other hand, a city or county income tax would be objectionable because it would plunge municipalities into a free-for-all competition resulting in constant reduction of rates or special favors in administration, with a corresponding drop in the fiscal effectiveness of the tax. In its freedom from considerations of competition, the federal government has an advantage over the states. The advantage is particularly important in the case of the income and inheritance taxes. It is also of some importance in the case of business taxes, sales taxes, and even property taxes on personal property and buildings.

Adaptation to Local Opinion. Diversity of tax systems sometimes has the merit that it affords the opportunity for an expression of differences in opinion. This is particularly true in the case of liquor taxes, where the levies are closely associated with regulation or prohibition. Opinon concerning the freedom which should be allowed for the sale and consumption of liquor differs radically in different sections of the country. This was one of the reasons why national prohibition was unpopular and not too successful. Differing liquor taxes afford an opportunity for expression of local opinion regarding the liquor business. To a lesser extent, state income and sales taxes also afford an outlet for differing views as to equality in distribution of wealth and income.

Conclusion. As a small step forward, the federal government, in the interest of separation, might withdraw from the motor vehicle tax field or confine its taxes in this area to a levy on aviation gasoline. The states can administer motor vehicle taxes with reasonable efficiency; these levies are closely associated with the function of providing highways, which is primarily a state and local responsibility.

Deductibility of Taxes

A co-ordination device seldom recognized as such is the *deductibility of taxes* levied by other jurisdictions in calculating the net base of the tax in the taxing jurisdiction. In the United States this is most highly developed in the field of federal and state income taxes, where it (federal allowance for deductibility of state taxes, and in some cases the reverse) materially reduces the total load of the two taxes, diminishes the differentials between income tax burdens in an income tax state and those in a non-income tax state, and avoids threats of confiscatory burdens. It operates to check tax avoidance by migration, although this effect has generally escaped attention. Deductibility operates much like a credit, but it is less drastic as to degree.

Credits

The crediting device permits taxpayers to pay federal taxes with state tax receipts. It is now used to provide some co-ordination in the case of death taxes and payroll taxes. The credit is limited in its objectives; it is an effective antidote for interstate competition but, as used thus far, it has provided little alleviation for the evils of dual administration and compliance, diversities of laws and practices, and multiple taxation. However, the credit could be used for wider objectives. The inheritance tax credit, still attached to a 1926 schedule of federal rates, could at least be modernized and extended to cover gift as well as estate taxes. Use of the credit in the income tax field looks promising but confronts the fact that one-third of the states are opposed to the income tax as a source of state revenue (or can muster insufficient support to amend their constitutions to allow such taxation).

Federal Collection and State Sharing

This is one of the most commonly advocated of the co-ordination devices. It would make dual administration unnecessary and could be used effectively to achieve a completely co-ordinated tax system. This is a device by which the obvious advantages and the superior position of the federal government in tax administration and collection can be utilized without destroying local independence as to expenditures.

The system of central collection and local sharing is attractive for those who attach supreme importance to logical and simple mechanisms, but it encounters impressive objections. It involves a high degree of centralization as to both levies and administration. The fiscal independence of the local units under sharing is about the same as that of a minor son placed upon a revocable allowance by a generous father. Moreover, sharing on the basis of origin (enabling the smaller units to "tap their own resources") encounters not only difficulties of determining origin but also distribution beyond the

point of need in the case of wealthy districts. Distribution on other bases is likely to lack an easily available objective standard and runs the danger of political abuses. Considerable experience with federal sharing in Germany is said to have led to state and local extravagance in the few years of prosperity in which it was applied, and in times of depression it brought maldistribution of funds, since the neediest districts generally received the least. Constant revision was found necessary to keep the system functioning at all.

An overlapping tax situation most favorable for sharing would need to meet the following conditions:

1. State imposition of the tax is fairly general and fairly uniform. Otherwise, the charge will be made that the federal government is forcing the spread of a particular kind of tax. Some degree of uniformity is necessary in order to strike a least common denominator of distribution which will satisfy most of the states and at the same time not be wasteful of federal money.

2. State administration is expensive or otherwise unsatisfactory. This provides the cause for action in inaugurating sharing.

3. Simple and acceptable bases of distribution are readily available. This will help to avoid excessive "politics."

4. States have a relatively small stake in their discretion over rates and other provisions connected with the particular tax. This is important to minimize the loss of state sovereignty which sharing involves.

If any federal-state tax situation presents all these characteristics, it might be worth recommending for an application of the sharing device, at least as an experiment. The tobacco tax is the principal candidate and it measures up to the above qualifications fairly well.

Although the federal government has never developed any program of sharing revenues with the states, the latter have extensive arrangements of this sort with their municipalities. Liquor and sales taxes, public utility taxes and, less commonly, income and inheritance tax revenues are distributed on varying bases, such as origin or population.

Supplements

It is often proposed that the federal government impose and administer certain taxes, at the same time inviting the states to add a percentage to the federal levy. Precedent for such procedure exists in France and Mexico, and to a limited extent in the United States. In its extreme form it has never been popular in this country. States do not relish the prospect of having their revenue system changed by act of Congress. But state supplementation of federal programs consists mainly of two elements—single administration and uniformity of laws. Viewed in this light, supplementation can be approached by degrees and is a highly desirable objective in such fields as those of income and death taxation.

Supplementation might also be used by local governments where they

overlap those of the state. This could conceivably be the means by which municipalities might make direct use of the income tax without too great impediments. The general property tax has provided a precedent for supplementation, only in this case the state has supplemented local levies, and responsibility for administration has been mainly local.

Grants-in-Aid

Grants-in-aid, or subventions,[3] are often lumped with shared taxes, but the two are distinguishable in that the former are based on appropriations whereas the latter are based on the yield of a particular tax. The aid system permits the distribution of receipts from the federal income and death taxes (often not subject to fair localization) and relieves the pressure in the state and local quest for revenue.

Evidence concerning the geographic distribution of income discloses wide differences; in fact the average prewar income in one state was not even an acceptable relief standard in another. The average old-age pension in one state exceeded the per capita income in the poorest state by 70 percent.

Federal aids developed rapidly but not very systematically during the thirties. They are well adapted to use in a federal system, but they, too, encounter plenty of difficulties. There are many ways in which aids may be distributed, and it is always difficult to agree on a formula. The circuitous routing of revenue from local communities to central units and back again is not conducive to economy nor to local self-reliance and independence. Dispute also often arises concerning the control features of aids. For example, federal aid for elementary education, which seems overdue, is delayed by such controversial issues as whether such legislation ought to specify how federal funds should be apportioned among whites and Negroes.

Joint Administration

More collaboration between federal and state administrative officials offers promise of considerable achievement in economy and efficiency. Some achievements along this line have already been realized. It is now possible for state officials to utilize federal income tax returns for information, and such services are available on tolerably economical terms for the states. The evidence indicates that some states have employed this means of improving state administration quite extensively, and others would be well advised to utilize this cooperative privilege on a wider scale. Particularly the "automatic transcript service," under which states can in effect get the results of federal audit and delinquency action, has proved of high value at nominal cost to those states now using it—more than three-quarters of the income tax states. Kentucky, for instance, gets something like the equivalent of 20

[3] Further discussed in Chapter XXIV.

auditors' work at a cost representing the salary of one investigator for less than one month. The techniques of collaboration have been more highly developed in the liquor tax field than anywhere else in the tax system. Joint use of facilities, information, and personnel in the field, although quite informal, has been extensive and highly successful. Some preliminary attempts to utilize a single return for state and federal income tax reporting proved unsuccessful, but this result is by no means conclusive.

Experience of the federal government with the automobile use tax is particularly illuminating in the matter of administrative collaboration. In this case there was a strong presumption in favor of federal use of state administration. But the Bureau of Internal Revenue concluded that such an arrangement was impractical. Grounds for the decision were that legal authority for a bargaining arrangement were lacking; that the attitude of states toward undertaking the task was uncertain; that sufficient power or influence to ensure the adequacy of state enforcement and accounting was not available; that diversity of state procedure, and the delegation by the states in some cases to the counties, made the procedure too complicated. In spite of the absence of formal arrangements, some states rendered considerable assistance in the administration of the federal tax, and some volunteered legislation which required payment of the federal tax as a condition for the issuance of a state license. The Virginia legislature had before it a bill which would make it a misdemeanor to operate a car on the state highways without a federal "sticker." Nevertheless, the experience with this tax proves that delegated administration cannot be improvised but requires careful and detailed preparation. Joint administration, in the fullest sense of the term, would require even more facilitation.

In other countries with a federal system, cooperation in administration is far more advanced than in the United States. In Australia, where both the states and the central government have had an income tax (the former relinquished its tax to the latter for the period of the war), the central government administered both in one state, and the states administered both in the others, but nowhere was there duplication. In Western Australia, beginning with 1920, "the state hired the federal government to administer practically its entire state revenue system." [4] In the other five states a similar arrangement could not be consummated: instead the governments in 1923 agreed "to farm out to the states the administration of the greater part of the federal income taxes on both individuals and corporations." [5] Several states also solicited the services of the federal government in the administration of entertainment or admissions taxes. In these arrangements the unit which agreed to administer the tax for another did so essentially on a cost basis. It is reported that this arrangement justified itself on the ground of

[4] Robert Murray Haig, "Amalgamated Federal-State Tax Administration in Australia," *Proceedings of the National Tax Association Conference*, 1937, p. 373.

[5] *Ibid.*, p. 373.

economy and in the stimulation it afforded to uniformity of laws and practices.[6] After their experience, however, many Australians feel that administration by a joint board would be superior, at least under American conditions, to their arrangement.[7]

Centralization of Governmental Functions

The present situation is one in which the central units of government have the advantage in the application of most taxes, and the local units have the major public responsibilities—highways, education, and health, for example. These local functions of government are no longer strictly local; there is now great national interest in their proper performance. It seems logical to conclude that economic centralization has proceeded faster than political centralization and that the thing to do now is to centralize the performance of certain governmental functions. Centralization is taking place steadily, but slowly. It lags because of tradition, vested interests, and constitutional impediments. Centralization of functions, within limits, is probably the soundest solution of the problem under discussion, but it is certain to proceed too slowly to avoid the necessity of other immediate solutions. Moreover, there are important values which are lost with the centralization of functions, among them the opportunity for a wide participation in government and the adaptation of laws to divergent local conditions. There is danger, too, that the federal government may become too large and develop great co-ordination problems within itself.

AGENCIES OF CO-ORDINATION

The machinery of government in the United States is very elaborate, consisting of over 165,000 states, counties, cities, villages, towns, school districts, special units, and the federal government. The model for most of this machinery was devised either before or shortly after the Revolutionary War, and it would not be surprising if some lags had developed in adjustment to modern conditions. Congress represents the states quite faithfully and adequately in most respects, but it does not supply the contact with Washington needed by state administrative officials. In the absence of official co-ordinating institutions, a large amount of unofficial machinery designed to promote cooperation and co-ordination has developed.

One mechanism that can be used to facilitate cooperation, and which is especially authorized by the Constitution, is the interstate compact. Congressional assent to compacts is required. This instrumentality has proved quite useful in some fields, such as the regulation of interstate waterways,

[6] *Ibid.*, pp. 371-380.
[7] *Ibid.*, p. 379.

but there are very few instances of its application to taxation. Efforts to achieve uniformity in state legislation often occur, and such uniformity is promoted by the Conference on Uniform State Laws, etc. But here again apparently there has been little success in attacking the diversity of tax laws. Reciprocal legislation has made a larger mark. These laws are conditional in their application, the condition being that other states will follow suit. In death, income, motor vehicle, and insurance taxation, reciprocal legislation has played a considerable role and has in some fields mitigated the evils of multiple taxation and trade barriers. But probably most has been accomplished through voluntary associations, such as the Council of State Governments, the Tax Administrators' Association, and the Municipal Finance Officers' Association. These have successfully promoted cooperative efforts among state and local public officials and have achieved notable successes in improving the administration of some taxes, such as the gasoline tax. They also have performed important educational services concerning such problems as trade barriers.

Recently, a study of intergovernmental relations, sponsored by the Treasury, recommended an addition to our governmental machinery to facilitate intergovernmental cooperation. The agency recommended was to be a joint federal-state "Fiscal Authority," mutually sponsored, manned, and supported. Among its duties would be that of constantly promoting collaboration between federal and state officials. This proposal seems promising but, if it proves too ambitious, something could be accomplished were the Bureau of Internal Revenue to appoint a state relations official to work with a similar personage appointed by the Council of State Governments or some other organization representing the states.

PROBLEMS OF INTERSTATE RELATIONS IN TAXATION

Multiple Taxation. A principal problem of interstate relations is that of territorial multiple taxation. Reference has been made to the many ways in which such multiple taxation can occur: the manipulation of state tax laws and administration to reach more railroad property than lies within the borders of the taxing states; the attempt to tax air transportation fleets in full in the state of the company's home office, and again in part in the states through which the company operates; double taxation of intangibles under the death tax, owing either to disagreement as to the taxpayer's domicile or to a combination of domiciliary and nondomiciliary taxation; application of the personal income tax both at the taxpayer's domicile and residence, with diverse rules as to the latter, as the basis of personal taxation; corporate income apportionment; capital stock apportionment and taxation of stock in full at the corporate domicile. The quantitative volume of this multiple

taxation is a matter concerning which there is almost no evidence, a fact which suggests a first-rate field for future study.

Since the Supreme Court appears ready to wash its hands of the multiple taxation problem, the question of what can be done about the matter is particularly timely. Several approaches and attitudes toward interstate multiple taxation may be considered.

First, there is the view that nothing can or should be done about multiple taxation; that the problem is exaggerated; that it is principally big taxpayers who suffer and they can afford good lawyers to keep them out of trouble; that the difficulty represents, in any event, but a necessary price that we must pay for our federal system.

Second, the view is expressed that the states can and will solve their own problems. In most cases, though by no means all, they have little to gain from multiple taxation, which exists largely as a result of inertia and the difficulties of getting states to agree and act on a cooperative program. To spur them on, the states have (and should have) the threat of federal occupation of fields where failure to cooperate leaves the impediments to national economic development intolerable. State action, through reciprocal legislation, interstate compacts, and other cooperative devices, is much to be preferred to federal action. But, judged by past performance, it is quite probable that state efforts will prove "too little and too late."

Finally, there is the possibility of direct federal action. Although the Supreme Court abdicates the field, there are still Congress and the federal administration to fall back on. This means some interference with state and local fiscal independence, but in the long run it will support such independence. The federal government should seek to acquire the determination of state jurisdiction by means of favors and subsidies extended to the states. Present increasing multiple taxation acts as an unfortunate penalty upon cosmopolitan business—a sort of trade barrier, which the federal government is duty-bound to prevent. It should not shirk its proper task in the matter.

Interstate Competition. Another important problem in the field of interstate relations, to which reference has already been made, is interstate competition in taxation. This may take the form of state or municipal rivalry in giving tax favors to industry. But the problem is not only one of building adequate and equitable state and local tax systems in this competitive environment. It is also one of fairness to interstate businesses, some of which may be handicapped because they must pay heavier taxes than those imposed upon their rivals. Equity in taxation within the boundaries of a particular state may call for one solution of the tax problem, and fairness in interstate competition another. Interstate competition in taxation affects residents as well as businesses. Individuals as well as businesses can move from areas of high tax pressure to those of low.

Under such conditions the tax systems tend to treat migratory wealth and industry with special favor. The use of inheritance tax advantages by the

states to lure the aged wealthy has been discussed in an earlier chapter. In this case the federal government came to the rescue with its 80 percent credit clause.[8] State income taxes have always been confronted with the allegation that they drive out wealth and industry.[9] Sometimes states and municipalities make property tax concessions as an inducement to industry. The same influence is at work, of course, in other social legislation. It has led to the demand upon Congress for legislation which amounts to the application of the police power to large-scale industry and business. Recently Congress has responded to some extent with legislation controlling wages, hours, and the civil rights of labor. A considerable rivalry goes on among certain states in attracting corporations to incorporate under their laws. Here the concessions are in leniency of regulation rather than in taxation, but they offer a good illustration of the possible advantages a state may reap by "proper" legislation. The use by Delaware of lax corporation laws to build up an "incorporation business" is notorious. The policy is a fiscal success, however, and brings into the state's treasury large sums each year in incorporation fees and franchise taxes. One writer suggests that the other states could afford to pay Delaware the cost of running its government if it would go out of the incorporation business.[10] He recalls in this connection that the Insull Middle West Utilities and Kreuger's International Match Company were both incorporated in Delaware, and concludes that although the conduct of these companies and their calamitous collapse cannot be ascribed entirely to the absence of any effective regulation by the state of their incorporation, no doubt this laxity was a contributing factor.

Business and wealth are by no means as shy as many often suppose; actually, both will remain and flourish under a system of rigorous regulation and equitable taxation. There is considerable evidence [11] that the income and inheritance tax states have not lagged behind in their industrial development and that the equal administration of the property tax is not fatal to industrial success.[12] But it must be admitted that both the fear and the danger of "killing the goose that lays the golden egg" are very powerful factors in the development of state and local tax systems.

Diversity of Laws and Procedure. Another problem in the field of interstate relations arises from the wide diversity of tax laws and procedures that has developed and is still developing. The diversity may be thought to offer some advantages in that it involves widespread experimentation in new and

[8] See Chap. X.

[9] See Chap. IX.

[10] John T. Flynn, "Why Corporations Leave Home," *Atlantic Monthly*, Vol. CL, No. 3, Sept. 1932, pp. 268-276.

[11] Geo. L. Leffler, *Wisconsin Industry and the Wisconsin Tax System*, Bul. No. 2, Wisconsin Bureau of Business and Economic Research, Madison, 1931. James W. Martin, *The Possibilities of Income Taxes as Sources of State and Local Revenue*, American Legislators' Association, Chicago, 1932, p. 21.

[12] Claude W. Stimson, "The Stimulation of Industry through Tax Exemption," *Tax Magazine*, Vol. XI, No. 5, May, and No. 6, June 1933, pp. 221-226, 242, 244.

different tax measures. But it also has many disadvantages. One is the augmented cost which private business incurs in reporting to governments and in keeping itself informed of its tax obligations.

Studies by Professors Haig and Martin [13] support the plausible conclusion that compliance costs vary greatly among concerns, depending upon many factors, including size, line of business, geographical spread, and mechanization of accounting practices. Geographical spread is particularly important in the case of state taxes, though it is suggested that this may be due to a light tax in a large number of jurisdictions. A concern with a ten-million-dollar business spread evenly over ten states may not spend more than ten times as much in compliance costs as a million-dollar concern operating in only one state. With regard to state income taxes, it is doubtful if the additional tax adds greatly to compliance costs, since the state tax is based almost entirely upon taxable net income as first determined for federal tax purposes.

As to compliance costs for particular taxes, special excises show a very low public and private cost. Property taxes probably entail substantial costs of administration but low costs of compliance, and the opposite is true of payroll taxes. Income taxes are relatively high on both kinds of costs, the highest figure (1941) being that of state corporate and personal income taxes, with a compliance cost of 3.2 percent. Cost of withholding has added considerably to the federal income tax compliance burden. State retail sales taxes are placed at the relatively high figure of 2.3 percent.

Reducing compliance costs is, of course, an end in itself, but it is also a means toward better government-taxpayer relations. Increased attention to compliance costs in the framing of tax legislation is needed. The simplified federal income tax return is a step in this direction.

Trade Barriers. Recently many critics have become alarmed at the growth of trade barriers. A trade barrier has been defined as "any state statute or regulation which, on its face, or in practical effect, tends to operate to the disadvantage of persons, products, or services coming from sister states, to the advantage of local residents, products and business." State legislation, such as the special levies on oleomargarine, taxes and restrictions on liquor importation, and registration fees and regulations which apply to trucks and buses moving in interstate commerce, is common.

Legal restrictions to protect producers' interests have become so prevalent in American life that the application of such a program by one group takes on a moral justification it ought not to have. It is easy to condemn a particular group, with a vital interest at stake, for promoting its own interest (and probably only its short-run interest) at the expense of the public good.

[13] The study by Robert Murray Haig was made with the assistance of the American Management Association. Preliminary findings were published in "The Cost to Business Concerns of Compliance with Tax Laws," *The Management Review*, Vol. XXIV, Nov. 1935, pp. 323-333. James W. Martin, "Costs of Tax Administration: Examples of Compliance Expenses," *Bulletin of the National Tax Association*, Vol. XXIX, No. 7, Apr. 1944, pp. 194-205.

But it is also easy to understand how these vested interests "get that way," and how one malpractice is used to justify another. A better example might be set for the dairy and liquor industries by other businesses throughout the United States. But this does not alter the conclusion that industry should conform to the consumer's interest, of which the consumer himself should be the judge, and that, except to prevent misrepresentation and fraud, discriminatory taxes to protect one set of producers against another are thoroughly unsound.

Indirect Taxation of Some States by Others. Finally, the states occasionally have within their power the ability to impose taxes which in effect are a burden upon other states. Thus, a state which has a monopoly upon the production of a particular commodity might impose high taxes upon it, which would be paid in higher prices by consumers in other states. Because such monopolies are quite unusual, this probably rarely happens. Minnesota imposes very high taxes upon iron ore and the mining of such ore, but it is doubtful whether this affects the price of iron. The gross production taxes on oil by Oklahoma and Texas may be paid to some extent by consumers all over the country. Delaware imposes light taxes upon the capital stock of domestic corporations whether or not such corporations do business in that state. Of course, it must keep the rate of those taxes sufficiently low so as not to offset entirely the advantages to corporations which the state offers in its favorable incorporation laws. These taxes are in effect collected outside of Delaware. The General Motors Corporation annually contributes a substantial sum to the Delaware treasury, a charge which is not based upon either assets or business in that state. The transaction tax levied by New York upon transactions on the New York stock exchange may be thought of as a levy in large part on out-of-state residents. Of course, even a property tax or gross income tax on a corporation doing an interstate business may represent to some degree an imposition upon out-of-state consumers.

GOVERNMENTAL INSTRUMENTALITIES

A storm center in intergovernmental relations is the treatment of governmental instrumentalities in federal and state taxation. One aspect of this field is federal payments in lieu of local property taxes on the large and growing volume of federally owned property. Another is the tax-exempt security issue. These problems have been discussed in the previous chapter.

CONCLUSION

Probably no problem in public finance has occasioned more talk and less action than this one of intergovernmental tax relations. It is a field in which

indecision appears to be the outcome of all effort. It is to be hoped that something, however modest, will soon be achieved.

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CHAPTER XXII

General Aspects of Public Expenditures

INTRODUCTION

In the preceding parts of this treatise consideration has been given to the principles, practices, and problems involved in the raising of governmental revenues. In this and several following chapters an attempt will be made to analyze the principles, practices, and problems involved in spending these revenues. As has been previously observed, the field of public expenditures is about as wide in scope as one chooses to make it. This chapter will present a few salient observations concerning expenditures as a whole. An attempt will be made to explain the nature of economy and to suggest some ways and means for its achievement. In the coming chapters some attention will be given to the component parts of the field, including the mechanics of the spending agencies, the institutions of public expenditure, and the functions for which public money is expended. The treatment will necessarily be quite general; the size of the field precludes any exhaustive analysis.

THE TREND IN PUBLIC EXPENDITURES

The extraordinary conditions of the First and Second World Wars and the depression of the thirties have made it difficult to get any true perspective concerning the trend in public expenditures in the United States. During the First World War public expenditures assumed what were then regarded as astronomical proportions: from 1917 to 1921 the federal government spent over one-half more than it had from the administration of George Washington down to that of Woodrow Wilson! The depression (which some regarded as an aftermath of the war) was also an unusual period of large-scale spending, partly to relieve distress, partly to lift the country out of depression, and partly to provide employment for idle men and resources. This was followed by the Second World War, appropriately described as a "total" or "all-out" war, which eclipsed the two preceding periods in the

volume of expenditures. Total federal outlay in 1944 was nearly five times that of 1919.

Table 13 presents the development of expenditures by the federal government in the United States. It tells a story of rapid expansion with periodic spurts during wars and the depression of the thirties.

TABLE 13

Federal Expenditures of the United States in Selected Years

(In Millions of Dollars)

Year	*Expenditure*	*Year*	*Expenditure*
1791	4.2	1919	18,952.0
1830	15.1	1921	4,467.0
1857	67.8	1925	2,464.0
1865	1,297.6	1935	6,802.0
1867	357.5	1942	32,396.6
1886	242.5	1943	78,178.9
1910	693.6	1944	93,744.0
1916	724.0		

Source: Adapted from Tables in W. J. Shultz and M. R. Caine, *Financial Development of the United States;* original source, U. S. Secretary of Treasury, *Annual Reports;* 1942 data from *Annual Report of the Secretary of Treasury for Fiscal Year Ended June 30, 1943*, pp. 470-471; 1943 and 1944 data from *Bulletin of the Treasury Department*, Nov. 1944, p. 5.

Table 14 presents the development of expenditures in recent years by all units of government in the United States.

Data concerning the trend in public expenditures must be qualified by the circumstances of time and place. The figures must be adjusted, first of all, for changes in the purchasing power of the monetary unit. Without any change in policies or the quantity of services supplied, a government will show an increase in dollars expended if the dollar itself has shrunk in purchasing power. Except for short periods, the general trend of the value of monetary units has been downward. Estimates of postwar expenditures are frequently qualified with assumptions about the price level. The trend of public expenditures in terms of dollars of constant purchasing power covering recent years is shown in Column 5 of Table 14.

The picture becomes even clearer when the expenditure figures are deflated for changes in population. Nations which expand in population may be expected to increase their public expenditures. They have more people to provide for and more producers of wealth from whom to collect taxes. Allowance for population change can be made by reducing expenditure figures to a per capita basis. This is done in Column 6 of Table 14.

Finally, it helps to correlate expenditure figures with figures showing the wealth and income of the nation. Although the expenditures of the late twenties in the United States were eight times as great as those of the early

1900's, the proportion of the national income represented by such expenditures was only about double. A nation which held its public expenditures at a constant relationship to its income would certainly have no occasion for alarm because of the increase in the former (Table 14, Column 7).

TABLE 14

Governmental Expenditures in Selected Years, All Units of Government in the United States

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
		(*In Millions of Dollars*)			*In 1926 Dollars (Millions)* (*)	*Per Capita Total Expenditures in Current Dollars* (†)	*Ratio to National Income* (‡)
	Federal	*State*	*Local*	*Total*			
1890....	$ 291	$ 77	$ 487	$ 855	$ 1,521	$ 13.56	7.07%
1903....	475	182	913	1,570	2,630	19.39	7.00
1913....	692	383	1,844	2,919	4,182	30.24	8.17
1923....	3,117	1,208	4,593	8,918	8,865	79.96	12.00
1929....	3,046	1,943	6,720	11,709	12,287	96.35	14.50
1930....	3,237	2,170	6,630	12,037	13,932	97.79	17.71
1931....	3,640	2,298	6,541	12,479	17,095	100.55	23.33
1932....	4,712	2,257	6,448	13,417	20,705	107.36	33.93
1933....	4,732	2,067	5,433	12,232	18,561	97.26	29.25
1934....	6,784	2,044	5,621	14,449	19,291	114.11	29.15
1935....	6,844	2,230	5,857	14,931	18,663	117.09	27.17
1936....	8,576	2,433	6,038	17,047	21,098	132.73	26.72
1941....	13,878	4,837	5,562	24,431	27,984	182.79	26.00

Source: National Industrial Conference Board, *Cost of Government in the United States* (Various Years); Dept. of Commerce, Bureau of Census, *Financing Federal, State, and Local Governments: 1941*, 1942.

* Computed from the United States Bureau of Labor Statistics Wholesale price index.

† Lewis H. Kimmel, *Cost of Government in the United States, 1935-1937*, National Industrial Conference Board, New York, 1938, p. 4, and previous studies by the National Industrial Conference Board covering the years 1890-1913.

‡ In Current Dollars.

National income statistics: 1890 from W. I. King, *The Wealth and Income of People of the United States*, National Bureau of Economic Research, New York, 1915, p. 129; 1903 from National Bureau of Economic Research, *Income in the United States*, New York, 1922, Vol. II, p. 234; 1913, 1923, from W. I. King, *The National Income and Its Purchasing Power*, National Bureau of Economic Research, New York, 1930, p. 74; 1929-1936 from *National Income 1929-1936*, p. 11, U. S. Department of Commerce, Bureau of Foreign and Domestic Commerce, Washington, 1937.

It is the popular impression that public expenditures have been increasing steadily since the dawn of history. This belief, however, is fallacious. The tax burden on the French peasants prior to the Revolution may have reached an all-time high. In the transition from feudalism to capitalism, the burden of government probably lightened considerably. Feudal dues and mercantilistic regulation gave way to laissez faire at a time when income and wealth

were advancing rapidly. The downward trend, however, did not continue. It has been calculated that the ratio of public expenditures to the national income in Great Britain was 14.69 in 1919 and 19.45 in 1923.[1] However, writing in 1898, Professor Adams in his treatise on finance[2] submits figures which show a lesser ratio of expenditures to property for Great Britain in 1890 than in 1822, for the United States in 1890 than in 1850, and for France in 1886 than in 1871. There is much reason to believe that the secular trend upward began only with the twentieth century. Both the tendency of capitalism to cease expanding and the sharp reaction to laissez faire would support this theory. Regardless of what may be and has been the secular trend, it is certain that, at least in the United States, expenditures have fluctuated widely from period to period, depending upon fortuitous circumstances such as wars and the phase of the business cycle. As a rule, governments have taken their cue in public expenditures from private business, spending freely in prosperous years, just like everyone else, and sparingly during hard times, again, just like everyone else.[3]

INCREASE BY UNITS OF GOVERNMENT

Government in the United States is far more decentralized than in most other modern countries. Before the depression of the thirties the disbursement of public funds was divided among the three layers of government roughly as follows: 35 percent federal, 15 percent state, and 50 percent local. This was quite in contrast with the situation in England and France. In the former, 70 percent of the total expenditures were made by the national government and only 30 percent by the local units (with no equivalent for our states). In France the centralization was still greater.[4] During the depression the federal government in the United States assumed a larger portion of what were formerly local responsibilities. From 1930 to 1934, federal expenditures rose 109.6 percent while state and local expenditures dropped, the former 5.8 percent and the latter 15.2 percent. But over a considerable period, and emergencies excluded, the state and local governments have shown the greatest increase (see Table 13). Increased urbanization and other factors which resulted in the assumption of new governmental functions have affected mostly the local governments. To be sure, the tendency toward centralization of functions relieved the smaller units to a certain extent but insufficiently to offset the general influences making for expansion. It is quite possible, however, that the changes wrought by the depression and the

[1] Paul Studenski, *Chapters in Public Finance*, Ray Long and Richard R. Smith, Inc., New York, 1933, p. 441.

[2] H. C. Adams, *The Science of Finance*, Henry Holt, New York, 1898, pp. 92-93.

[3] The depression of the thirties in the United States is an exception in that respect.

[4] Paul Studenski, *Chapters in Public Finance*, pp. 455-456.

Second World War, will give the federal government the predominant position from now on. Of about $30 billion of public expenditure generally forecast for the postwar years, about two-thirds has been allotted to the federal government.

INCREASING SCOPE OF GOVERNMENT

Mention has been made of the governmental reaction to the laissez-faire policy of the early capitalistic period. In recent years the reaction has been more and more marked. Perhaps a calendar of the new federal agencies added to the federal directory since 1913 will emphasize the fact.[5]

1913 Federal Income Tax
1914 Federal Reserve Board
Federal Trade Commission
The Alaska Railroad
1915 Bureau of Efficiency
1916 U. S. Shipping Board and Merchant Fleet Corporation
1917 Inland Waterways Corporation
U. S. Employment Service
Federal Bureau for Vocational Education
1920 Federal Power Commission
1921 Bureau of the Budget
1922 Grain Futures Administration
1923 Personnel Classification Board
1924 Federal Oil Conservation Board
1926 Aeronautics Branch, Department of Commerce
1927 Federal Radio Commission
1928 Federal Farm Board

This list brings us only to the depression. The new additions then made include the Reconstruction Finance Corporation, the Resettlement Administration, Civilian Conservation Corps, National Youth Administration, Home Owners' Loan Corporation, Tennessee Valley Authority, Rural Electrification Administration, and the Social Security Board. Needless to say, this is only a partial list. The war added or substituted its own new directory, including the Office of Price Administration, the Board of Economic Warfare, the War Production Board, and so forth.

In recent years several countries of Europe have carried the scope of government to new high levels. This is particularly true of the Soviet Union and only to a little less extent of the fascist countries of central Europe. The extent and degree of governmental control in Germany before the war was indicated by the fact that a state official could compel an industrial estab-

[5] Stuart Chase, *Government in Business*, The Macmillan Co., New York, 1935, p. 29

lishment to employ as many workmen as he saw fit, whether they were needed or not.[6] This was a far cry from the free capitalism of the classical economists. In countries like Sweden industrial activity is more free, but government ownership of natural resources and government participation in industrial and commercial activities is far more developed than in the United States. In all countries engaged in the war, new high levels of regimentation were developed.

PREDICTIONS OF POSTWAR OUTLAYS

Important items of federal outlay for the postwar period include a fixed charge of 5 or 6 billion dollars for the public debt. This is not much below the maximum revenue raised in taxes in any previous peacetime year. The figures are based on assumed interest rates of from 2 to 2½ percent. They make no allowance for debt retirement. Military items are variously estimated at 5 to 9 billion dollars. These estimates are based on the assumption of a peace that will create a tolerable world stability but yet will not ensure us against war. The assumption is that no successful agreement to limit armaments will be achieved. This may be realistic, but it is more pessimistic than our best reasonable hopes. The maintenance of armed forces at least four times as large as before the war is contemplated. Prewar outlays for national defense averaged about a billion dollars per year for the fiscal years 1935-1939. Social security outlays of from 2.5 to 3 billion dollars are likely to occur, with some allowances made for expansion of coverage and additions to reserves.

DIRECTIONS OF GOVERNMENT EXPANSION

Governmental invasion of what were formerly private spheres has been taking place on several fronts.[7]

First, governments have enlarged the field of services supplied to the consumer free or at less than cost. Education, public health, and public recreation are familiar examples. Housing and medicine are next in the line of advance, and these fields have already been entered. These services are supplied by government on the theory that a wider consumption than could be financed by the direct beneficiaries is in the public interest.

The second type or direction of governmental expansion is the fast developing industrial controls established under the police power.[8] Where it

[6] *Ibid.*, p. 83.

[7] The following list is not intended to be exhaustive.

[8] Theoretically the federal government has no police power, but actually through its other specific powers, such as the power to regulate interstate commerce, it does a great deal of "policing."

was once thought that industry was obliged to serve the general interest by automatic controls, it is now held that these controls were not adequate or have broken down. Thus we have agencies to protect labor, such as industrial commissions and the Labor Relations Board; we have agencies to protect the consumer, such as the Federal Trade Commission, the Interstate Commerce Commission, state food inspection service, and so forth; we have agencies to protect the investor, such as the Federal Securities Commission and the state banking commissions.

Closely associated with this direction of development is that of industrial promotion. Departments of commerce and agriculture have long been features of the federal government. More recently the government has embarked upon an elaborate program to promote agriculture, or at least to enhance farm income. The National Industrial Recovery Act (declared unconstitutional) was a similar attempt to help industry police itself, both in its own interest and to protect labor.

Many of the railroads of the United States were built in large part with public money, including grants to the roads of an empire of about 262,238 square miles, an area equal to the size of the state of Texas.[9] More recently, the automobile and air transport industries have been aided by the construction of public highways and airports.

The fourth direction of governmental expansion is what is commonly referred to as "government ownership." This represents an attempt on the part of government to provide goods and services on a more or less commercial basis. Government may undertake such a role to avoid the difficult problem of regulating monopolies or near-monopolies, to provide consumers with goods and services at reduced cost, or to provide a "yardstick" for private operation. In its decision to embark upon such undertakings, the government may weigh the effect such a course may have upon labor and the distribution of wealth and power. Sometimes the government makes a profit out of such undertakings, but this is not always the objective.

In addition, the government may take over private business in order to make a profit for the treasury. This is particularly true of the fiscal monopolies, common in Europe. Thus the Swedish government has monopolies on the sale of liquor and tobacco and upon radio broadcasting. It also considered monopolies of coffee and gasoline but did not embark upon these undertakings. In the case of some of these monopolies, the state aims at consumption regulation as well as revenue.

Finally, governments have increased expenditures for public works in order to relieve distress and to utilize unemployed resources and labor. Some have regarded this expenditure as desirable not only for its own sake but

[9] B. H. Hibbard, "Land Grants in the United States," *Encyclopedia of the Social Sciences*, Vol. IX, 1933, p. 35.

also to lift the country out of depression. The importance of this factor can be seen in the rapid rise of federal expenditures during the depression of the thirties.

CAUSES OF INCREASING PUBLIC EXPENDITURE

Among some of the causes of increasing public expenditure, many of which have already been suggested, the more important ones are: wars, growth of cities, concentration of business, development of democracy, development of cultural interests, and change of attitude toward government.

Wars. It goes without saying that one of the major causes for the sharply upward trend of public expenditures has been war in general and the First and Second World Wars in particular. This becomes evident in the abnormally heavy expenditures of the war periods. The First World War left the federal government a legacy of interest and pensions; and not a few of the critics lay the depression of the thirties and the huge outlays for emergency appropriations during that period to the War. The cost to the United States of the Second World War is still not fully calculated, but it probably will run to more than ten times that of the First. Fear of war is responsible for the large outlays for war preparations which have continued to occupy a very important place in the national budget.[10]

Urbanization. Undoubtedly, increased urbanization of the population is an important cause of rising public expenditures. Many cities follow the rule of increasing costs. Per capita cost of water supply, of traffic service and control, of police protection, and of health and sanitation rise with the size of the city. This is pictured vividly in an interesting article by George Soule on the development and effects of urbanization in New York State.[11] In 1840, says Soule, industry and population were widely scattered over the state. Power was largely water power. An abundance of small manufacturing cities were connected by highways and canals. The local community was nearly self-sustaining. Factory hands ate vegetables grown in their own gardens, and farm and factory labor was more or less interchangeable.

It was about 1860 that farm and village population in New York began to shrink. The date for the country as a whole is somewhat later. There are fewer people living on farms and in villages of less than 2,500 population in New York State now than in 1820.

This centralization is attributed by Soule to the development of railroads and steam power. These technological changes gave certain strategically located cities an important advantage in manufacturing and trade. It brought more distant agricultural regions into competition with New York farmers.

[10] See Chap. XXIII.

[11] Geo. Soule, "Will the Cities Ever Stop?," *New Republic*, Vol. XLVII, No. 602, June 16, 1926, pp. 105-107.

Soule is of the opinion that the development of trucking and electric power may reverse the tendency toward concentration of population. The tendency toward increasing costs of city government is another factor making for decentralization.

As examples of increasing cost, Soule cites the per-family cost of protection in New York City which, at the time his article was written in 1926, was $36.61 as compared with $8.75 for the typical city of the second class. New York City paid $4.46 per family for health and $14.52 for sanitation against $1.63 and $5.00 for similar services in second and third class cities. The corresponding figures for villages and towns were still lower. Total annual cost of government per family was $151.56 in New York City as compared with $56.44 in the typical city of the second and third class. It is common knowledge, of course, that urban life requires many outlays for health, welfare, and recreation not required in the rural regions. Of course, it is also true that rural standards are often lower.

Concentration of Business. The concentration of business as well as the concentration of population has played a part in increasing public expenditures. Many of the modern problems of government, such as labor relations, consumer protection, labor protection, monopoly, and unemployment, have to a great extent resulted from the development of large business and industrial units, corporations, and factories.

Development of Democracy, Quite probably the development of democracy and democratic sentiment have had a bearing on the growth of public expenditures. Democracy tends toward liberal spending. There are certain cities in Minnesota where the mine-owners pay most of the taxes and the miners do most of the voting. These cities have a very high scale of public living. Somewhat the same situation prevails in the nation as a whole and has prevailed since the abolition of property qualification for voting.[12] As far as direct taxes are concerned (the ones that make the taxpayer tax conscious), the overwhelming proportion has been paid in normal times by a minority of the voters. Several states have attempted to restore the qualification in part by providing that only those people who own property may vote upon a bond issue. Several states (particularly those in the South) have provided a payment-of-the-poll-tax qualification for voting.

Development of Cultural Interests. As the individual acquires more income, a larger and larger place is given in his budget to those wants described as sundries. This item includes a variety of recreational and cultural satisfactions. The government is in a strategic position to aid in the satisfaction of these wants and to make their satisfaction general. Government expenditures rise as the government assumes a more active role in this respect. John R. Commons describes this tendency as follows: "Governments must have

[12] It must be admitted, however, that modern dictatorships, perhaps partly to keep themselves in power, have been at least as generous as the democracies in their public expenditures.

revenues in increasing amounts, not because they are corrupt and inefficient, which can be remedied, but because the social needs of education, ethics, morality, art, equality, liberty, protection of the weak, highways, health, recreation grow faster in an improving civilization than do the private needs of food, luxury, ostentaton." [13]

Change in Predominant Attitude Toward Government. Undoubtedly some of the increase in public expenditures is due to the general change in attitude toward government. A century ago governments were feared as a source of tyranny and arbitrary power; today the more preponderant view is that a square deal for the common man and more abundant life for all cannot be achieved without relying heavily upon government. This change is undoubtedly due to many causes, of which mention may be given to a few which seem especially important:

1. Technical changes have increased the feeling of interdependence and the inability of many to work out their own salvation amidst forces many of which are entirely beyond their control.

2. The economic system which may have functioned fairly well as an automatic mechanism when business and production were carried on by small units now appears to stall badly at times, to be subject to monopoly control, and to lead to exploitations of many varieties. The result has been a demand upon government to counteract business depressions and keep the economy in balance. Some have urged the government to compete with private business in order to provide a yardstick by which to judge the service and efficiency of the latter.

3. An increasing humanitarianism deplores the presence of wholesale poverty and approves collective action to alleviate and eliminate it. Here is found a partial explanation of the huge recent increase in outlays for public welfare and public works.

4. There has been a feeling that political and economic problems have increased greatly in complexity and that this, among other reasons, warrants a large outlay for education.

Graft and Inefficiency Not a Cause of Increasing Expenditures. It is sometimes argued that increasing public expenditures suggest increasing graft, inefficiency, and incompetence in the conduct of government affairs. This, of course, does not follow from the facts in view of the other possible explanations of the trend. Moreover, there appears to be no evidence of increasing graft and inefficiency. The consensus of informed opinion would probably hold that there has been considerable improvement in the methods, personnel, and standards involved in conducting the affairs of government.[14]

[13] John R. Commons, *Institutional Economics*, p. 831.

[14] This is not to say or imply that plenty of room for improvement does not still exist

ATTITUDES TOWARD EXPANDING GOVERNMENT

The Laissez-Faire Attitude. Benjamin Franklin expressed one attitude toward government very common in his day: "Perhaps in general it would be better if government meddled no farther with trade, than to protect it, and let it take its course. Most of the statutes, or acts, edicts, and placards of parliaments, princes, and states for regulating, directing or restraining trade, have, we think, been either political blunders, or jobs obtained by artful men for private advantage, under pretense of public good." [15] This was the view also of John Stuart Mill, who held that "the business of life is better performed when those who have an immediate interest in it are left to take their own course, uncontrolled either by the mandate of law or by the meddling of any public functionary." [16] Mill admitted that there were many exceptions, but held that the burden of proof lies upon those who favor governmental interference. He supported his general proposition on the following grounds:

1. Governmental interference restricts liberty. We need constantly to be on guard against tyranny.
2. The individual is most interested in his own affairs and the best judge of his own interest.
3. Governments are inferior in the operation of industry and commerce to private enterprise.
4. People acquire education and gain self-reliance by doing things for themselves.

A modern expression of much the same attitude toward government can be found in Walter Lippmann's *The Good Society*. Of recent developments in Europe, Mr. Lippmann says, "Though despotism is no novelty in human affairs, it is probably true that at no time in twenty-five hundred years has any western government claimed for itself a jurisdiction over men's lives comparable with that which is officially attempted in the totalitarian states." [17] He regrets that "nearly everywhere the mark of a progressive is that he relies at least upon the increased power of officials to improve the conditions of men" . . . forgetting "how much of what they cherish as progressive has come by emancipation from political dominion, by the limitation of power, by the release of personal energy from authority and collective coercion." [18]

Lippmann expresses the fear that government has or will become too large

[15] Benjamin Franklin, *Principles of Trade*, Vol. II, From the Works of Benjamin Franklin (edited by Jared Sparks), Chicago, 1882, p. 401.

[16] John Stuart Mill, *Principles of Political Economy*, Ashley ed., 1923, Book V, Chap XI, p. 952.

[17] Walter Lippmann, *The Good Society*, p. 4.

[18] *Ibid.*, p. 5.

to be managed by finite men, that it will be under the constant strain of pressure groups battling for spoils, and that all this merely leads eventually to the end of both democracy and peace. He conceives of government as mostly imposed upon the governed, a policeman who needs to be constantly told the proper bounds of his authority.

There is some support for the view that an effort to develop more far-sighted business statesmanship can solve many of our economic problems. Certainly, events of recent European history have created more skepticism than formerly prevailed that democratic political institutions can successfully assimilate a large and persistent expansion of government, particularly of the federal government.

The "Progressive" Attitude. As Lippmann suggests, the prevailing view among so-called "progressives" at the present time is undoubtedly in a sharp contrast to his. They hold that the individualism of the past is outmoded. Instead of the slogan "paddle your own canoe," they say that "we are all in the same boat." They think of the government not as a policeman but as a cooperative. They tell the workingman and the farmer that the government is his partner and that he cannot hope to solve his problems except through its aid. The ultimate boundaries of governmental and private spheres should be determined not by deductive analysis but by the experimental test of trial and error.

The "progressives" stress the contention that the automatic controls have been tremendously weakened by the development of the huge factory and the equally huge corporation. Some would use the power of government to turn back the onrush of "bigness" and "monopoly." Others accept these developments as inevitable and urge the government to assume a large measure of control over concentrated industry. Others urge the government to take over such industries and operate them directly. Approaching the problem from a different angle, some are contending that the time is ripe for economic planning, by which they mean the substitution of governmental blueprints for automatic controls.

There are some among those who feel that private industry, as now constituted, fails to serve the public interest who look to private and voluntary organization of consumers for salvation. Many of these deplore the prospect of an ever larger and stronger government. In Sweden, for example, an aggressive and competent consumers' cooperative movement has succeeded over a considerable field in preserving competition and in protecting the consumer. The proponents of a strong and positive government reply, however, that consumers' cooperation, although it may play a useful role, has not demonstrated its capacity to regulate the heavy industries. Moreover, they say that consumers' cooperation grows slowly and requires great capacity for democracy among its constituents to ensure its success.

Those who favor the expansion of government on the commercial or in-

dustrial front are hopeful that some new techniques—notably, the government corporation—can be perfected to simplify the task of public administration. They point out that many modern corporations, and particularly holding companies, are notoriously complex institutions, rife with many of the sins of bureaucracy. Moreover, many are flagrantly irresponsible and top-heavy in control. They see in these conditions a justification for replacing private enterprise at certain points with government ownership and operation.

Attitudes toward the proper scope of government range all the way from that of the socialists, who believe that government should assume the ownership and management of all the essential means of production, to that of the extreme individualists, who hold that the best of all possible governments is the one most limited in its activities. Probably it is correct to say that in most countries the predominant view is that governments should assume an active and positive role both in the control of industry and in the provision of services, but that they should leave in private hands, and mainly under private control, the chief functions of the economic system.

Complaints against the widening scope of government and the mounting public expenditures are very common though by no means a new development. They come partly from those who resent what they regard as an undue extension of government and partly from those who object to making large outlays for which they perceive no direct and immediate return. It is curious how many people object strenuously to taxes and yet protest vigorously at any suggestion to cut some governmental service in which they happen to be interested.

PRINCIPLE OF MAXIMUM ADVANTAGE IN PUBLIC EXPENDITURE

The main principle in public expenditure is so obvious as scarcely to require stating. It is that governments, like individuals, should determine the direction and the degree of public expenditure by balancing alternatives: one possible direction of public outlay against another, and all public outlays against the private use of the income, were it allowed to remain in the hands of the taxpayer. Thus, the government must decide which it needs most, a new city hall or higher pay for school teachers, and whether either should be voted in preference to more food or automobiles which the taxpayers might enjoy privately were they not taxed as contemplated. To provide public luxuries at the expense of private necessities is a violation of this principle and one that is too often exemplified in practice. Although this principle is elementary and in accord with the clear dictates of common sense, its intelligent application is neither simple nor easy. Pressure groups

sometimes control the votes of legislatures, in which case voting may become not a matter of seeking the maximum social advantage but of retaining public office.

NATURE AND POSSIBILITIES OF ECONOMY IN GOVERNMENT

There are three types of economy in government. The first consists in the curtailment of governmental expenditures to the lowest possible figure which seems feasible at a given time and under given circumstances. This is a negative type of economy, perhaps more properly called parsimony. The second type consists of wise and intelligent selection of the purposes of public outlays and of public as compared with alternative private outlays which may become impossible if the government conscripts private funds through taxation. This is the balancing process which has been discussed in general in this chapter and will be considered more specifically in other chapters of this book. Finally, there is the type of economy which consists of getting the most output from the least input. In subsequent chapters, particularly in Chapter XXIII, some possibilities for economy of this last type will be suggested.

SELF-LIQUIDATING, REPRODUCTIVE, PRODUCTIVE, AND NONPRODUCTIVE PUBLIC EXPENDITURES

It has been said or implied by some critics that governments are not productive. This proposition will be considered in more detail later. In general, however, a few points may be mentioned here. It is fairly obvious that a public highway is quite as productive as a private railroad, and the fact that either may be publicly or privately owned is not relevant. Under any proper modern definition of the word, both the highway and the railroad are productive.

But public expenditures may be productive in different ways and senses. The difference may be important when it comes to selecting public works in a period of unemployment.

In the first place, there are public outlays which are properly comparable in almost all respects to private investment in productive equipment. These outlays are self-liquidating from direct charges upon the beneficiaries who receive service from the outlays. The beneficiaries are willing to pay for these services in the same way that they pay for services in the private commercial world. Expenditures of this character may be called self-liquidating, reproductive public expenditures. Examples include publicly owned utilities, hous-

ing, and rural electrification. The last two named may be only partially self-liquidating.

The second class includes outlays which are reproductive in the sense that they create economic advantages for the community through which the national income and the income tax base will be enlarged in future years. They are self-liquidating in a sense, but not without the use of the net income or some other tax to help finance them. Possibly a fee might be charged to compensate for special benefits resulting from such expenditures, but it is not usually regarded as desirable. In this class fall soil conservation, public health, and public education. Highways financed by the gasoline tax are a sort of cross between these two classes.

The third class includes outlays which are productive but not self-liquidating or reproductive. They are useful and add to the national income in the sense that they add to the current enjoyment of life. If the outlay is for a durable service, it may add to enjoyment over a period of years. However, the expenditure does not add to the income tax base, except as it, along with other expenditures, gives employment and puts purchasing power into circulation. Examples of this type of expenditure are public recreation, public parks, and most public buildings.

A fourth class of public outlays must be classed as nonproductive or wasteful. An excessive outlay for armaments (beyond the needs for defense) would go into this category. Make-work projects of little value, such as "leaf-raking," also belong in this class. Even this outlay, of course, adds to the income received by individuals, at least at the time of distribution and at least if it is financed out of credit.

Perhaps a fifth class of public expenditures should also be mentioned: the kind that involve a present governmental outlay but which may save a greater or, at all events, some governmental outlay in the future. Aids to dependent children, for example, may be defended on the ground that, were they not granted, the government might have to enlarge its expenditure for dependency and delinquency when the children became adults.

Thus, government outlays may be justified on several grounds:

1. that they are investments which will add to future economic power;
2. that they add currently to human enjoyment;
3. that they save greater future outlays; and
4. that they give employment and spread purchasing power.

The outlays justified on the first and third of these grounds may be thought of as investments, warranted if wisely selected and more reproductive or more conserving of future outlays than other investments, public or private, which might offer themselves as alternatives. Those based on the second are productive outlays which afford enjoyment and are warranted if they provide more enjoyment than alternative private or public outlays. Those based on the fourth are warranted, perhaps, in an emergency to stimulate private business during a depression. Needless to say, expenditures which rest only

on the fourth justification are seldom warranted if alternatives which rest on one of the first three justifications exist. Also, most public expenditures are defended on more than one of the above grounds. Economy consists of an intelligent balancing of alternatives, public against private, present against future, and one object or direction against another.

CAPITAL AND DURABLE GOODS EXPENDITURE

In the accounting procedure used in a modern business, a sharp line is drawn between expenditures for current operating expenses and expenditures for capital outlay. An example of the former is a manager's salary; of the latter, a new truck or building. One major distinction here is that the capital outlay is usually for durable goods [19] and is more properly written off through annual depreciation than as a single large negative item offset against current operating income. In addition, the capital outlays of private industry are usually self-liquidating and thus more properly looked upon as an investment than as an expenditure. Their cost, less depreciation, appears on the balance sheet of the business as an asset. Outlays for such capital are more or less flexible as to time; that is, they can be hastened or delayed considerably according to the decision of the management.

Expenditures for durable goods (such as a piano or automobile) also have a distinct place in the budget of the private consumer. Such goods are not income-earning like an industry's capital, but they do serve over a considerable period of time and their cost is properly budgeted in installments. Consumers' outlays for durable goods are also flexible as to time and may be greatly expanded during one period and contracted during another.

Governments also spend money for durable goods and productive equipment which may or may not be self-liquidating. Government accounts usually show capital outlays distinct from the current operating expenses of government. The purchase of a durable good, such as a new schoolhouse, may be a proper occasion for borrowing to spread the cost of the improvement over a considerable period. Governments, however, maintain nothing similar to the private corporation's balance sheet (exception: municipal utilities and other government corporations) and take no regular account of depreciation.

It is generally recognized that the capital expenditures of industry and the durable goods expenditures of consumers play a very strategic role in the cyclical movement of business and in maintaining the balance of the industrial process. Until recently, relatively little attention has been given to the equally important strategic importance of government outlays for durable and capital goods. Some present-day economists give considerable support

[19] Goods which are not used up or consumed within a short period, such as a year.

to the view that regulated and expanded public expenditures or investments in public works are (or might be) of major significance in coping with depressions and chronic unemployment.

LIMITS TO PUBLIC EXPENDITURE

It goes without saying that no nation can enjoy more than it produces, whether privately or collectively. Beyond that, little can be said about the capacity of governments to tax and to spend, except that it is all a matter of judgment, depending upon the circumstances of time and place. A great deal depends on how and where the revenue is spent. Much of the recent discussion of taxable capacity has concerned the question of how much a nation can afford to pay outside its borders on debts and indemnities. The limiting factor here is likely to be the inability to transfer[20] rather than inability to pay. But there is a limit to ability to pay under these circumstances. From the standpoint of those outside the country and divorcing consideration of ability to pay from that of willingness to pay, the limit is set by the fact that production may be seriously handicapped if taxation is carried beyond a certain point. The situation is quite different, of course, where revenue is expended within the country from which it is raised. Here the community gets a return for its taxes and the problem becomes one of public versus private satisfaction of wants. Certainly something depends on how the taxes are levied and for what the expenditures are made. When the government takes taxes from *A* to pay or service *B*, it must consider the effect of the transaction on both. As Sir Josiah Stamp points out, the capacity to pay may be stretched a great deal if the stretching is gradual. It is interesting to observe that Bastable thought an income tax of five shillings on the pound (25 percent) would prove too much even for the United Kingdom.[21] Stamp calls attention to the fact that the British "were deploring the appalling weight of taxes and the absolutely suicidal policy of adding 3d [1.25 per cent] to the income tax" in 1910.[22] Almost any additional taxes, within the productive capacity of the country, are warranted if they are thought by the majority of the people to be necessary in order to preserve the nation from annihilation by a foreign foe. And there are other public objectives which may be regarded as only a little less important than self-defense.

[20] See Chap. XXVI.

[21] C. F. Bastable, *Public Finance*, 3rd ed., p. 676.

[22] Sir Josiah Stamp, *Wealth and Taxable Capacity*, P. S. King and Son, Ltd., London, 1922, p. 131.

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CHAPTER XXIII

Expenditures for Particular Functions and Possibilities of Economy

INTRODUCTION

This chapter is devoted to a discussion of the nature of, and the financial problems associated with, certain functions for which governments make large outlays. No attempt will be made, however, to deal with all governmental functions nor exhaustively to treat those covered.

The latest available information concerning the functional division of public expenditures by all units of government in the United States is presented in Table 15. These data, of course, are greatly influenced by the extraordinary character of the period they cover.

EXPENDITURES FOR PROTECTION

No service of the state is more important historically nor more universally accepted than that of protection. Originally, expenditures for this service were easily classified, but in recent years the term "protection" has come to include much new and loosely defined territory. Thus, meat inspection service is for the protection of the consumer, labor legislation for the protection of the worker, securities regulation for the protection of the investor, and so forth. In a narrower sense, protection covers the defense of life and property from foreign foes, which includes wars both for offense and defense; it is sometimes difficult to distinguish between the two. It includes protection from violence to person and property by lawbreakers within the country. This may include insurrections which not only endanger life and property but also challenge the authority of the state. The third element of protection is the state's administration of justice between citizens. Although the interest in personal disputes may be largely private, still there is a secondary public interest in proper adjudication. The final aspect of protection

is the safeguarding of life and property against the natural elements, such as fire, flood, and earthquakes. Principal attention will here be given to the outlays associated with wars and defense, which are much the largest in the field.

Importance and Forms of Military Expenditure

Successive wars have been largely responsible for the expanding budgets of all the major national governments of the world.

Military expenditures fall into three categories: (1) the prewar or peacetime cost of national defense; (2) the outlays for actual warfare; and (3) the postwar expenditures for pensions to veterans and for interest and principal on war debts.

The money costs of the wars alone reach enormous proportions. It has been estimated that the First World War, excluding allowances for lives lost and other nonmonetary factors, cost all the nations involved $211 billion.[1] The estimated money cost of the First World War to the United States up until June 30, 1934, was almost $42 billion.[2] Of course, these figures will look small in comparison with costs of the Second World War. Total expenditures of the federal government in the fiscal year 1942-43 exceeded, by more than half, our total national income in 1917-18. Up to September, 1942, over $200 billion had been appropriated by the federal government for military purposes associated with the Second World War.

Problems of Military Supply. The problems of military supply always present considerable difficulty, and during a "total war" they become critically important. The concern for volume and speed is predominant, but there is also an interest in avoiding excessive profits and in securing for the government its "money's worth." One alternative is direct government production of munitions. This has the advantage of eliminating war profits entirely but might be deemed contrary to the long-standing tradition of reliance on private enterprise. Moreover, less delay probably occurs when going concerns are entrusted with war production. Sources of new capital for plant and equipment are the next consideration. During the First World War, plant extension was financed mainly by private credit institutions, but, during the Second World War, government agencies provided the principal source of capital. The latter policy reduces the risk factor and facilitates rapid expansion, but it may leave the government with a large problem of plant disposal at the end of the war. Whether government plants should be retained as stand-by military facilities; sold to the highest bidder; sold by negotiation, with some regard to avoidance of monopoly and to priority of bids for those who used the plants in wartime; or leased on some of the

[1] E. R. A. Seligman, *Essays in Taxation*, 10th ed., p. 757.

[2] *Annual Report of the Secretary of Treasury for the Year Ending June 30, 1934* Table 43, p. 392, 1935.

TABLE 15

Federal and Estimated State and Local General Government Expenditures: 1941 *

Function	*Expenditures from Own Sources (Thousands of Dollars)*				*Intergovernmental Grants* [a] *(Thousands of Dollars)*				
	Federal	*State*	*Local*	*Total*	*Federal to State*	*Federal to Local*	*State to Local*	*Local to State*	*State and Local to Federal*
General administrative, legislative, and judicial	438,590	185,184	595,653	1,219,427	4,520	5,498	59	—	—
National defense	6,685,427	—	—	6,685,427	—	—	—	—	—
Police and other protection	46,476	140,110	571,697	758,283	—	—	8,941	—	—
Education	165,195	908,527	1,473,582	2,547,304	100,984	29,412	735,439	—	—
Highways and streets	205,005	1,001,771	467,065	1,673,841	183,839	18,194	341,707	4,211	—
Agriculture and natural resources	1,287,676	89,198	55,186	1,432,060	24,801	13,840	814	—	—
Relief, welfare and social security [b]	3,101,840	1,509,734	349,752	4,961,326	396,843	1,124	406,990	12,189	—
Health and hospitals	68,755	293,117	271,743	633,615	29,607	4,552	8,223	695	—
Interest	1,098,135	116,901	462,659	1,677,695	—	—	8,714	5,358	12,070 [c]
All other	740,954	335,289	895,939	1,972,182	9,500	63,987	195,641	22,686	—
Total expenditures	13,838,053	4,579,831	4,940,597 [e]	23,358,481	750,094	136,607	1,706,528	45,139	12,070
Debt retirement	40,462	256,709	621,000	918,171	—	—	39,786	23,545	24,043 [d]
Total expenditures, incl. debt retirement	13,878,515	4,836,540	5,561,597 [e]	24,276,652	750,094	136,607	1,746,314	68,684	36,113

TABLE 15 (Cont.)

Federal and Estimated State and Local General Government Expenditures: 1941 *

Function	Expenditures for Own Functions (Thousands of Dollars)				Expenditures for Own Functions (Percent of Total)				Expenditures for Own Functions (Percentage Distribution)			
	Federal	State	Local	Total	Total	Federal	State	Local	Total	Federal	State	Local
General administrative, legislative, and judicial	426,057	189,645	601,210	1,216,912	5.0	3.3	4.9	8.2	100.0	35.0	15.6	49.4
National defense	6,685,427	—	—	6,685,427	27.6	51.4	—	—	100.0	100.0	—	—
Police and other protection	46,476	131,169	580,638	758,283	3.1	0.4	3.4	7.9	100.0	6.1	17.3	76.6
Education	33,600	274,072	2,238,433	2,546,105	10.5	0.3	7.0	30.5	100.0	1.3	10.8	87.9
Highways and streets	1,023	848,114	822,755	1,671,892	6.9	—[f]	21.7	11.2	100.0	0.1	50.7	49.2
Agriculture and natural resources	1,248,497	113,185	69,840	1,431,522	5.9	9.6	2.9	1.0	100.0	87.2	7.9	4.9
Relief, welfare and social security [b]	2,699,021	1,511,776	745,677	4,956,474	20.4	20.7	38.7	10.2	100.0	54.5	30.5	15.0
Health and hospitals	33,378	315,196	283,823	632,397	2.6	0.3	8.1	3.9	100.0	5.3	49.8	44.9
Interest	1,110,205	110,945	456,545	1,677,695	6.9	8.5	2.8	6.2	100.0	66.2	6.6	27.2
All other	660,993	171,834	930,202 [c]	1,763,029	7.3	5.1	4.4	12.7	100.0	37.5	9.7	52.8
Total expenditures	12,944,677	3,665,936	6,729,123 [e]	23,339,736	96.2	99.5	93.9	91.6	100.0	55.5	15.7	28.8
Debt retirement	64,505	238,368	615,298	918,171	3.8	0.5	6.1	8.4	100.0	7.0	26.0	67.0
Total expenditures, incl. debt retirement	13,009,182	3,904,304	7,344,421 [e]	24,257,907	100.0	100.0	100.0	100.0	100.0	53.6	16.1	30.3

* Source: U. S. Department of Commerce, Bureau of the Census, *Financing Federal, State and Local Governments: 1941.*

[a] "Intergovernmental grants" shown do not include federal grants to territories totaling $18,745,000, which sum, however, has been deducted from "Expenditures for Own Functions."

[b] Relief, welfare, and social security expenditures include net additions to reserves as follows: federal, $693,782,000; state, $540,705,000; local, $3,199,000; total, $1,240,345,000.

[c] State and local grants to the federal government for interest include: state, $2,600,000; local, $9,470,000.

[d] State and local grants to the federal government for debt retirement include: state, $2,100,000; local, $21,943,000.

[e] Total local expenditures have been decreased by $202,679,000, the amount of unspecified federal and state aid to local governments. By definition, this amount cannot be allocated to the functions, the aggregate of which is necessarily reduced by this sum to show true total expenditures.

above principles, is a problem destined to figure heavily in the public affairs of the postwar period. In the case of war plants built with private capital, accelerated depreciation was allowed (the entire cost could be written off in five years in calculating net income for tax purposes), and this reduced the private risk factor. In all of these policies there is a strong trend to eliminate the risk from war production or to shift it to the government.

The techniques of government contracting in wartime involve further problems. If contracts were based on proper estimates, much of the work of the excess profits tax would be unnecessary and scandals of war profiteering would be unknown. Thus the estimating feature of making contracts is important and should be handled by the best personnel the government can recruit. But in many cases the estimates are necessarily largely guesswork based on no prior experience. Under such circumstances large profits often result "which neither side contemplated and the contractors neither anticipated nor wished to retain." [3] This is the basis for legislation providing for the renegotiation of contracts "whenever, in the opinion of the Secretary of the Department, excessive profits have been or are likely to be realized." [4]

Legislation providing for renegotiation was criticized on the ground that it was one-sided, recapturing profits if the contractor were successful and allowing him no additional rewards if his venture proved unprofitable. But the administration interpreted its mandate more liberally than the statute specified, taking into account the over-all profits of a concern when renegotiating the contract for any one item of supply. Nevertheless, it remained true that renegotiation did not operate fully both ways.

The renegotiation mandate involved a heavy administrative load at a time when accountants were difficult to procure. It was highly important for all concerned to "find out where they were at" without excessive delay. The administration also faced the difficult task of steering a middle course between undue generosity and undue niggardliness. Some allowance was expected for superior efficiency, thus preserving an incentive to management.

Although renegotiation of contracts may have resulted in some waste, it was less open to this criticism than the cost-plus contract, used considerably in the First World War. This type of contract allows profits as a percentage of costs and is not to be confused with a cost-plus-fixed-fee contract, used more frequently in the Second World War. The latter allows a predetermined profit independent of costs.

On the whole, the renegotiation experiment appears to have saved the government substantial amounts and to have worked well generally.

Postwar Military Outlays. The reabsorption of ex-soldiers into the civilian population and the postwar responsibilities of governments to veterans are old but growing problems. The obligation of government is usually con-

[3] Major Harley C. Stevens, "The Renegotiation of War Contracts," *Proceedings of the National Tax Association Conference*, 1942, p. 288.

[4] *Ibid.*, p. 284.

ceived to end with care and compensation for those injured in war and for their dependents. But in the United States, which has surpassed all nations in its liberality to veterans, the obligation is conceived as going much further and including care and compensation for veterans and their dependents generally, whether or not injured in war.

In foreign countries, where payments are largely limited to compensation for deaths and injuries directly caused by war, expenditures for veterans reach a high point immediately following a war and then gradually diminish. In the United States, where pensions are paid to many who were unscathed by war, the peak of payments may be long delayed and the end postponed for several generations. For example, in 1937 the United States was still paying pensions to dependents of veterans who served in the War of 1812. At this rate, the United States would not be absolved from responsibility for the First World War veterans until the year 2045.

To eliminate the pension problem, an elaborate system of war-risk insurance was inaugurated in the First World War. The system probably filled a useful purpose but it failed to stop the postwar demand for bonuses and pensions. Higher pay for soldiers was added to insurance during the Second World War.

It has become customary for veterans to organize themselves into associations at the close of wars. A principal purpose of such groups is to seek legislation favorable to their members. These groups are customarily referred to as pressure groups. Their power lies in the fact that they are well organized and more articulate and aggressive than their opposition. Any legislator who votes for veterans' legislation makes himself many more friends than enemies. Any legislator who votes against such legislation is likely to find only a virtuous conscience as his reward. It is plausibly argued that veterans seek and secure special privileges, but this raises the question of what is a fair reward for serving one's country in arms. It is not an easy question to answer, particularly in a society where economic rewards generally are largely a matter of economic power. That the pension history of the United States has been marked by much extravagance and abuse, however, few disinterested persons would deny. Democracy has yet to discover a remedy for pressure groups.

Economics of Military Outlays. It is sometimes argued that under present economic institutions it is impossible to find an outlet for idle men and resources except in war and war preparations. In other words, it is contended that military expenditures play a benevolent role as a means of relief for unemployment and as an outlet for the enormous productive powers of modern capitalism. No one will dispute that unemployed people can be given jobs building battleships. But they can also be given jobs building houses. If our present economic institutions are incapable of functioning at full capacity in the peacetime production of useful goods and services, then it is time to inaugurate some new economic institutions.

The true cost of military expenditures is the (enormous) "opportunity cost," that is, the goods and services which might be provided were these outlays avoided. It can be argued that it is pointless to count opportunity cost when the opportunities are quite clearly and conclusively inaccessible. We would be fortunate if it were unnecessary to spend money to prevent and relieve damage from floods. But "acts of God" must be coped with by human beings as best they can. On the other hand, wars are the result of human errors and are certainly not "acts of God."

Conclusion. Predicted postwar military outlays of from 3 to 10 billion dollars annually may be required for our security and to keep the world at peace. It may well be that we have erred by underpreparedness for war and that this has caused unnecessary loss of life and substance when we became involved. On the other hand, there is real danger that immense preparedness programs will promote the excessive nationalism and authoritarianism out of which wars develop. At least the opportunity cost of such large outlays ought to be fully counted. And the hope rightly persists that the cooperative achievements of human beings will eventually make these immense outlays unnecessary.

EXPENDITURES FOR PUBLIC EDUCATION

Upward Trend in Importance

Adam Smith noted that education in his time was mainly a private responsibility, but he was impressed with the importance of learning and was of the opinion that the government might well concern itself with ensuring minimum instruction to all. Among other reasons for this, he held that "an instructed and intelligent people . . . are always more decent and orderly than an ignorant and stupid one," more respectful of their lawful superiors, and more capable of seeing through "the interested complaints of faction and sedition." [5] Contrast this with the view of colonial Governor Berkeley of Virginia: "I thank God, there are no free schools and printing, and I hope we shall not have these hundred years; for learning has brought disobedience, and heresy, and sects into this world, and printing has divulged them, and libels against the best government. God keep us from both!" [6]

The New England colonies made important innovations in public education, laying down the fundamental principle that, although the obligation to provide an education rests primarily on parents, the state must make sure that all are able to obtain it and, to this end, may resort to the taxing power.

The second quarter of the nineteenth century was the period of the great

[5] Adam Smith, *Wealth of Nations*, The Modern Library, New York, 1937, p. 740.
[6] E. E. Brown, *The Making of Our Middle Schools*, 3rd ed., Longmans, Green and Co., New York, 1907, p. 50.

battle for publicly controlled and directed nonsectarian elementary schools, and by 1850 such schools were becoming an actuality in almost every northern state. The southern states were somewhat slower in recognizing this trend. Gradually the publicly supported secondary school also became predominant, replacing the earlier semiprivate academy. However, it took the Kalamazoo case of 1874 to establish that public support for secondary schools was even legal.

Throughout time and space, many different relationships between the church and the state with reference to education have prevailed and now exist. In some countries (Sweden), the two authorities are merged; in others (Russia), the state has a monopoly; and in still others (United States), the relationship is one of tolerance with competition. In the United States, most of the states prohibit the appropriation of public money for sectarian education. Sectarian schools are generally exempt from taxation, and pupils are considered as complying with compulsory attendance laws when attending such schools. Usually some measure of control is exerted over sectarian schools, as, for instance, in the requirement of certification of teachers.[7]

At least up to the end of the twenties, expenditures for public education in the United States experienced a prolonged expansion in absolute and relative importance. This was due to a steady increase in enrollment and attendance, a lengthening of the schooling period, and the undertaking of a broader and more ambitious role by the schools. Contributing to the trend were the child labor laws and compulsory school attendance. Parents preferred to delegate to the schools some of the responsibilities formerly assumed at home. Then, too, opportunity for adult education became of growing interest. Increased wealth and income enlarged the possibilities of expanding education. On the other hand, the drop in the birth rate and the increasing average age of the population has been and is a factor checking the acceleration of educational expenditures. Recently, youth and the aged have become, to some extent, contestants for the public dollar. It will be observed in Table 15 that total expenditures for education in 1941 amounted to about $2.5 billion and over 30 percent of local outlay.

Philosophy of Public Education Expenditures

The Educational Minimum. Should some kind of minimum educational opportunity for all be underwritten by the public? Nearly everyone would give a positive answer to this question. For civic and economic reasons, a certain minimum level of literacy and enlightenment is highly desirable to the community as a whole.

In a democracy it is obviously of great civic importance that everyone be equipped with the background and tools to form an intelligent opinion.

[7] See H. R. Niebuhr, "Sectarian Education," *Encyclopedia of the Social Sciences*, Vol. V, 1931, p. 422.

Citizens must pass judgment on momentous issues, and, unfortunately, the vote of the ignorant man counts quite as much as that of the man who is well informed. The Chinese have been quick to perceive that widespread general education is a condition precedent for a properly functioning democracy.

From the economic point of view, it is essential in these days of impersonal economic relationships that everyone at least learn to read instructions and write a simple letter. Certainly the vast majority of occupations require much more than this bare minimum of education for their efficient performance. Agriculture, for example, particularly under owner-occupant farming, gains greatly in efficiency when the farmers can read and understand farm magazines, government bulletins, and so on. Even in the most mechanized trades, education becomes an economic value (from both individual and social standpoints) when men are organized into trade unions and exercise collective economic power.

This certain minimum, however much it may include, should be available to and required of all alike, regardless of race, color, or sex. A large body of free citizens maintained in ignorance and illiteracy may be properly regarded as a first-rate public menace.

Diffusion of the Results of Education. There remains the question of territorial interest in, and responsibility for, the educational minimum. In an era of highly developed economic and social interdependence, the results of good and bad education are so widely diffused that education may properly be considered of state and nationwide interest. The diffusion can be seen in the evidence concerning migration. Of the children between 10 and 20 years of age living on farms in 1920, approximately 40 percent were living in villages and cities in 1930.[8] In 1930, more than one out of every five persons in the United States was living in a state other than that in which he was born. In Detroit, to take one example, there was, in 1930, a Negro population of 130,066, only 16,881 of whom were born in Michigan; 25,400 were born in Georgia.[9] Population shifts were especially great during the Second World War period.

Opportunity Beyond the Minimum. Beyond a minimum for all, how much opportunity for education should be offered at public expense? Should the public maintain secondary schools and colleges which all may attend? Should it adapt these institutions to the needs of very large numbers? A strong case can be made for a generous educational program beyond the

[8] The Advisory Committee on Education, *Report of the Advisory Committee on Education*, U. S. Government Printing Office, Washington, 1938, p. 32.

[9] *Hearings on House Resolution 5962*, U. S. 75th Congress, 1st Session, 1937, House of Representatives, Committee on Education (statement of Howard A. Dawson, Director of Rural Service, National Education Association, on the Harrison-Black-Fletcher Federal-Aid-for-Education Bill); see also *Hearings Before the Select Committee to Investigate the Interstate Migration of Destitute Citizens* (Tolan Committee), House of Representatives, 76th Congress, 3rd Session, 1940.

minimum. It is important from the social viewpoint to maintain a recruiting ground for talent, of which much may be discovered and promoted by the equality of opportunity which public education affords. Where youth is relatively free to choose its vocation, schools may provide valuable orientation and vocational guidance. Above these and many similar considerations is the fact that education is an end in itself. Disregarding expense, the more who can be persuaded to participate, the better.

Under a private educational system, the question of who should participate, and for how long, depends upon the financial ability of the prospects. This is true to some extent of a public system supported largely by the fees of participants. Under most prewar European educational systems, the question of who should continue, and for how long, has been partly one of finances and partly one of talent. Those who showed talent were given material encouragement to continue their education, whereas others were generally required to pay much of their own way beyond the minimum. In the United States, although both of the two criteria named above play important parts, there is a strong propensity to provide education largely at public expense for all those willing to partake of it. The "willingness" test is a worthy and laudable one, but it is expensive. It should be qualified by the general rule of public expenditure; that is, that public outlays for any service are justified only so long as they serve a more important end than would any alternative use of the money, either public or private.[10]

Public Support versus Endowment. Is it better to finance education by endowment or by taxation? Higher education in the United States has always been supported to a substantial extent by the donations of wealthy people. For example, the University of Chicago has been built and maintained very largely from the contributions of Mr. Rockefeller; Duke University from the Duke fortunes, made in tobacco; and the University of Pittsburgh from donations by the Mellons. Many of these endowed universities are rated in the forefront among educational institutions.

Chief among the questions raised by philanthropic support is whether it is compatible with academic freedom and an objective point of view. Some of the endowed colleges have made enviable records in maintaining academic freedom. Others have succumbed to flagrant violations under pressure from donors. At best, philanthropic support can hardly fail to exercise some restraint, however subtle, upon the freedom of its donee. On the other hand, educational institutions supported by taxes are frequently subjected to pressures of various sorts from political groups. Some of the worst "witch-hunting" has been conducted by legislative committees in state-supported institu-

[10] Of course the impression that education is confined to schooling is an illusion. There is much doubt as to whether mass education beyond the elementary level is most effectively and economically provided by our school system. For a stimulating discussion of this issue, see H. G. Wells, *The Salvaging of Civilization*, Cassell and Co., Ltd., London 1921, pp. 180-81.

tions. Moreover, research which offers no immediate return to taxpayers is likely to receive scant support outside of endowed institutions.

Perhaps a more valid objection to endowment as a source of support is that it provides too narrow a basis for responsibility in an educational institution. Privately supported and controlled schools, to the degree that they are accountable to any group, are responsible to their wealthy donors who constitute a special economic class within society. Although it is true that in publicly supported and controlled institutions some educators take the view that nothing they do is ever to be questioned by the populace, such institutions are nevertheless far more responsive to public opinion than are private institutions.

Sources of Support for Public Education in the United States

In 1941, about 58 percent of the total revenue receipts for public elementary and secondary schools in the United States came from local governments, about 36 percent from state governments, and slightly more than 6 percent (representing aid for vocational education and aid for general education in defense areas) from the federal government.[11] States differ widely in the degree of support they give their public schools. Delaware (1940-41), North Carolina (1938-39), and Texas (1939-40), provided approximately 92 percent, 60 percent, and 52 percent, respectively, of the total revenues of their public elementary and secondary schools; the corresponding figure for Oregon (1939-40), at the other end of the scale, was 1.7 percent. Iowa met a correspondingly low percentage of total school costs, preferring to earmark newer state taxes for property tax relief through the homestead tax exemption credit device.[12] Among the taxes, the general property tax, the necessary concomitant of local support, is predominant as a source of revenue. In spite of increased support from state taxes, a major portion (probably 65 to 70 percent) of the tax revenue for schools in the United States comes from the general property tax.[13]

Contrary, perhaps, to the general impression, higher education in the United States is financed mainly by private means. Roughly a third of the cost is paid through fees by students, and grants and endowments add substantially to the portion provided privately.[14] Enrollment in institutions of higher learning is about evenly divided between public and private institutions.

[11] Computed from *Financing Federal, State and Local Governments: 1941*, Bureau of Census, 1942, Table 16, p. 52.

[12] *School Finance Systems*, Series I, State Systems; Elementary and Secondary Schools, Revised, June 1941, National Education Association, Washington, 1941.

[13] Letter from Timon Covert, U. S. Office of Education, Washington, May 17, 1943.

[14] "Statistical Summary of Education, 1939-40," *Biennial Survey of Education in the United States, 1938-40*, United States Office of Education, Washington, 1943, Vol. II, Chap. I, p. 29.

Size of School Unit

The typical unit of school finance in the United States is the independent school district, of which there are well over 100,000 in the nation. The small rural district often finds itself unable to collect sufficient revenue to support an adequate program of education. The small-enrollment school is likely to have a high cost per pupil. The one-room school is also handicapped in the character of its instruction. Broadening the unit of support and of attendance has made some progress and offers a promising opportunity for improvement in our educational machinery.

STATE AIDS TO EDUCATION

The Case for State Aid

As social and economic interdependence increases in the United States, there is a growing feeling that education is of statewide and even national interest. At the same time, the units of financial support for elementary and secondary education differ enormously in financial strength, both absolutely and in relation to the load they carry. If the local units of support are to be maintained and anything like a standard minimum program for education is to be assured, state grants-in-aid for education are necessary.

Methods of Distributing State School Aids

The two objectives most commonly sought in granting state aids to education are tax relief and equalization.

Methods Which Emphasize Tax Relief. The method of state aid most frequently used is that which provides for a flat grant for each unit of educational need. This method, although it does equalize school costs to a certain extent, takes no cognizance of inequalities in taxable resources as between districts. It serves chiefly to lessen the burden of property taxation in all the districts and to ensure more adequate funds for education. Complete equalization would be effected by the flat grant only if the grant were large enough to finance an adequate program of education in every district.

The unit of educational need has been variously defined by the different states in terms of (1) the school census; (2) school enrollment; (3) average daily attendance; (4) number of teachers employed; and (5) number of instruction or teaching units.[15] Under the Wisconsin law, for example, certain elementary school aid is annually granted by the state at the rate of $250 per teacher. All of these bases for granting aid are open to the criticism that they disregard variations in local financial ability; the first three are

[15] Numbers of student groups suitable for one teacher to instruct.

open to the additional criticism that they are based only haphazardly on need. A district with 20 pupils may require only one teacher and be subject to only a little more expense than a district with 10 pupils.

A large majority of the states use the flat-grant method in apportioning some or all of state public school funds; for the country as a whole, considerably more than half of all state school aid is apportioned in this manner.[16]

Equalization. Nearly two-thirds of the states attempt to equalize educational burdens and opportunities by apportioning at least a part of their state school funds according to an index of need in relation to ability. Most such equalization schemes are based upon the difference between the yield of a specified local tax rate (plus all other available revenue) and the revenue required to support a state-prescribed minimum educational program. For example, Michigan distributes aid to make up the difference between the cost of a minimum program and the yield of a two-and-one-half-mill levy plus miscellaneous other receipts. The Wisconsin law, in addition to providing a flat grant to elementary schools, provides a lump sum out of which the state pays for each employed teacher the equivalent of the local school rate, not to exceed 4 mills on the amount by which $200,000 exceeds the equalized value (per teacher employed) of the school district's taxable property. Under this part of the law the state will not contribute over a maximum of $350 per teacher and contributes nothing to districts with more than $200,000 of taxable value per elementary teacher.

A thorough system of equalization within a state would not require any district to levy a higher tax rate for the support of an adequate program of education than any other one. States fail to reach this objective either because the state-prescribed minimum program is inadequate, the specified local tax rate used in computation is too high, or a limit is set to the amount of aid granted to any one district.

FEDERAL AID FOR EDUCATION

Education is a function which is traditionally and legally a responsibility of state and local government. This responsibility is included as a constitutional guarantee in Canada. Although the federal government has had one finger in the educational situation for a long time, its present financial contribution runs to only about 6 percent of the total, and local control is jealously guarded. A movement for more general and more generous federal aid is not of recent origin, but it is becoming increasingly insistent. The movement has been restrained thus far by fear of federal control, sectional dis-

[16] Timon Covert, *State Provisions for Equalizing the Cost of Public Education*, Bul No. 4, U. S. Department of the Interior, Office of Education, Washington, 1936, p. 47.

putes over the equalization principle, opposition of religious groups, and the strained condition of federal finances.

Proponents of federal aid have submitted a persuasive case for the view that there is a national interest in education justifying federal support. Elaborate statistics have been produced which demonstrate wide differences in per capita expenditures and educational opportunity among the states and marked variations in financial ability and educational burdens to be borne. Citizenship interests in minimum standards for education are obvious. Local tax relief also enters the argument. Evidence concerning birth rates and the migration of population adds support.

The case against an extension of federal aid has been suggested above in explaining the reasons why it has not materialized. Exception is taken to the view that the so-called "ability" taxes can carry indefinitely expanded loads of direct federal expenditures as well as constantly increasing grants for various state-local functions promoted by pressure groups. The general objection to aids—that they make for extravagance—is also emphasized. But most pronounced is the fear of federal control and disagreement as to the plan of distribution.

Any program of federal aid confronts major issues in the degree and manner of central controls which should be included. Division between whites and Negroes can hardly be neglected. In many states the average expenditure per pupil in average daily attendance is less than half as high for Negroes as for whites. Lack of proper equalization procedure in state-aid laws is another aspect of the educational situation with which a federal aid program must be concerned, particularly if it is to involve equalization features. Obsolete state-local administrative organization, including small school units, is also involved. It would be a serious mistake merely to raise the level of school expenditure without tangible improvement in the quality and usefulness of the educational offering. Just how much coercion, as contrasted with persuasion, should attend a federal aid program is a debatable point, but the latter would probably prove more effective in most cases.

In the field of secondary and higher education, the federal government participated during the depression of the thirties by assisting needy students (National Youth Administration). This precedent might well be continued in the postwar period. Better exploitation of talent would help to increase national income and diminish differences in its distribution.

EXPENDITURES FOR PUBLIC WORKS

Nature of Capital and Durable Goods Expenditures

Attention has already been called to the distinction between the outlays for capital and durable goods and expenditures for consumption goods

and services. This distinction exists in public as well as in private economy. To recall some of the more obvious differences, the outlays for capital and durable goods may be more in the nature of an investment than an expenditure (this applies particularly to outlays for capital goods) and are therefore a more proper object for borrowing; they tend to be irregular; and finally, they play a very strategic part in the smooth and successful functioning of the economic system.

Trend of Public Works Expenditures

Public works have always been an activity of government, and in the case of the United States, all units of government have been more or less involved. The promotion of canals, railways, and highways by federal, state, and municipal governments constitutes a long and interesting, if not always creditable, chapter in American history.

Although the idea of government spending to relieve unemployment was entertained and applied at least as early as the building of the Egyptian pyramids, it counted little, if at all, with the statesmen who ordered public works in the early history of the United States. The public did its building when everyone else did, that is, during the high tides of optimism when it looked as though prosperity would continue forever.

During the thirties, the public works program of the federal government became significant not only in the volume of outlay but also in the part it played in the economic strategy of the period. A large part of this program was delegated to the Public Works Administration, popularly known as the P.W.A. This organization claimed the following accomplishments, among others, during the first four years of its operation: it made possible four-fifths of all public construction in the United States, including 70 percent of the school buildings, 62 percent of the hospitals, and 64 percent of the water works and sewers. In addition, it sponsored the first federal slum clearance and low-cost housing projects.[17]

Development of Highways

During the early history of the United States there was much interest in through highways (turnpikes), but, by the middle of the nineteenth century, this interest was displaced by that in developing a national system of railroads. The advent of the automobile brought highways once more into the limelight. In 1916 the federal government inaugurated its highway aids, which have since been developed consistently. The states also extended aids and started the construction and maintenance of state highway systems.

[17] Four-Year Record of P.W.A. June 1933—June 1937, Federal Emergency Administration of Public Works, Washington, 1937. The P.W.A. is not to be confused with the W.P.A. (Works Progress Administration), which also sponsored projects but usually not in the field of construction.

Responsibility for Highways Among Various Units of Government

Reason for Central Interest. The construction and maintenance of certain highways transcends local interest and, in fact, may even be of great national concern. Roads connecting important centers of population may extend through desolate country, the residents of which have neither the interest nor the resources to maintain a good road. Or, in the absence of central control, such good roads as are developed may form no connected system. Many motorists have had the disagreeable experience, after driving on a well constructed road, of suddenly hitting a sea of mud at a town or county line. Kansas, which at one time had no state system of highways, was a good example of this.[18] Although it had many miles of highly developed highways, there were few, if any, good through routes across the state in any direction. Since then the state has amended its constitution and has assumed sufficient authority over the highway system to ensure a fairly satisfactory system of through roads.

Grants-in-Aid. Mention has been made of the fact that both the federal and the state governments first expressed their revived interest in highways by means of grants-in-aid to the local governmental units. Even today the federal government influences the highway system mainly through this means, but its control, though indirect, is very important nevertheless.

In 1921 Congress authorized the state highway departments, with the approval of the United States Bureau of Public Roads, to designate a system of main roads, not to exceed 7 percent of the mileage in any one state, to be known as the Federal Aid System of Highways.[19] Although certain exceptions have been allowed, federal aid in the main has been available for expenditure only upon these roads. This system connects nearly all cities of 5,000 or more in population and has been a major factor in the development of a co-ordinated system of roads. It is said that a zone 10 miles on each side of this system includes 90 percent of the population of the country.[20] For many years federal aid has been distributed according to an average of three ratios—area, population, and miles of post road.

Conditions attached to federal grants have been the basis of substantial federal control of the national highway program. For example, insistence by the Bureau of Public Roads that the states assume responsibility for the maintenance of the federal aid highway system has had considerable effect in centralizing highway administration. Recently some federal pressure has

[18] See Jens P. Jensen, "Mud and Muddle in Kansas Roads," *Bulletin of the National Tax Association*, Vol. XII, No. 8, May 1927, pp. 223-227.

[19] The federal aid system is not to be confused with the marking of routes with federal numbers. The routes are marked for the convenience of interstate travel, and, although the federal numbers correspond closely with the federal aid system, there is no necessary or complete identity between the two.

[20] Henry R. Trumbower, "Roads," *Encyclopedia of the Social Sciences*, Vol. XIII, 1934, p. 408.

been exerted to eliminate the so-called diversion of motor vehicle tax revenues from road building to other uses.[21]

State and Local Highways. Highways have all degrees of central interest. Roads are classed from this point of view as interstate, state, county, and local. Some states have well-designated systems of highways corresponding to this division. In Wisconsin, the state system covers about 10,000 miles, of which nearly two-thirds is eligible for federal aid. An additional 18,000 miles have been designated by counties as county highways, and about 64,000 miles are town roads, or village and city streets.

Units of Highway Administration. Highways are administered by every important unit of government in the United States except the federal government [22] and the school districts. This includes the states, counties, towns, incorporated cities and villages, and miscellaneous local divisions of government. The relative importance of each unit and the co-ordination in the highway programs in the various states differ substantially. In a few states all rural roads are administered by the state highway departments. On the other hand, a much larger number have state and county organizations, some have state and township systems, and others have all three of these systems: state, county, and town. In addition to these rural systems, all states have municipal organizations in charge of urban streets. The multiplicity of administrative units in the field of highway financing has proved to be very unsatisfactory in many states and, since 1930, there has been a decided trend toward centralization.

Most experts in highway finance are of the opinion that the town has no place in an efficient system of highway administration. The central units have certain advantages in the more constant utilization of machinery, the purchase of machinery and materials, and in the letting of contracts. To be sure, some towns and villages have adapted themselves quite effectively to changed conditions by arranging with other administrative units for the joint use of equipment. Central responsibility has a disadvantage in that it encourages local jealousy and dissatisfaction. But there can be little doubt that decentralized administration of rural highways is, on the whole, a wasteful system. In passing, this may be pointed out as another case where technological change has undermined local government.

Problems in the Distribution of Highway Funds

Many opposing interests battle for the public highway dollar. To mention a few of these conflicts:

1. There is the claim of other possible expenditures. The motor vehicle taxes are levied on the presumption that the receipts therefrom will be

[21] See Chap. XIV.

[22] The federal government, however. has direct control of certain roads in the national forests.

spent exclusively upon the highways. But this presumption may be upset; occasionally funds raised from motor vehicle taxes are diverted to other purposes. On the other hand, much more frequently though with less notice, funds from other sources are expended upon the highways.[23]

2. Much rivalry exists between those who are interested in through highways and those who are interested in secondary roads, the so-called "feeders" to the through system.

3. There is the battle between urban interests, who seek more state money for urban streets, and rural interests, who want most of the funds expended outside of city boundaries.

4. Another conflict occurs between the poorer, undeveloped, or declining areas of the states and the well-developed and more affluent territories.

It would seem that a balanced highway program should appeal to all—that there is more solidarity of interest here than real conflict. Actually, however, there is a strong feeling of conflict and considerable "log-rolling" among the interests.

These conflicts involve questions of equity as well as expediency. The motor vehicle taxes are levied on the benefit theory, that is, with the expectation that the taxpayer will receive an equivalent for his contributions. Unless the revenues are distributed with some fair relation to motor vehicle use, the reciprocal feature will be weakened.[24]

It is conceded that the state must give its first attention to building up a tolerable system of through roads. But as soon as it is well under way toward the accomplishment of this objective, the claims of the secondary system must be considered. It is important for the citizenry to have some improved county (and town) roads before all the through roads are surfaced with concrete. These improved secondary roads make the through roads more accessible and enable the farmer to transport his children to school and his produce to market. There is also property tax relief to consider, and the maximum of such relief can be had by a wide distribution of highway funds.

The cities particularly seem to have reason to complain of the existing distribution. They have usually received "small pickings" from the motor vehicle tax barrel. According to the criterion of highway use, and also to accomplish some badly needed tax relief, the cities are entitled to a much larger "cut" in motor vehicle tax revenues than they have so far been accorded.[25]

Borrowing versus Pay-As-You-Go in Financing Highways

Highways represent a form of public expenditure for which borrowing may seem especially justified. They are "durable goods" which render service

[23] See Chap. XIV for a discussion of "diversion" of motor vehicle revenues.

[24] Distribution according to use of highways is facilitated by the traffic count, data from which is now a part of the inventory of every well-equipped highway department.

[25] See Chap. XIV.

for many years. They may be thought of as self-liquidating in the sense that users of the service can be made to pay for it through motor vehicle taxes. Given a certain number of motor vehicles and a certain amount of traffic, it is easy to demonstrate that there are highways which the state cannot afford not to build. The saving in motor vehicle operating expenses—depreciation, gasoline, tires—will in a few years more than pay for the cost of the highway. On the other hand, the pay-as-you-go [26] proponents point to the fact that borrowing adds an important item (interest) to highway costs and that buying on credit tempts one to extravagance. Highways can be built piecemeal and do not require outlays so large as to upset the current budgets. Probably the conclusion should be that borrowing is warranted occasionally but that it should be used conservatively. At least no highway bonds should be issued so as to mature beyond the life of the improvement.

Other Possible Public Works

Only passing mention can be given here to other possible fields for public construction. Of these, low-cost housing and slum clearance probably offer the greatest possibilities for human betterment. A prominent English architect, commenting on American housing, said that he had inspected housing conditions in South America and in all the great European cities, but had never seen anything quite so bad as the worst housing conditions of New York City. For several reasons, which cannot here be discussed, good housing is beyond the means of many people. Public housing has made rapid headway in Europe and, during the two world wars and the thirties, some progress has been made in the United States. It is quite probable that the postwar era, particularly if it involves a recurrence of severe unemployment, will bring a much wider development of public housing. Rural electrification and regional development (such as the Tennessee Valley project) are other candidates for inclusion in postwar public works programs.

Public Works as an Agency of Economic Stabilization

As previously suggested, public works as an economic stabilizer and an antidote for unemployment received much attention during the depression of the thirties. Many look to an improved program of this sort to solve the postwar problem which may result from expanded equipment and mobilized manpower. It is hoped that private business will be able to cope with this problem, and it should be given all reasonable encouragement toward this goal. But government should be ready with a well-planned compensatory public works program should it be needed.

[26] It is argued by some that the term "pay-as-you-go" is a misnomer; rather, it should be "pay-before-you-go." The aptness of the terminology depends upon whether the "go" in the disputed phrase refers to traveling or spending.

A public works program for these larger economic objectives has been criticized on the ground that it must necessarily be too small to accomplish its purpose and that experience has proved public works to be a wasteful form of relief. In answer to the first proposition, it is said that, even though they might not solve the whole problem, well-timed public works could help substantially in counteracting depressions. At the very least, such a program would take advantage of depression prices, wages, and interest rates, and thus effect economies in the construction of public works. To the second proposition, that public works are wasteful relief, the answer is made that this has been true only because the program has not been planned in advance. Moreover, public works and work relief are not to be confused. The former is designed to include only socially useful and needed projects and employs men on a going-wage basis without regard for need. The latter, exemplified by the Works Progress Administration, pays less heed to the usefulness of the work as such and employs people on a relief basis.

The degree to which public works may be utilized successfully as an economic stabilizer is in considerable dispute. Much will depend, of course, upon the volume of work which can be crowded into depression years. This in turn will depend considerably upon the cooperation of the municipalities and upon their ability to finance a public works program during depressions. In this connection, it has been suggested that municipalities should be given greater flexibility under constitutional debt limits. But they should also be educated to conserve their credit for emergency periods. Of course, central units of government can expand construction directly on works which are of general interest. Some contributions to local projects may also be justified by the general concern in relieving unemployment.[27]

It is usually agreed that public works (particularly from borrowed funds) give more employment and more stimulus to business indirectly than result directly from the public expenditures on them. Those receiving income from the government's new outlays usually spend much of what they receive, and the expenditures create a new demand for additional goods and services. The same is true of those who receive income from the expenditures thus created, and so on. This tendency of public expenditure to augment business and employment beyond its immediate effects has been called "the multiplier." According to the theory of the multiplier, the total effects within a period of time will depend upon the willingness to spend new income and the rate of turnover involved in the process.

Other objections to public works as an economic stabilization program are (1) that such works cannot be adapted to care for diverse types of labor,

[27] Various complications also arise because of the international relations of the country inaugurating a works program. The program tends to raise or maintain prices, which in turn invites imports and encourages business abroad. For the fullest effectiveness of a public works program as an antidote for depressions, international cooperation would be required.

(2) that the work and the men may not be in the same place, (3) that such a program may make matters worse by discouraging the deflation of costs (particularly wages) necessary to bring about recovery.

It is argued by some that public works, in order to provide maximum stimulation, should not be self-liquidating. Public participation in the field of self-liquidating works, it is said, discourages private industry which might venture into the same fields. There are plenty of cases, however, where the latter is not true. Moreover, the budgetary problems created by public works are difficult enough even when the program aims at self-liquidation.

If public works are to be used as an antidote for depressions, their proper timing will be an important aspect. It is generally thought that the works program should come after a certain amount of necessary deflation has occurred. At just the right moment, the program would not only give employment directly and indirectly and sustain purchasing power, but it would also check the psychological deflation which plays a large part in every depression. In spite of important difficulties which public works as a depression antidote encounter, it can be said with assurance that they are a useful instrument for dealing with economic instability.

Public Works as an Outlet for Idle Men and Resources [28]

It is quite possible that the capitalistic world is approaching an era of short opportunity and a chronic oversupply of labor and capital. In that event, it may be that we should contemplate a normal public works program on a very wide scale as a means of keeping our human and natural resources employed. It seems that there would be no difficulty in finding projects for such a program. A few such possibilities have been suggested in this chapter. There are others that could readily be projected. Some of these projects are partially or fully self-liquidating, and all add much to the national wealth. Many of them could be financed in part through taxes upon the increased wealth and income which such a program might itself create. The way to have a higher standard of living is to produce more. The country should not tolerate for long a demoralizing and wasteful phenomenon of chronic unemployment.

PUBLIC WELFARE

Introduction and Importance

As though the responsibilities of government before the depression of the thirties were not sufficient to engage the full capacity of the tax system, as well as the ingenuity of those in charge, there arose a new and rapacious claimant for the public dollar. This new claimant was public welfare. It was

[28] See Chapter XXVIII for an elaboration of this subject.

weighted with at least as many perplexing problems as any previously more important function of government. Chief among these problems was its cost, the figures for which mounted in a few brief years from a rather negligible level to alarming heights.

In 1941 relief, welfare, and social security accounted for the impressive public outlay of $4,961 million (Table 15) and, without the old-age assistance and unemployment compensation programs, to about $3,000 million. Although the expenditure for some parts of this program can be regarded as cyclical or fluctuating with economic conditions, a large part also, such as old-age insurance and, to a lesser extent, unemployment compensation and old-age assistance, is independent of business trends. Probably all levels of government spent from $50 million to $75 million on these functions in 1913.

Alternative Methods of Caring for the Poor

The enormous volume of public welfare expenditures during the depression of the thirties forced the public to turn its attention to the alternative methods of providing for the poor. Among the chief of these were the following: (1) institutionalized care; (2) outdoor or "direct" relief; (3) work relief and public works; (4) categorical aid; and (5) social insurance. Institutionalized care, which usually means the orphan asylum, the poorhouse, or the county home, was at one time the typical form of public support for the needy. However, since the welfare problem has increased in scope and the public has assumed a more humanitarian attitude toward the poor, institutional care has come to be regarded with disfavor and is being gradually displaced by other methods.

Outdoor or non-institutionalized assistance may be given either by public or private agencies. Before the depression of the thirties, the larger part of such care was provided by private agencies and supported not by taxes but by donations. Frequently such voluntary giving for this and other purposes has been systematized through a community union or community chest. During the depression of the thirties, voluntary contributions and private agencies proved quite unequal to their task, and the public agencies took over the major portion of the relief burden. It was felt by many that this was a fairer and more democratic method of raising money for relief than voluntary donations. As the depression of the thirties developed, local communities found themselves overwhelmed with welfare costs and welfare demands. Consequently, first the states and then the federal government were drawn into the picture. It was plausibly and soundly contended that the destitution caused by unemployment and business failures neither was local in origin nor would the results of its neglect be confined within local boundaries.

In the later thirties, the federal government withdrew from the field of direct relief and inaugurated its work relief and categorical aid programs.

Work relief and public works have an advantage over direct relief in that they are better for the morale of the recipient and are intended to result in a useful return for the public outlay. However, the work programs involve greater immediate outlays. Work relief differs from public works in that it is provided on a means test, at such monthly wage and hour schedules as will finance a predetermined relief budget, and on work more or less adapted to the capacities of the applicant.

In earlier times, all the needy were covered by the general term "paupers." There has been a continuous trend, however, away from the view that all the destitute are blameworthy and must be subjected to hardships in order that they may have sufficient incentive to rid themselves of "what ails them." Progress in caring for dependents has come by classifying them; instead of including all in one almshouse, each class—criminals, delinquent, insane, feeble-minded, aged, ill, and so forth—has gradually been given separate treatment. One manifestation of this tendency has been the movement to substitute various "categorical aids," including the several kinds of public pensions, for the traditional general relief. The pensions differ from relief in that they are granted in cash. They are based on a needs test, as is relief, but their dispensation is not accompanied by the same degree of supervision nor do they involve the stigma that is usually associated with direct relief. Categorical aids assumed great importance with the passage of the federal Social Security Act in 1935. The act provided pensions for three classes of the needy: children, the aged, and the blind. Federal participation took the form of generous aids to the states along with some control of state programs.

Social insurance differs from pensions in that its benefit payments are distributed without regard to need. Social insurance in the United States was slow to develop, but it arrived as an outgrowth of the thirties. The Social Security Act of 1935 provides a system of old-age insurance which covers most of the industrial population. Unemployment compensation was also provided through a tax credit to the states and an aid to meet the cost of state administration. Following the appearance of the Beveridge Report in Great Britain, much speculation and some planning concerning the post-war development of Social Security in the United States has occurred.

Patterns of Welfare Expenditures and Their Financial Effects

From what has been said heretofore, it is apparent that there are many possible patterns of welfare expenditures, each with its own results. The pattern followed before and during the early depression years of the thirties was: mainly local responsibility for welfare expenditure; general assistance rather than categorical; direct assistance rather than in the form of a work program. The pattern followed in 1938 was: local responsibility for relief (with help in some cases from the state); categorical aid to replace general relief to some extent; federal and state contributions toward categorical aids;

a works program financed largely by the federal government. The former system as compared with the latter could be expected to produce the following results:

1. It should mean a lower level of total expenditures for welfare and a lower standard of welfare program. This would be expected because:

   a. local responsibility, involving expenditure by those in close and direct contact with the taxpayers who must pay the bills, makes for a minimum outlay;
   b. categorical aids call either for no means test or for one less strictly applied than in the case of general relief;
   c. work programs (ignoring the value of the product) are more expensive than direct relief; and
   d. local districts frequently have little ability to support welfare expenditures.

2. The former system should mean a heavier and more unequal drain upon local finances.

3. Finally, it should involve support for welfare expenditures very largely from the general property tax rather than the sources relied upon by the federal government and the states, namely the payroll, net income, and sales taxes.

Pressure Groups in the Welfare Field

Mention has been made of the prominent place occupied by pressure groups in the outlays for veterans. Such pressure groups have also been prominent in the field of welfare. Groups of aged persons, dependent and otherwise, have sought to procure a generous system of old-age assistance or pensions. Most notorious in this field has been the Townsend Movement. Because of organized pressure, expenditures for the aged have tended to be much more generous than those for dependent children. In Colorado, a program of $45 per month for all qualified persons over 60 was incorporated by referendum vote into the state constitution in 1936. Other state services have been extremely cramped by this program.

Questions Regarding Future Policy in Welfare Expenditures

The welfare experience of the thirties raised many important questions. Some of them can be listed here but an attempt to answer them would carry us too far afield. What revenue sources are suitable for financing welfare? Must the central units of government, particularly the federal, continue to support the welfare program in large measure? What form should federal assistance, if any, take? Should the federal government confine itself to categorical aids? For instance, is there a logical defense for the pres-

ent arrangement under which the federal government assumes a major responsibility for categorical aids and leaves the general relief burden to each locality? Should a work relief program be continued for the employable unemployed? What proportion of the national income should be set aside for welfare? Looking to the future, what can be done to reduce the welfare problem and the welfare population?

Concerning the last of these questions, there are several kinds of preventives that might be developed. There is the eugenics approach, which starts with the observation that probably two-thirds of feeblemindedness is hereditary and that something further might be done to prevent the procreation of feebleminded children. Approaching the problem from the environmental angle, the development which would probably help most to reduce welfare expenditures is the maintenance of a high level of opportunity, such as we had when free land was available and the economy was rapidly expanding. This is not a simple undertaking, to say the least, and may involve more radical measures than most people are willing to contemplate. The development of a well-rounded system of social insurance can also be classed as a preventive. To avoid many welfare needs resulting from ill health, some public outlays, although inadequate, have been made. Better medical care for more people may take the form of expanded public health work, or health insurance, or more voluntary programs to spread costs and to make provision for illness by periodical payments.

No thoughtful person could survey the mounting numbers of the welfare population and the cost of the welfare program during the thirties with equanimity.

POSSIBILITIES OF ADMINISTRATIVE ECONOMIES

Public Personnel Management

Government represents by all odds the largest and most important business in the United States. As in most other businesses, the successful management of personnel is a major factor in the success or failure of that enterprise.

The merit system is an attempt to apply objective standards in the recruitment, retention, and promotion of public employees. It provides for public employees minimum qualifications, competitive examinations, and permanent tenure during satisfactory performance.

There are few competent critics who still believe that free appointment and removal of all administrative personnel by elected officials is conducive to maximum economy and efficiency in government. Those who have not reconciled themselves to the merit system argue that party loyalty is an important qualification in a subordinate employee and that to deprive a chief

administrator of freedom in the choice of his staff is to weaken responsibility.[29] The so-called merit system is said "to attract" large numbers of steady-going unimaginative people who rapidly sink into the bureaucratic rut.[30]

Whatever validity there may be in these arguments, the fact remains that the excessive turnover under the spoils system is highly detrimental to efficiency. The loss of administrators' and legislators' time in attending to patronage, the employment of people who are totally unfit for the work (such as stenographers who have never operated a typewriter), and the failure to utilize heavy investments in public education, must also be charged to bad personnel management.

It can hardly be doubted that governments in the United States spend huge sums annually on the luxury of the spoils system. As government advances from a relatively insignificant to a major role in human welfare, the problem of proper personnel policy assumes increasingly greater importance.

Although the merit system has made rapid and consistent progress in its extension among federal employees, there still remain many (including some in positions of great responsibility in tax administration) whom it does not cover. But it is the states and municipalities that are the worst offenders in matters of personnel. Only a minority of the states, by no means all of the large cities, and a negligible percentage of the smaller cities, counties and other districts, operate under the merit system.

Selection, retention, and promotion by merit are not synonymous with the merit system even though they are its objectives. Loopholes are available in all such systems. The sympathy of those in high office and a vigilant public opinion are important lubricants which are necessary for the successful operation of any civil service machinery. Attitudes are quite as important in good personnel management as laws. Moreover, "merit" and "spoils" in the management of personnel are always a matter of degree. The spoils system never existed in the sense that public office was universally dispensed to political followers as a reward for political assistance, or as a token of friendship regardless of fitness for public office. Likewise, the merit system never existed in which merit alone guided the choice of personnel. There is no "spoils-proof" system of civil service.

That the government has an unsavory reputation in the minds of many people is due very largely to its inability or unwillingness to handle its personnel problem effectively. This aspect of government undoubtedly offers many opportunities for economy. Moreover, here is abundant proof of the rule that those who believe in government need to exert their constant and utmost effort to make and keep it respectable.

[29] William Turn, "In Defense of Patronage," *The Annals of the American Academy of Political and Social Science*, Vol. 189, Jan. 1937, p. 24.

[30] *Report of the Civil Service Study Commission*, State of Michigan, Lansing, Michigan, 1936, p. 43.

Centralized Purchasing

Governments are important not only as employers but also as purchasers of materials and supplies, ranging from pickles to bridges. Although the public has never fully grasped the fact, and many public officials cannot or will not see it, herein lie many opportunities for economy. The spoils system is not confined to personnel management but can also be found in public purchasing. Proper machinery is important in this field, but no more so than a proper attitude on the part of the public and the officials.

In the past few decades, government buying has developed a technique known as centralized purchasing. Instead of allowing all government departments to purchase more or less at random as their needs arise, many governments require all or most of the purchases to be made through one agency, either a separate department organized for that purpose or a division in some other department, such as the department of finance. Centralized purchasing makes possible the development of expert specialized personnel, large-quantity buying, standardization of grades, more genuine competition in bidding, and so forth. Many examples of substantial economies through the use of this technique have been cited.

Reorganization of Governmental Units

The multiplicity of governmental units in the United States has, particularly in the last few years, attracted considerable attention. Recent inventories of the "governmental family" have placed the number of units at 165,000.[31] These governmental units run not only to large numbers but also to great diversity of pattern and function among the various states. The proponents of reorganization contend that social, political, and economic conditions have undergone momentous changes since these units were devised and that the changes have made existing machinery obsolete. Some of the claims for possible economies by reorganization have probably been extravagant; and the resistance to change in the existing pattern is certainly very strong. But it remains true that rationalization of governmental machinery in this and other respects affords a fertile field for administrative economy.

Mention has been made in an earlier chapter of the economies that might be effected by closer collaboration between the federal government and the states in the administration of tax laws.

[31] William Anderson, *The Units of Government in the United States*, Public Administration Service, Chicago, 1942, p. 2.

SUMMARY

Wars and preparation for wars loom very large in past, present, and predicted future budgets. During wars, public expenditure problems center about the supply of equipment and ammunition for the fighting forces. An innovation in letting war contracts during the Second World War was the provision for renegotiation. Though difficult to administer and accepted by businessmen under protest, it has proved a valuable tool for keeping war profits within bounds. After wars, the problem of pensions for veterans becomes pressing. In most countries, pensions are confined to persons or dependents of persons who die or become disabled as a result of war. Our own program has usually extended pension privileges to those who engaged in wars generally. War outlays involve a very high "opportunity cost" that might be avoided in large part with more effective cooperative efforts among nations.

Various factors have contributed to the upward trend of expenditures for education. Strong grounds are presented for the view that all should acquire a minimum of education and that many should have access to, and be encouraged to acquire, much training beyond the minimum. Education is still supported predominantly by local governments and the general property tax, though the trend is toward state support. This support usually takes the form of state aids, sometimes distributed according to school population and sometimes on bases designed to equalize school costs. The federal government has been frequently urged to extend its subvention system to cover a grant for general education. One of the impediments to this program is disagreement as to the degree of control that should accompany the aid.

Public works are capital goods expenditures and are especially significant as a tool to cope with the business cycle and under-employment. Works programs may or may not aim to be self-liquidating, and the latter can be defined to include outlays which pay for themselves indirectly. Highways are a major item of public works, in the responsibility for the provision of which all governments participate. Here, as elsewhere, there are conflicting interests that compete for the public dollar.

Welfare outlays increased sensationally during the thirties and are sure to occupy an extremely important place in the budgets of all levels of government in the future. There are many alternative means of alleviating poverty, including institutional care, outdoor relief, categorical aid, social insurance, and work relief. In addition, the unit of government and the taxes relied upon for support are vital factors in the pattern of welfare expenditures. More interest in the preventive aspects of a welfare program can be heartily recommended.

One type of governmental economy consists of getting the most in out-

come from a given amount of input. There are many opportunities for this type of economy, including among the most conspicuous, better management of personnel, better purchasing practices, and a more logical arrangement of governmental units.

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CHAPTER XXIV

State and Federal Aids

INTRODUCTION

Mention has already been made of the fact that the central units of government have a comparative advantage in the administration and collection of most types of taxes, particularly the newer ones.[1] Not only do these governments have recourse to additional tax revenues, but they have, or at least the federal government has, the most ample facilities in borrowing. Meanwhile, the one great financial resource of municipalities, the general property tax, is being challenged on many fronts. All these factors give the central units of government a superior financial position. At the same time the local units have inherited the responsibility for most of the important functions of government, many of which, particularly public welfare, have assumed increased significance in recent years. Moreover, most of these functions have come to have a more or less general interest. This situation appears to call for financial assistance of some sort by the central to the local units of government.

One form of such assistance might be the granting of additional tax powers or resources to the municipalities. Many states have surrendered the state property tax and now subsist without any levy upon property for state purposes. This affords the municipalities some additional tax resources, since, without augmenting property tax burdens, they can levy upon property for local purposes the equivalent of what formerly was paid to the state. This creates an element of instability in state revenues, however, as the taxes substituted for the property tax are more "cycle-sensitive." Consequently states are forced to rely in emergencies upon assistance from the federal government. Moreover, the ground gained by municipalities in the state surrender of the general property tax is frequently lost through property tax limitations and exemptions.

[1] The terms "central unit" and "local units" as used in this chapter call for some explanation. "Central unit" refers to (1) the federal government in its relation to the states, which are then the "local units" and (2) the state governments in their relation to their constituent school districts, townships, villages, cities, or counties, which in such relationship are the "local units."

Another form of assistance is possible through central assumption of local functions. For example, the administration and financing of the principal state highways (and, in some cases, all rural highways) have been transferred from the counties and localities to the state. The welfare function, performed by the states and localities in the early years of the depression of the thirties, was later administered to a considerable extent directly by the federal government. This centralization of functions is perhaps the most logical adaptation of government finance to changed and changing economic conditions.

Finally, and what is the most important form of assistance, the central units are distributing considerable amounts from their treasuries to the local units for locally administered functions. Distributions of this sort are of two types: grants-in-aid and centrally collected, locally shared taxes. Distribution from the central treasury to the local units recognizes the fact that the unit of government best fitted to perform a certain function often fails to coincide with the unit best able to finance the function. This method of assistance is a compromise which allows central administration of taxes and local administration of functions, thus preserving the advantages of both. However, as will presently be observed, the central distribution of aids encounters many difficulties.

GRANTS-IN-AID CONTRASTED WITH CENTRALLY COLLECTED, LOCALLY SHARED TAXES

Differentiation. Grants-in-aid and centrally collected, locally shared taxes differ in several respects. The customary criterion of differentiation is that the grant-in-aid is distributed by appropriation, whereas the shared tax is apportioned according to fixed percentages of the yield of a particular tax. In the case of an aid, the amount distributed is largely independent of the yield of a particular tax; in the case of a shared tax, it is entirely dependent upon such yield. Appropriation from the state treasury for local education is a familiar example of aids; distribution to municipalities of a specified proportion of state income tax receipts is a common form of state-sharing of taxes. At times the two do not differ by a very wide margin. In Wisconsin, for example, state funds for highways are distributed to the local units from the receipts of the motor fuel taxes. The distribution, however, is not based on any fixed percentage but rather on what the legislature appropriates. This is an illustration of aids. On the other hand, the same state distributes its hard liquor tax receipts (after a prior appropriation is taken out) to the towns, villages, and cities, according to population. The amount each receives depends entirely upon its population and the net yield of the tax. This is a case of state-sharing.

Types of Control. Usually the grants-in-aid have some strings attached specifying the general purpose for which the funds may be expended and

providing for some degree of central supervision. Aids are not always given upon condition of specific use, however. The British Local Government Act of 1929 provided for distribution of large sums without specification as to use, substituting for other controls the reorganization of local government and the shifting of the function of highway maintenance from the rural districts to the counties and of the function of poor relief from the smaller units to the counties and county boroughs.[2] Shared taxes, on the other hand, much more commonly carry no strings. Professor Hutchinson found that almost half of the shared taxes in use in the United States in 1929 did not require expenditure of the distributed funds for specific purposes.[3] These funds are regarded as belonging to the local units as much as though they had been raised by local taxes and may be expended as the unit sees fit.

Criteria of Distribution. The localities' share of centrally collected, locally shared taxes is frequently distributed where collected or on some basis designed to return the money to the community of origin. Grants-in-aid, on the other hand, are generally distributed on some basis of need, thus involving a redistribution of revenues. In practice, however, both shared taxes and aids may be distributed on bases which have some relation to need but are somewhat arbitrary in character. Thus, of the counties' share of the former Kentucky sales tax, one-third was distributed on the basis of area, one-third on the basis of population, and one-third equally among the counties. School aids are often distributed according to the school census, which is only roughly correlated with necessary outlay for education and not at all with the financial ability of local units.

OBJECTIVES OF GRANTS-IN-AID

Stimulation. Among the various objectives of aids, the first to appear historically and the most important even today with respect to most federal aids is that of stimulating local activity.

A central government selects a function which is thought to be of general interest and worthy of considerably more development than the local units have been able or have seen fit to allow for it. The function is promoted both by the central aid itself and by the manner of granting it. Through the device called matching, strong pressure is exerted upon the local units to spend more generously than hitherto in support of the selected function. Matching provisions specify that the central unit will contribute a certain sum for the selected function if the local unit will do likewise. The local unit is likely to feel that it cannot afford to "pass up" the funds of the cen-

[2] Mabel Newcomer, *Central and Local Finance in Germany and England*, Columbia University Press, New York, 1937, p. 185.

[3] Ruth G. Hutchinson, *State-Administered Locally-Shared Taxes*, Columbia University Press, New York, 1931, pp. 125-126.

tral unit in view of the fact that its taxpayers contribute along with others to the treasury of the central unit. Thus it is obliged to make the desired local outlay for the selected function in order not to lose a fair share of the central money. This device was used at one time to stimulate local expenditure for local roads. To make the pressure somewhat greater, the state in some cases provided that the county as well as the municipalities must match state outlays. Few localities could withstand the pressure to get this large proportion of "free money" for themselves.[4]

Another statement of the local-stimulation objectives of aids is that they are a "reward for local effort." Local units which draw upon their resources to maintain certain standards of local services—educational standards, for instance—are allowed grants in recognition of their sacrifice for the common good.

Equalization of Costs and Opportunities. Central aids may also be given to equalize the cost of certain functions among local units and to equalize opportunities within such units.[5] The equalization or differential grant is most plausible (1) when the function is one in which there is a strong central as well as a local interest, and at the same time (2) wide variations exist among local units in financial ability to provide the function. The equalization objective is especially prominent in state aids for education. A strong state-wide interest in educational opportunity is recognized; there is a feeling that the benefits of education are so wide and general that no particular group of taxpayers should be expected to undergo heavier, or much heavier, expense in supplying an adequate program of education than any other. Perhaps the logical course under these circumstances would be to make education a state function and pay for it directly with state-collected taxes. However, there are generally strong objections to complete centralization and, in lieu of it, a program of state aids is accepted as a fair compromise.

The equalization grant conserves funds by applying the state revenues where they do the most to raise or maintain standards. This has been aptly described as "applying the oil where the squeak is."

The two objectives discussed above may not be compatible. An aid given with the matching requirement or as a reward for local effort may have the opposite effect from equalization. Local effort for a particular function may

[4] The state and federal governments are now reimbursing the counties in Wisconsin to the extent of 80 percent of what they expend on old-age assistance. The reimbursement is limited to a maximum outlay per individual beneficiary, and each beneficiary must meet certain conditions to qualify. This financial arrangement creates a strong incentive for county boards to be generous. To pass up 80 cents which might be brought into the community from the outside because of unwillingness to put up 20 cents will seem to many county board members as very bad business. Nevertheless, most counties have not granted pensions promiscuously and those granted have been less than the maximum permitted by law.

[5] With the possible exception of the temporary relief grants and some of the minor social security grants, federal aids to date have not sought to equalize. On the other hand, in case of state aids, equalization has frequently been a major objective.

be limited by small resources and large necessary outlays for other functions; some local units may be unable to match general funds. Given this situation, no aid will be granted to these units under the matching system, and thus inequalities will be increased rather than reduced. Sometimes, then, the matching system fulfills the Biblical doctrine: "To him who hath it shall be given." Equalization, on the other hand, is an attempt to reduce territorial inequalities.

Relief of Local Taxation. A third objective of central grants, chiefly of state aids and then usually accompanied by other objectives, is to relieve local taxation. The general property tax is the only tax which has proved even tolerably well-adapted to administration by localities. The net income tax and the sales tax are far better administered by the state than by localities, and many have advocated the federal government as the proper unit to administer these taxes. The local communities in most states still have the primary responsibility for some of the important and expensive functions of government, including education and a large part of the highway system. During the depression period of the thirties, even the states had to look for welfare aids to the federal government with its superior taxing and borrowing powers. As has been previously explained, the problem thus is in getting some of the revenues that the central authorities can most efficiently collect to the local units for expenditure upon the primary functions of government. There are several ways in which this gap can be bridged, one being the institution of state and federal aids now under discussion.

Central Control of Local Expenditures. A fourth objective of aids is to secure some effective central control over local expenditures through setting standards of adequacy and efficiency in the performance of a function. State educational aids are frequently granted only on condition that certain standards be observed. Such standards relate usually to length of school term, training and certification of teachers, salary schedule of teachers, and so forth. Regardless of the objectives, grants are usually featured by controls designed to ensure that central and local funds will not be wasted or spent on functions of purely local concern. In the interest of efficiency and economy, grants may also require a certain degree of consolidation of school districts, or other small units of government, as a condition for receiving aid. Michigan, for instance, formerly provided that certain school aids should not be distributed to districts with less than 12 pupils except with approval of the state superintendent. There are few cases where aids have been used to promote local economy (beyond the expenditure of the central funds themselves) and fewer, if any, where aids have been inaugurated for such purpose. Nevertheless, the aid institution lends itself well to a state program of promoting economy in local government. Probably more will be heard in the future about the use of conditional aids to eliminate waste in local expenditures.

The federal government, with its limited powers, is particularly concerned

with the control aspects of federal aid. For example, it has "bought" a very high degree of control over the administration of state unemployment compensation systems by means of federal aids and credits. It is said of the British system of aids that, from 1832 on, the national government "bought" from the local authorities the privilege of audit, supervision, initiative, and control of local finances.[6]

IMPORTANCE AND FUNCTIONAL PURPOSES OF AIDS

Federal aid to states and territories amounted to $744 million in 1941, and similar state distributions were more than twice this amount—$1,746 million.[7] The states distributed $290 million to local units in shared taxes; the federal government does not use this device. The upward trend in the aid figures can be observed in comparing these data with those of 1932, which show federal aids at $215 million[8] and state aids at $519 million.[9] Shared taxes show less tendency to increase; the amount in 1932 was $240 million.[10] Fiscal aid, exclusive of military payments, amounted to 14.6 percent of all civil government costs in 1941.[11] Federal aids are predominantly for welfare, with highways and education following in order. State aids are mainly for education, with welfare and highways next in line.[12] Shared taxes of states are predominantly motor fuel and vehicle taxes, with a substantial amount of liquor, income, corporate, and sales taxes also included. Sharing of death taxes is unusual and minor.

FUNCTIONAL PURPOSES OF FEDERAL AID

Early Grants-in-Aid. The first form of federal aid to the states was in the disposition of the public domain. Something like 250,000,000 acres of land were distributed to the states for various purposes, the most important of which was education.[13]

[6] Russell J. Hinckley, *State Grants-in-Aid*, Special Report No. 9, New York State Tax Commission, Albany, 1935, p. 21.

[7] Department of Commerce, Bureau of Census, *Financing Federal, State, and Local Governments: 1941*, 1942, pp. 50, 53.

[8] Henry J. Bittermann, *State and Federal Grants-in-Aid*, Mentzer, Bush and Co., New York, 1938, p. 133.

[9] Mabel Newcomer, "Revenue Sharing Between Federal and State Governments and Between State and Local Governments," *Proceedings of the National Tax Association Conference*, 1936, p. 278.

[10] Twentieth Century Fund, Inc., *Facing the Tax Problem*, p. 577.

[11] Department of Commerce, Bureau of Census, *Financing Federal, State, and Local Governments: 1941*, p. 53.

[12] See Table 15, Chap. XXIII.

[13] According to the principle embodied in the Ordinance of 1787, in the sale of the public domain, section sixteen of each township was assigned for the maintenance of

Although in a few instances grants of money had previously been distributed among the states during periods of surplus revenues, it was not until 1887 that the present federal system of annual money grants-in-aid was inaugurated. These aids have been gradually extended to include a variety of purposes, although it was not until the depression of the thirties with the accompanying widespread distress and unemployment that they became of first-rate fiscal importance.

Present and Recent Grants-in-Aid. Some of the major present and recent federal aids may be briefly described as follows:

1. *Agricultural Colleges, Experiment Stations, and Agricultural Extension Work.* This includes federal participation in the extensive program of activities centering about the "county agents" entrusted with carrying on extension work in agriculture and home economics.

2. *Forest Conservation Work.*

3. *Highways.* Since 1916, federal aid for highway construction by the states has been provided in generous proportions. In 1930, about 75 percent of the federal grants-in-aid were for highways.[14] In general, the aid is distributed according to the average of three ratios: area, population, and miles of post roads. Since 1921, the federal law has required that the aid be used upon a federal system of primary and connecting highways selected by the state highway departments, with the approval of the United States Bureau of Public Roads, and that it be spent only for construction.[15] In general, federal grants for state highway projects require matching on the part of the state, although during the depression years of the thirties this requirement was largely eliminated.

4. *Vocational Education.* Under the Smith-Hughes Act of 1917, and regularly since, revenue has been appropriated to help pay the cost of teaching certain vocational subjects in secondary and vocational schools and of training teachers of such subjects. The vocational subjects included at the present time are agriculture, home economics, industrial trades, and "distributive occupational subjects."

5. *Vocational Rehabilitation.* This aid is to encourage the training, retraining, and placement of disabled people. Grants for this purpose were enlarged and made more secure by the Social Security Act.

public schools. After 1848 two sections in every township were assigned for this purpose, except in the case of three states where four sections were ultimately so assigned. Various other grants were made to many states for the support of both common schools and institutions of higher learning. From such federal grants permanent school funds developed, of which only the annual income was to be used. The mismanagement and abuse of the federal grants form one of the most unsavory chapters in American history. Much of the land was sold for far less than it was worth, and some of it was virtually given away outright. The favoritism and racketeering practiced in the disposition added to the scandal (see Chap. XVIII).

[14] Henry J. Bittermann, *State and Federal Grants-in-Aid*, pp. 132-133.

[15] Recently there have been appropriations of special funds for purposes other than construction of main highways, such as the elimination of grade crossings and the construction of local farm-to-market roads.

6. *Unemployment Relief.* Aids for this purpose were of major importance during the fiscal years 1933 to 1936. The program of that period was characterized as "the largest undertaking ever attempted through the grant." [16] During the three years from 1933 to 1936, federal grants to the states for state-administered direct and work-relief programs totaled more than $3 billion. These aids not only assumed unparalleled proportions, but they also created a new precedent in the discretion over their distribution that was allowed the federal relief administrator. Ordinarily, under federal aid programs, administrators are given scant, if any, discretion in the distribution of aids. They merely calculate the division according to the objective rule provided by the legislative body. Partly because of the emergency character of depression needs, and partly because of the urgent necessity of stretching the funds as far as possible, this rule was abandoned in the federal relief program. The administrator was, in effect, told to make his own determination of need and distribute funds accordingly. He was given wide powers over the expenditure of the money, and in some cases he took over the central administration of state relief and managed it from his own office.

By the end of the fiscal year 1936, grants-in-aid to the states for work relief were practically discontinued. In their place the Works Progress Administration, inaugurated in 1935, provided that most future projects were to be directly administered by the federal government, although in close collaboration with the states and municipalities. At the same time, the financing of direct relief for "unemployables" was left to the states.

7. *Public Unemployment Service.* This was a matching grant distributed on the basis of total population. Inaugurated in 1933, it was discontinued during the war, when the federal government assumed direct responsibility for administering the public employment offices.

8. *Public Health and Welfare Service.* This aid has been given intermittently since 1921 for public health work in the field of maternity and infancy hygiene. The Social Security Act renewed federal aid for this purpose and added further features for the care of dependent and disabled children and for more general public-health work.

9. *Categorical Public Assistance.* The Social Security Act also provided grants-in-aid for three types of public assistance: the care of the aged, dependent children, and the blind. These were all grants of the matching, "open-end" type, providing (for the old-age assistance grant) that the federal government would match state and local outlays not to exceed a total of $30 (now $40) per month per individual receiving assistance. An additional 5 percent of outlays was granted to be used for the administrative costs of the program. The federal law lays down fairly definite conditions for state programs in order to qualify for federal aid.

[16] V. O. Key, Jr., *The Administration of Federal Grants to States*, Public Administration Service, Chicago, 1937, p. 17.

10. *Administration of Unemployment Compensation.* The Social Security Act also provides funds to the states for meeting the administrative costs of state unemployment compensation systems, conditioned upon the approval of the state law by the Social Security Board and upon requirements concerning administrative procedure. The aid is unique in that the federal government meets the entire cost of the supported service.

Other Federal Aids Proposed and Considered. Although the above list includes all the major items of federal aid now being or recently granted, there are many proposals pressed upon Congress for the extension of the aid system. By far the most important, and a lively issue since 1920, is the proposed federal aid for general elementary and secondary education.[17] Differences as to methods of distribution and as to the degree of federal control to be allowed, as well as budgetary difficulties, have deterred action. Federal aids have been proposed for libraries, recreational activities, eradication of noxious weeds, the education of handicapped children, public pregrade education, open-air health camps, demonstration centers in adult civic education, engineering experiment stations at land-grant colleges, "workers education," and business and economic research in schools of business in state universities.[18] There appears to be no limit to the "good causes" locally financed for which the federal government might contribute assistance.

Federal-Administered, State-Shared Taxes. Thus far there has been no case of federal sharing of taxes, but this also has been proposed, particularly as a solution of the conflicting fiscal relations between the states and the federal government. Much discussion has arisen concerning various plans proposing federal collection and sharing of the gasoline, liquor, and tobacco taxes and of a new manufacturers' sales tax.[19]

THE LEGALITY OF FEDERAL AIDS

Although the federal government is strictly limited in its grant of powers as far as regulation and control are concerned, it has been generally agreed that it may spend money for the public welfare; that is, for any public purpose which it chooses to support. This wide power of expenditure accounts for the fact that, although lacking the power to control agriculture, education, or child welfare, it nevertheless supports a federal department of agriculture and bureaus concerned with education and children. Congress has not only spent money directly for these functions but has also made grants-in-aid to help the states support them. As a feature of the latter program, it has set up conditions for the receipt of the aids. Of course, it is apparent enough that this is a method of indirectly extending the powers of Congress

[17] See Chap. XXIII.
[18] V. O. Key, Jr., *The Administration of Federal Grants to States*, pp. 22-23.
[19] See Chap. XXI.

and purchasing control over matters otherwise beyond the jurisdiction of the federal government. Two other devices have been used for the same purpose in recent years: the tax credit and taxation for nonfiscal purposes. The former is now used to "induce" states to set up unemployment compensation plans and the latter to regulate the opium traffic. Recently some doubt was cast upon the legal status of controlled aids by the decision of the United States Supreme Court in the case of United States v. Butler.[20] In this case, as previously explained, the Court ruled unconstitutional a bonus to farmers who met certain conditions prescribed by Congress or the Secretary of Agriculture. In more recent opinions, however, the Court has sustained the Social Security Act, including the several aids and the crediting device in that statute.[21]

One's reactions to the issue presented in these cases is likely to depend, in the first place, upon his attitude concerning government control and, in the second, upon the powers of the federal government. If one is opposed to extensive interference by government and to a liberal interpretation of the powers of Congress, he will probably praise the Butler decision and deplore the use of aids to "purchase" more control. If one believes that more government regulation is necessary and that only the federal government can regulate a national economic system effectively, he is likely to react in favor of freedom to grant aids.

AIDS VERSUS SHARED TAXES

Variations in Yield. From the standpoint of the local units, shared taxes, depending as they do entirely upon the yield of a specific tax, afford a less dependable revenue than the grants-in-aid. From the standpoint of the central unit, on the other hand, shared taxes are somewhat more flexible than grants-in-aid. Although appropriations can be revised downward at any time, this is not easily done once local units have become accustomed to certain assistance. Thus the aids tend to become a fixed charge upon the state. The allocation of a shared tax for a specific purpose is also likely to be perpetuated but, however, the local units bear their share of any loss in the tax yield.

Exercise of Central Controls. Mention has been made of the fact that central units often retain some control over the local expenditure of aids. Such a control has the advantage of being able to ensure the use of funds for functions of wide public interest and of tending to curb extravagance and to conserve revenue; it has the disadvantage of infringing upon local discretion and independence.

From the viewpoint of the local unit, the principal advantage of the shared

[20] 297 U. S. 1 (1936); see Chap. XIX.

[21] Steward Machine Co. v. Davis, 301 U. S. 548 (1937); Helvering v. Davis, 301 U. S. 619 (1937).

tax with no strings attached is that it gives the unit financial aid without interference. Many local units, having strained the general property tax to the limit, are now seeking some alternative sources of support. They do not wish, however, to sacrifice all their independence in the process. The unconditioned shared tax enables them to get revenue from the taxes especially adapted to central collection and still retain the attitude that the revenue does not come from the state, but is theirs. On the other hand, assistance without control can also be given in the unqualified grants-in-aid. The latter has the advantage of better adjustment to the needs and resources of the local units.

Where the object of central grants is to stimulate the local units to perform a function of general public interest or to maintain a national or statewide standard of adequacy in the performance of such a function, some measure of control is clearly necessary to ensure the utmost efficiency in the use of the funds. Although some shared taxes do carry such controls (notably the motor vehicle taxes), the grants-in-aid are better adapted to this purpose.

Apportionment of Revenue. Generally, the states make some attempt to return about one-half of the shared tax revenues to the community of origin. If distribution to the jurisdiction of actual origin could be accomplished, it would have a certain advantage in that the people would feel a proprietary interest in the revenue and the expenditure thereof. Under these circumstances the central units could be regarded as merely aiding the local ones "to tap their own resources."

Distribution according to origin, however, encounters two major difficulties. The first is that, in the case of most centrally administered taxes, origin cannot be determined with accuracy. In the case of the income tax, which is perhaps one of the easier ones to allocate, there is the problem arising from the relative claims of the district of the recipient's domicile and of the district where the income originates. There is also the plausible claim that the whole area in which exchange is carried on creates the income of one engaged directly or indirectly in such exchange.

The second difficulty in distribution according to origin is that it frequently bestows upon some fortunate districts far more financial receipts than such districts have need of or can utilize to the best advantage. Examples abound of wealthy suburbs, tax colonies, and small districts with a big and successful factory or public utility, which get from the state in shared taxes what appears to be an inordinate proportion of state-collected taxes.

Central grants designed to stimulate or to establish a state or nation-wide minimum standard in the performance of such functions of general public interest as education, highways, public welfare, etc., must necessarily be allocated on some basis of need rather than of origin. Although certain shared taxes are distributed on the basis of need, the grants-in-aid are the devices commonly used to achieve this end. They are better adapted to this

purpose inasmuch as annual fluctuations in the locally shared tax revenues do not synchronize with fluctuations in local needs.

Evaluation. Recently the New York State Commission on State Aid to Municipal Subdivisions recommended "that the sharing of all state-collected, locally-shared taxes, with the exception of motor vehicle license and motor fuel taxes, be abandoned." [22] This conclusion was based on the ground that it is not possible to adjust these taxes to local needs, that these taxes fluctuate so greatly in revenue that they are not dependable sources of income, and that their use is not readily controlled. All these criticisms are valid. Nevertheless, something is to be said for allowing municipalities some revenue which they are free to spend independently, either through an unconditional aid such as the British provide or through a few shared taxes.

METHODS OF CONTROL IN THE ADMINISTRATION OF AIDS

As stated above, one of the advantages which the grants in-aid have over shared taxes is that the former carry greater possibilities of control and of conserving funds by ensuring that the aids are spent effectively upon the designated purposes. Through the device of the conditional matched grant, the central government can assure itself of control over the expenditure by the local unit of at least twice the amount of the grant, and often much more than this. Thus, the federal highway aid specifies that the federal funds and the state funds which match it can be used only for construction purposes, while at the same time the state is required to maintain the highway system to the satisfaction of the federal government and (according to certain recent federal legislation) is forbidden under possible penalty to reduce its highway funds through diversion of the motor tax revenues.

The early federal aids, particularly the land grants, were not attended with any adequate machinery of supervision, and the results were notoriously bad.

Current techniques of federal control and supervision include required reports of operations and of receipts and expenditures; the withdrawal of funds to check abuses; the auditing of accounts and inspection of performance; advance review and approval of plans for expenditure; requirements concerning state machinery of administration, including personnel; and informal conferences and advice.[23] All of these have been used to good advantage in the administration of various federal aids, and they all have some legitimate place, at least as applied to particular aids.

[22] *Report of the New York State Commission on State Aid to Municipal Subdivisions*, Legislative Document No. 58, Albany, 1936, p. 10.

[23] See V. O. Key, Jr., *The Administration of Federal Grants to States*, for a full discussion of the development and use of these techniques for control and supervision.

Withdrawal of funds is frequently urged upon administrators, but they are reluctant to use this weapon because of its political repercussions and because it involves suspension of services. The reluctance is especially strong in the case of welfare aids. This attitude was well expressed by former Relief Administrator Hopkins when he said, "That [withdrawal] sounds easy; but when you cut off federal funds from a state the people who suffer are not the public officials, not the state legislature, not the employed groups, but the unemployed." [24] Withdrawal is effective, at best, only in extreme cases of abuse, but it probably has some value as a threat even if rarely used.

Aid legislation sometimes requires certain experience and training in state personnel selected to administer the expenditure of the funds. The aid for state employment offices went further by requiring the merit system of appointment, but some of the original conditions were later modified. Probably national legislation and administration should go further than they have in requiring proper state personnel in the expenditure of aids, including regular insistence on approved plans of selection by merit. Some outside criticism has a salutary effect on almost any government, and it is unfortunate that the federal government is not in a position to get much similar criticism from the states and municipalities.

Less is known about state controls in the administration of state grants-in-aid. It is a matter of common knowledge that frequently the administration is weak and the controls quite inadequate, aids not infrequently being spent even for other than designated purposes. All of the techniques of administration mentioned above are as applicable to state as to federal aids.

METHODS OF DISTRIBUTING AIDS

Grantee's Contributions

It is possible to distribute aids in a great variety of ways from the standpoint of division of costs. The central unit may require equal or more or less than equal contributions by the grantee, the limits ranging between no central grant at all and distribution to cover the full cost of the local service with no matching required. The latter is exemplified, as previously stated, by federal aid for the state administration of unemployment compensation. Most of the federal aids have required matching by state or state and local funds, although some of the recent appropriations under the Social Security Act and for highways and agricultural extension have relaxed the matching requirements somewhat. No general rule can be stated as to the desirability of the matching feature. In some cases it may unduly encourage expendi-

[24] *Hearings on House Resolution 7527, Federal Emergency Relief and Civil Works Program*, House of Representatives, Committee on Appropriations, U. S. 73rd Congress, 2nd Session, 1934, pp. 4-5.

ture; in others it prevents irresponsible expenditure and stimulates more local interest in administration.

Apportionment of Federal Funds

Aids may be distributed according to some rough criterion of need, such as population, or on a more refined basis of calculating what might be called "net need," with some account being taken of relative local ability to support the designated function. The first method purports to measure simply the relative needs for the service; for example, in the case of educational grants, the number of children of school age in the different districts. The second method attempts to correlate this need with the relative financial abilities of the various units to provide for the need. Most federal aids have been distributed solely by the first method and have been apportioned on a basis of either total population or some specific class of the population, such as rural, farm, or urban population.

The federal and many of the state grants for relief were left to the discretion of the administrators, who were supposed to distribute the funds according to their calculation of need. This led to quite elaborate efforts by both federal and state authorities to measure relative needs, "net need" as well as "service need."

The Social Security Act introduced the percentage grant, the volume of which was left indeterminate to depend upon the state and local requirements of service and the generosity, within limits, of state and local appropriations. This system is criticized on several grounds but chiefly because it is alleged to result in much larger grants to the wealthy than to the poor states. It has been demonstrated that the whole federal aid system operates in general to aggravate territorial inequalities.[25] States with the highest per capita income also receive the most per capita federal aid. Much of this is due to the formulas applied in the case of aids other than for welfare. There seems to be little tendency for states with very high per capita income to have very high per capita welfare grants. On the other hand, it is true that states with very low per capita income also have very low per capita welfare grants. A differential or equalization grant would provide more uniform welfare standards. However, some variation in welfare standards may be defended on the ground that these must be related to general economic standards of different regions. It would be folly to pay those who subsist on public funds a higher income than that received by most of the persons earning an independent income. Moreover, many states do no equalizing within their own territory.

A new technique for distributing welfare aid, possessing much merit, was that proposed in the Connally Amendment in 1940. This would operate as

[25] Committee on Intergovernmental Fiscal Relations, *Federal, State and Local Government Fiscal Relations*, pp. 185-225.

follows: For the old-age program the federal government would match on a 66⅔ percent basis up to the first $15-per-month of aid given eligible recipients; 50 percent from $15 to $25; and 33⅓ percent from $25 to $40. A similar graduated bracket system would be applied to the other welfare categories. The system has a number of advantages.

A strong federal interest in bare minimum standards could be given strong implementation by high matching proportions, and those matching proportions could be reduced in accordance with the rate at which the federal interest was believed to decline.

It might confidently be expected that state money would be matched at a higher over-all proportion in the poor than in the wealthy states, thus providing substantial equalization without encouraging "disproportionate" spending for welfare functions by poor states.

A premium would be placed on intrastate equalization, since the maximum of federal aid, in proportion to state expenditures, could be obtained by paying equal assistance grants to all recipients within each category. This would avoid the necessity of forcing states to adopt standardized equalization procedures. The graduated-bracket grant would also avoid the difficulties of obtaining precise measures of fiscal capacity.

Difficulty of Measuring Need and Ability. Differential aids, however, involve many difficulties. One of the most important of these is to arrive at a measure of ability and need which can be clearly stated in legislation and which is based on defensible measurement of facts. For example, federal aids could be distributed inversely according to per capita income, per capita wealth, or per capita expenditures (sales). Figures on per capita wealth among the states are either not available or not reliable. Per capita expenditure takes no account of income saved. Per capita income figures of a fairly reliable sort are available, and these seem to be the best basis for a differential aid. However, even here there is dispute as to whether it is income produced in a given state or income received by the residents of the state which should be used. As for state aids to localities, moreover, local finances are necessarily supported almost entirely by the property tax, and the basis for such tax may not correlate very accurately with income data. Once some clear basis of equal treatment is departed from, much quarreling over the formula of distribution is inevitable.[26]

One interesting method which has been suggested for calculating relative ability to support certain functions is to determine the yield of a model tax system in each state.[27] A main difficulty here seems to be that the public and the experts may not agree as to just what constitutes a model tax sys-

[26] An additional complication in the case of old-age assistance aids is the fact that costs of living differ in different parts of the country. No reliable information concerning this factor exists, and if it did, complications would arise in making allowance for it in a formula of distribution.

[27] Mabel Newcomer, *An Index of the Taxpaying Ability of State and Local Governments*, Bureau of Publications, Teachers College, Columbia University, New York, 1935.

tem, and there is not too clear a consensus of opinion even among the experts.

The Free Fund. It would be possible, of course, to create a free fund and to give some federal agency discretionary power to distribute it where most needed. Discretion of this sort is quite commonly granted in Europe. In the United States, however, there is a general feeling that no federal agency should be charged with such responsibility except perhaps in an emergency, and that if such were the case, the agency would be plagued to death with pressure of all sorts from the representations of the various states.

Equalization Aids in the States

Considerable precedent for differential aids exists among the states, particularly in their distribution of aids to support education. Here the aids are distributed according to various formulas, one of the most common of which apportions in some inverse ratio to the equalized value of property within the school district, with account taken of both the educational requirements of the district and the local efforts to meet them from local resources.[28] Although distribution on a differential basis is by no means universal, it is an established feature of state aids in many states.[29]

Distribution of Aids According to a Composite Index

The British so-called "block-grant," previously mentioned, provided for the distribution of aids according to need as measured by a composite index including four factors. Nominally revenues were to be distributed according to population, but the latter was to be weighted, that is, the population of a given unit was to be increased (a) by the percentage by which the number of children under five years of age exceeds 50 per 1,000 population; (b) in the proportion that the amount of per capita assessed valuation of taxable property in the unit falls below 10 pounds; (c) according to the density of population per mile of public roads; and (d) according to the number of unemployed.[30] The single formula resembles sharing in that it leaves local governments free to spend at their own discretion.

The history of intergovernmental fiscal relations in Canada affords an example of a sporadic application of specific aids (for designated purposes) and a long-standing application of general grants (flat sums according to population or to replace revenues lost through the centralization of taxes).

[28] See Chap. XXIII.

[29] These aids can be operated with reasonable equity, however, only in states which have an adequate equalization of property. Here we have another illustration of the importance of better property tax administration.

[30] See Mabel Newcomer, *Central and Local Finance in Germany and England*, pp. 161 290, for a more extended treatment of this act.

However, the Canadian unconditional grants have proved rather inflexible, poorly adapted to needed central controls, and a provocation of continual political bickering.[31]

Concept of National Minimum in Public Services

The aid system has developed no concept of a national minimum, that is, of functions of such strong national interest that the federal government should underwrite a minimum program and ensure that the minimum standard be everywhere provided without an undue strain upon local resources. It seems that the strongest claimant for preferred position in this respect is elementary education, followed by aid to dependent children. Although agitation for differential aids for old-age assistance has been persistent, minimum standards here are not so clearly of national interest, and all welfare outlays are more or less relative to the standards of wealth and income enjoyed by the general population in particular states. Probably differential aids should begin with elementary education. Of the social security aids, the support for dependent children would rank with education in its claim to a variable grant treatment.

Although the scope of federal aid developed very rapidly under the pressures of the recent depression, it is a mistake to call the existing practices a system. In many states, certain federally supported functions such as old-age assistance and vocational education have tended to get an undue share of federal, state, and local support at the expense of such locally supported functions as relief and general education. The system should be revised and brought into balance by an extension of its scope to include those additional functions in which there is a clear national interest.

The extension of federal aid to general elementary education will be objected to by some who see in it a national regimentation of our way of life, "unrivaled since prohibition." This point of view is entitled to much respect and some concessions. But in our modern day of interdependence, the general interest in education, from the standpoint of citizenship and economic productivity, is so impressive that some sort of standard as a national minimum appears imperative.

ARGUMENTS AGAINST THE USE OF AIDS

Not everyone is convinced that the institution of aids is a sound one, even though it is widely accepted and applied in many countries. The objection to the aids because of the central control which they entail has already been mentioned. In the case of federal aids, this objection has taken the line

[31] J. A. Maxwell, *Federal Subsidies to the Provincial Governments of Canada*, Harvard University, Cambridge, 1937.

of argument that they are an attempt to extend the power of Congress over the domain reserved by the Constitution for the states. Much of this objection seems unjustified, inasmuch as a great field is left open for local initiative and responsibility within the general limitations laid down by the central government to ensure the maximum efficiency in the expenditure of the funds.

The aids are also objected to on the ground that, being a case of spending other people's money, they encourage carelessness and extravagance in the use of funds. That the aids are a stimulus to spending no one can deny. Indeed, that is one of their purposes, it being assumed in the enactment of aids that increased expenditures for certain purposes is in the public interest. Recklessness or carelessness in spending is another matter. Adequate central supervision to prevent such abuses, although not always existent, is by no means impossible.

It is contended that where aids become a major source of revenue in a local community they tend to pauperize the community, to weaken local responsibility, and to encourage extravagance. This objection applies mainly to those aids which are distributed on a differential or equalization basis. There is the case of a community, for instance, which subsists upon state funds to the extent of 90 percent of its public revenues.[32] It is claimed that aids tend to perpetuate such unnecessary communities—that distress is a natural symptom of maladjustment and, when it is ameliorated by outside financial support, the necessary adjustment may be indefinitely postponed. It can hardly be questioned that aids are sometimes used to finance local functions and local units of government when it would be wiser to centralize the performance of the functions and to reorganize governmental units.

Aids are embarrassing financially to the central units because they create a high fixed charge on them not unlike bonded indebtedness. They make budget-balancing difficult during depressions. The central unit might build up a reserve, of course, or use a cyclical budget, but neither course is free from considerable difficulty.

A major trouble with aids is that they require a formula of distribution about which there may be endless quarreling and which may be arrived at by "balancing the pressures" rather than by an earnest attempt to serve the public good.[33]

Most aids involve an element of redistribution of income from those local units having a large proportionate share to those having a small proportionate share of whatever tax base supports the central tax structure. Through

[32] Mabel Newcomer, "Revenue Sharing Between Federal and State Governments and Between State and Local Governments," *Proceedings of the National Tax Association Conference*, 1936, pp. 281-282.

[33] In this connection it may be stated that legislative bodies in the United States usually have a considerable element of "rotten borough" representation—that is there are districts that are over-represented as compared with others.

the equalization aid, of course, redistribution takes place to a greater extent than through the simple flat or matching grant, since it is the express purpose of such an aid to equalize the tax burden necessary to support certain functions of general public interest. It was this distributive aspect of federal aids which caused most of the early opposition to them.

A plausible alternative to the use of aids is the development of more adequate revenue sources for municipalities. This would avoid the circuitous routing of funds that is involved in many aid programs. If municipalities had adequate means for "tapping their own resources," aids could be confined to equalization objectives. Self-reliance is still worth cultivating, and this proposition is as true of municipalities as of persons.

ARGUMENTS FOR AIDS

The principal argument for the aids is that they represent an application of the ability-to-pay principle. Aids apply this principle to governmental units in much the same way that it is commonly applied to individuals within a unit. Given a function of general interest such as education, the ability principle requires contributions by all individual taxpayers according to their means. Given the same general interest among units of government, the same rule can be logically applied to them. The taxation of the relatively well-to-do unit to pay for education in the unit of meager resources can be supported by the same reasoning that is used to support the taxation of individuals for a similar purpose and in a similar manner.

Another argument for the grants-in-aid is that, like the shared tax, they realize the benefits of centralized tax administration while preserving to a great degree the benefits which result from the local administration of certain governmental functions.

An argument often advanced in favor of a system of federal grants-in-aid is that it has succeeded, where the federal Constitution because of its inflexibility has failed, in providing a means by which some degree of federal control may be exerted over matters which have come to transcend state boundaries and are properly of national concern.

In conclusion, the aids are a product of stubborn economic, social, and fiscal facts. Among these may be listed: (1) the developing interdependence of local units, creating general interest in nearly all of what were formerly strictly local functions; (2) the inequalities in financial ability between local units; (3) the inadequacy of local revenue sources in view of local responsibilities for government; (4) the superiority of the central units in the administration and collection of most taxes; and (5) the unacceptability, and perhaps inadvisability, of wholesale centralization of governmental functions Given these conditions, the aids follow as both inevitable and desirable.

SUMMARY

State and federal aids are one of the several means whereby central units of government, with their usually superior financial powers, assist the smaller units, which frequently have the greatest governmental responsibilities. Aids proper differ from shared taxes in that the amount of the former is determined by appropriation and the latter by the yield of a tax. Aids usually carry more control than shared taxes and also pay more heed to needs in their distribution. Both aids and shared taxes, particularly the former, have been gaining rapidly in importance.

Objectives in granting aids include stimulation of local outlays, equalization, tax relief, and central control of local expenditures. Of the specific purposes for which aids are granted, education is most important among the state grants and welfare and highways among the federal. During the depression of the thirties, huge federal grants were made for relief and, although these have been discontinued, their place has been taken by the social security grants. There is considerable demand for an extension of the federal aid system. Grants by Congress rest upon its power to spend for the general welfare, but the aids involve indirect control in fields where Congress has no power to control directly.

Aids are usually preferred by the critics to shared taxes on the ground that the former involve more adequate control and more equitable distribution. Shared taxes distributed according to origin encounter particular objections both because of the difficulty of defining origin and because of distribution to relatively affluent localities. Nevertheless, local governments need tax relief and something can be said for allowing them some revenues which they can spend within their own discretion.

Extensive techniques of control have been devised by the federal government in the administration of aids. One of the most interesting is withdrawal of funds to enforce federal rules. This weapon, however, is seldom used and is most useful as a threat.

Aids may be distributed according to a great variety of formulas, differing not only in the share of expenditures which will be assumed by the central government but also in the plan of division among the units. A strong case can be made for the differential or equalization grant, but it encounters difficulties in choosing a standard and measuring the degree of need. This form of aid is used by many states in the distribution of state funds for education and is advocated for federal welfare aids as the only means through which the poorer states can maintain adequate standards. Of two institutions employed abroad—distribution at the discretion of an administrator and grant according to a composite index of need—the former has been employed occasionally in the United States, but neither has been accepted for general application.

The aids program has thus far failed to develop a concept of a national minimum—a selection of and provision for those services in which such a strong national interest prevails that a minimum standard of services is essential. The strongest claimants for such status are elementary education and provision for dependent children.

Argument over the merits and demerits of the aid system is perennial. The aids are criticized as causing extravagance, pauperizing local communities, and transferring to Community B what belongs to Community A. It is alleged that a more adequate municipal revenue system would greatly reduce their necessity. They are defended mainly on the ground that they are an application of the ability-to-pay principle in financing expenditures of general interest. But the aids persist and grow, not so much because of arguments as because of certain conditions which make them the best available means to an end.

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CHAPTER XXV

Nature, Development, and Principles of Public Borrowing

NATURE OF PUBLIC BORROWING

Public borrowing is a sufficiently distinct aspect of public finance to merit special treatment. It involves both the receipt and the outlay of public money. Sometimes it involves receipts, as when a nation borrows in order to get immediate cash to wage war. At other times it means outlay, as when one nation loans money to another or pays interest and principal upon its debts. Always there is a deferment and a promise-to-pay involved, features not found in the collection of other revenues and the expenditure of other receipts.

DEVELOPMENT OF PUBLIC BORROWING

General Development

Public borrowing is a relatively modern development. It did not appear as a regular and important feature of public finance until the latter part of the eighteenth century. Previous to this, governments borrowed occasionally, particularly during the late Middle Ages, but usually in smaller amounts and with greater difficulty than in modern times. Public borrowing in these early periods was more or less a personal matter between the ruler as the borrower and the lender who was ordinarily some wealthy trader or, in the sixteenth and seventeenth centuries, a trading company (such as the British East India Company). The king had difficulty in borrowing because of his limited power to tax, the precariousness of his own existence, and the uncertainty of whether his successor would assume his obligations. Loans to him were usually for short periods at high interest rates and were frequently secured by such personal property as the Crown jewels or Crown lands. Occasionally some specific revenue source, such as the customs, was pledged

This is a feature which still survives in public borrowing, particularly foreign borrowing, but it is usually regarded as an indication of weak credit standing.

Symbolizing the weak credit standing of the medieval sovereigns were the forced loans, such as those resorted to by Charles I of England. A similar indication was the treasure or horde, a time-honored institution, conceived principally as a preparation for war. Another institution of the period was the debasement of coinage by the monarch. None of these institutions have entirely disappeared from modern public borrowing, but, with the exception of the first, which assumed new significance in the Second World War, they are less important now than formerly.

Public borrowing became an important institution only with the development of certain favorable circumstances. One of these was the appearance of a money and credit economy. Before public credit could attain importance, it was essential that many people should have money to lend and that loans be sanctioned by public opinion. The development of industry and trade provided both the means to support government borrowing and the sanction for credit and interest. Another favorable condition was the recognition of the rights of the individual as distinct from those of the government. Control of expenditures and taxes by the public (usually including the creditors) contributed toward making government obligations secure. Additional security arose from the attainment of greater order and regularity in the financial affairs of the state. And finally, security was enhanced by the growth of wide powers of taxation.[1]

The innovation of public credit was not accepted without protest. Many early writers on public finance expressed toward it the skepticism which greets most innovations. David Hume, in comparing (1752) the new practice of borrowing to pay for wars with the older one of building a "war-chest" in advance of a conflict, expressed a preference for the latter on the ground that its dispensation during the war period helped to atone for the calamities of war. His objection to public borrowing was based on the increased cost to the public arising from interest, the undue advantage alleged to attend the private ownership of securities, and the idleness which results from "living on interest." But Hume looked with favor upon the proposal to convert the national debt into individual private debt—so much per capita—a proposition which suggests the capital levy.[2] He was of the opinion that nations, once they began to borrow, would be unable to desist until they reached the point of bankruptcy.[3]

Adam Smith (1776) was hardly less hostile to public borrowing and spoke of the expedient of perpetual funding as "ruinous."[4] "The practice of fund-

[1] C. F. Bastable properly emphasized the connection between public borrowing and the growth of constitutionalism in government.

[2] See Chap. XXVI.

[3] David Hume, *Political Discourses*, 1752, Chap. VIII.

[4] Adam Smith, *Wealth of Nations*, The Modern Library, New York, 1937, p. 872.

ing," he observed, "has gradually enfeebled every state which has adopted it." [5] Early writers, including Smith, Ricardo, and Mill, placed considerable weight upon the alleged fact that loans tend to a greater depletion of capital and potential capital than taxes.

Contrast these early attitudes with that of Bastable (1892) who observed: "We may say that any State that pretends to be civilized regards the creation of a debt as one of the essential marks of its having reached that position." [6]

Development of Borrowing in Foreign Countries

To an American, the outstanding feature in the development of public borrowing in foreign countries is the slight effort put forth and the small results attained in the retirement of debts. Heaviest borrowing occurs during wars; in some cases this is followed by peacetime borrowing for internal improvements; retirement, except by repudiation, makes very little inroad upon this accumulation of debt, which consequently grows to enormous sums.

Thus, Great Britain, with a debt of £861,000,000 at the end of the Napoleonic Wars, added £310,000,000 more to it in the course of the next hundred years. Of this, the largest items were £35,000,000 for the Crimean War and £163,000,000 for the Boer War. Up to 1914 it had redeemed only £354,000,000 of this indebtedness, or less than 35 percent during a century. The First World War increased the British debt about elevenfold. As of October 1944, the British debt stood at about £19,700,000,000 or $78,800,000,000. France and Germany had somewhat the same experience except that they retired less and added considerably to their debt by borrowing during peacetime, the former for public improvements and the latter to finance war preparations. Of the German debt, a large portion was eliminated by repudiation and by the adoption of a new monetary unit in 1924; that of France was also substantially reduced by the devaluation of the franc.[7]

Development of Borrowing in the United States

National Borrowing. Experience with borrowing in the United States, as far as the federal government is concerned, has been marked by heavy borrowing for wars and a quite rapid retirement of the debt thereafter. In fact, the federal government started out with a war debt, that of the Revolutionary War, which together with the accrued interest amounted to about

[5] *Ibid.*, p. 881.
[6] C. F. Bastable, *Public Finance*, 3rd ed., p. 626.
[7] Paul Studenski, "Chapters in Public Finance," *Economic Principles and Problems*, Vol. II, Walter E. Spahr and Others, Ray Long and Richard R. Smith, Inc., New York, 1932, pp. 529-531.

$54,000,000 in 1789. In addition, it also assumed the state debts incurred for the purpose of carrying on the war, which together brought federal indebtedness to a total of approximately $72,000,000.[8] This debt was cut in half by the time the War of 1812 added its quota, but by 1835 the combined total was retired.

The Civil War debt of $2,500,000,000 was at first retired slowly, then rapidly for a period of 10 years, and from then on very slowly. With some additions for the Spanish-American War, the construction of the Panama Canal, and other purposes, the debt stood at about $1,000,000,000 in 1914. As in the case of other belligerent countries, it was greatly increased—to $24,000,000,000—during the First World War. Steady retirement during the twenties cut the total by about a third, but large and recurring deficits after 1930 not only restored the wartime total but added roughly another half to it. During the Second World War, debt mounted rapidly until, in 1945, it far exceeded any volume previously known or contemplated in the United States.

State and Municipal Borrowing. State and municipal borrowing in the United States has been mainly for the purpose of financing the construction of works of internal improvement, such as canals, railways, and roads. Borrowing has been sporadic, following the trend of the business cycle, and has often been intemperate.

The financial history of the United States records three principal periods in which states and municipalities have plunged recklessly into debt and ended with much financial distress and defaulting. One period began after 1820 and ended with the panic of 1837. During this time, states and municipalities borrowed heavily to finance turnpikes, canals, and railroads. Charleston, South Carolina, prior to the Civil War, contributed $5,000,000 from the proceeds of municipal bond issues to finance railways leading into the city.[9] Michigan began its career as a state in 1837 by voting the construction of 557 miles of railroad, 231 canals, and 321 river improvements.[10] Many states inaugurated state banks or subscribed to stock in private banks. Among them was Alabama, which proceeded to abolish its tax system in anticipation of sufficient dividends on state-owned bank stock to pay for its government. Total state debt rose from $26,000,000 in 1830 to $175,000,000 at the close of the decade.[11] In 1842, eight states were in default,[12] six of which, however, later made good on their obligations.[13] These excesses led to constitutional

[8] Paul Studenski, *Public Borrowing*, National Municipal League, New York, 1930, p. 5; D. R. Dewey, *Financial History of the United States*, 7th ed., pp. 89-94.

[9] Philip H. Cornick, "The Debt Problem of American Cities," *Municipal Finance*, Vol. VI, No. 1, Aug. 1933, p. 15.

[10] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, p. 220.

[11] *Ibid.*

[12] Philip H. Cornick, "The Debt Problem of American Cities," p. 16.

[13] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, p. 235.

restriction on state borrowing, a feature which, by 1857, was a part of most state constitutions.

The second period preceded the panic of 1873. This was a time of heavy capital outlays, particularly for railroads. The situation was complicated by the "carpetbagger" governments in the South. Following this "spree," 12 states and numerous cities and counties had to default. "Some defied federal courts for years in their refusal to levy taxes for the support of their bonds; others entered into compromises with their creditors, and issued new bonds with lower face value and bearing a lower rate of interest. But the majority paid their bills when due out of the taxes collected almost in sweat and blood." [14]

Following this second period of reckless financing, state governments borrowed little from 1875 to 1914. The per capita state debt declined from $9.14 in 1870 to $2.80 in 1895, but rose to $3.75 by 1915. Municipal cessation from extensive borrowing, however, lasted only until 1890, at which time there began a 22-year period of increase, followed by a more stationary debt which held until 1919.[15]

The third period of public borrowing lasted from 1920 to 1930. During this time municipalities again greatly expanded their indebtedness, so much so that in 1926 the total municipal debt was six times the total state debt. An important feature of expansion during this period was the improvement of suburban areas. The depression of 1929 brought on a great deal of distress and default. By April 1933, three states and over one thousand municipalities were technically insolvent.[16]

It is characteristic of American states and cities to borrow when times are good and taxes comparatively easy to raise, and to pay off their bonds when times are bad and tax collection difficult. Thus in the midst of the depression, in 1933, $144,000,000 more municipal bonds were retired than issued.[17]

Development of International Borrowing

The early experience of the United States with debts and international credits was in the role of a debtor nation. During the Revolutionary War, the colonies were the seekers rather than the grantors of foreign loans. The Revolutionary Army was so poorly equipped that Benjamin Franklin had to go abroad to seek financial aid. Several million dollars' worth of assistance was received from Spain, Holland, and particularly France. Under the Articles of Confederation these obligations were in default and the states were threatened with intervention by foreign creditors. For instance, there were rumors that France would insist on the acquisition of Rhode Island.[18] With

[14] Philip H. Cornick, "The Debt Problem of American Cities," p. 17.
[15] Paul Studenski, *Public Borrowing*, pp. 10-13.
[16] W. J. Shultz and M. R. Caine, *Financial Development of the United States*, p. 666.
[17] *Ibid.*
[18] Carl Russell Fish, *American Diplomacy*, 3rd ed., Henry Holt and Co., New York, 1922, p. 78.

the inauguration of the federal government in 1789, the foreign debt was gradually retired.

During the early years of their history, however, the states were guarantors for a substantial amount of private debt financed abroad. These debts were incurred for the building of canals and railroads. In the South the banks, both state and private, obtained extensive loans abroad, particularly in England. The private banks borrowed with the aid of state guarantees. In the difficulties occasioned by the crisis of 1837, two states repudiated their obligations. This created so much bitterness abroad that, when the federal government sought to obtain a loan in 1842, the bankers of London and Paris gave its representatives a cold reception.

During the reconstruction period following the Civil War, several states repudiated foreign obligations incurred mostly for internal improvements. However, state default has been rare since that time. The total default on foreign obligations up to 1928 has been estimated at $75,200,000 principal and $252,820,000 interest,[19] exclusive of Confederate loans. The states have justified their repudiation on the ground that the loans were contracted by nonrepresentative "carpetbagger" governments supported by northern troops. The defaults, nevertheless, are regarded as a blot on the financial record of the United States. It is interesting to observe how, in 75 years, the situation has reversed itself and American bankers have turned a cold shoulder to foreign supplicants because of the default of their governments' obligations to the United States.[20]

The problems arising in connection with the most recent and important phase of international borrowing, the war debts and reparations, will be discussed in the following chapter.

EXTENT AND CHARACTER OF THE PUBLIC DEBT IN THE UNITED STATES

Over-all Picture and Its Recent Development. At the end of the First World War, the federal government emerged with a federal debt of $24 billion, which was reduced during the prosperous twenties to $16 billion. With the onslaught of the depression of the thirties, the federal government reborrowed all that it had paid off in the postwar period and considerably more besides. After 10 years of unbalanced budgets preceding the war, the debt had mounted to $41,530 million in 1941.[21] During the Second World

[19] Max Winkler, "Defaults and Repudiation of Foreign Loans," Foreign Policy Association, *Information Service*, Vol. IV, No. 11, Aug. 1928, p. 244.

[20] B. H. Williams, *Economic Foreign Policy of the United States*, McGraw-Hill Book Co., New York, 1929, pp. 13-16.

[21] The figures are for net debt, which allows a deduction for cash balances, investments in securities, and so forth. Net burden is the net burden which the taxpayer may anticipate because of borrowing.

War, it soared to unprecedented figures. The gross debt on January 1, 1945, was $232 billion and it seemed probable that by the end of the war the figure might be as high as $300 billion.

State debts, which had mounted greatly throughout the twenties, continued to climb during the subsequent depression, although at a slower rate. There have been modest reductions during the war years. Municipal debt, which had also risen greatly during the preceding decade, fell off sharply from 1932 to 1934 and leveled off thereafter. In 1941, the net debt of state and local governments was $14,464 billion.

Debt figures become more significant if they are related to population and income and if the interest factor is taken into account. It has been universally characteristic of public debts that an increase in population has tended to reduce the burden on the taxpayer. This was particularly true of the debts incurred by nations throughout the nineteenth century. The universal increase in per capita wealth has operated in the same direction. The per capita federal public debt as of January 1, 1945, was about $2,000. This means that the total for a family of 4 was about $8,000.

It is also significant that governments have been able to borrow at progressively lower rates of interest since 1919, and particularly since 1930. In 1929, the average rate of interest paid on federal obligations was 4.178 percent and, in 1937, 2.582 percent. The enormous borrowings of the war period did not result, as might have been expected, in higher interest rates. The average interest rate on all federal obligations in 1944 was 1.924 percent. This low figure compares with British and Canadian averages of 2.441 and 2.751 respectively.[22] These low interest rates may create some problems of debt management in the postwar period but they greatly reduce the fixed charges of the government.

Who Owns the Debt? The borrowed funds of national governments do not necessarily come from the savings of individuals. They may come from the savings of corporations, insurance companies, or banks. In the case of banks, they often represent "new money" in effect; the banks create additional credit on the strength of the bonds. When banks purchase government bonds, they may use them as security to borrow from federal reserve banks. Thus, borrowing from banks is an especially inflationary means of financing a war or any other government enterprise. The acquisition of large amounts of government obligations by banks also creates some problems for these institutions. They are now chiefly custodians of federal debt rather than retailers of commercial credit. Treasury obligations constitute over 70 percent of banks' earning assets. Thus the future of banking depends on the future of the federal security market to an extraordinary degree. If a rise in interest rates were to result from large-scale private demand for credit, the securities, at least without government support, might depreciate.

[22] Harold L. Seligman, "Patterns of Wartime Borrowing in The United States, The United Kingdom and Canada," *Federal Reserve Bulletin*, Nov. 1944, p. 1064.

Banks maintain a high degree of liquidity and safety as long as the government or the federal reserve system maintains a market for their securities. However, were the government to commit itself to the policy of maintaining such a market, the banks might demand long-term securities with their higher interest rates, and cease to be a market for bills and certificates. The expansion of Treasury holdings by banks has been mainly at the expense of their capital ratio (ratio of stockholders' equity to bank assets). This has helped to offset the effect on earnings of a decline in the rate of interest.

In 1944, at the end of the fiscal year, the government debt was held as follows:

	%
Commercial banks	33.9
Federal reserve banks	7.9
Governmental agencies	8.5
Other corporations and individuals	49.7

Comparable figures in Great Britain show the commercial banks holding but 17.8 percent of the British debt and the Bank of England an additional 8.3 percent; governmental agencies held 7.4 percent and other investors, 66.4 percent.[23]

Capacity to Pay or Service the Debt. Considerable alarm over the sharply upward trend of the public debt was manifest during the Second World War.

Just how much debt a nation can carry without too great a strain will depend on many factors, including the distribution of the debt, the distribution of income, the tax system, and, most important of all, the maintenance of a high income. The ideal economic order for carrying a high debt comfortably would be a large national income, equitably distributed throughout all income groups; a wide distribution of the debt; and a reasonably progressive tax system. The nearer we approach the ideal, the less difficulty will the debt give us. A debt of twice the national income is generally recognized as not so large as to cause alarm.

Purposes of Borrowing. Debts incurred for expenditures which in no way increase the productive power of the community, yielding neither revenue nor a future flow of benefits, are sometimes termed deadweight debt. War expenditures are usually taken as the prime example; sometimes relief expenditures are also included. It is not to be concluded that these debts are not necessary and important. They are protective in nature but they are without the benefit of self-liquidating characteristics.

Debt incurred for expenditures which, while yielding benefits to the community, do not return a money income, are called passive debts. Parks and public buildings for administrative purposes are cited as examples. Of course,

[23] Harold L. Seligman, "Patterns of Wartime Borrowing in The United States, The United Kingdom and Canada," p. 1066.

parks may indirectly create income by improving the health of the citizenry and thus increasing earning power. The same type of analysis could be applied to public buildings.

Debt incurred for capital expenditures which are self-liquidating or which in a high degree increase the productive power of the community are classed as active debt. Expenditures for public health might be classed as active. Obviously the difference between class 2 and class 3 is one of degree.

One-third of the municipal debt is for revenue-producing enterprises such as water systems, other utilities, docks, and subways. Much federal debt incurred during the thirties was more or less of the active or productive type, but of course the recent additions for war purposes have been of the deadweight variety.

INSTRUMENTALITIES OF PUBLIC BORROWING

Public credits and debts may be classified according to a variety of forms. First of all they may be classified according to the governmental unit doing the borrowing, in which case they are national, state, or local. Or they may be classified according to the territorial source of the credit; that is, as foreign or domestic. Or if foreign, they may be classified according to the character of the borrower, in which case they are intergovernmental or not intergovernmental (that is, from private foreign sources). Several other possible classifications and special characteristics will be apparent from the discussion that follows.

Interest-Bearing and Noninterest-Bearing Debt. Ordinarily government loans, like private loans, command a certain rate of interest. It is possible, however, for governments to issue notes, customarily called money, which bear no interest. In order to make such notes acceptable, it may be necessary to make them legal tender, that is, compel their acceptance at par in the payment of debts. The value of government notes may also be maintained by the establishment of a reserve and the privilege of redeeming the notes in other currency on demand. The "greenbacks" of the Civil War period are an example of public credit extended by the issuance of legal tender notes. The treasury notes of 1890 also were credit instruments as well as money. The latter have practically all been retired, but some $349,000,000 of United States notes (reissued greenbacks) are still outstanding. During most of their history, these notes have been redeemable in specie.

Other nations have frequently issued noninterest-bearing notes irredeemable in specie. Germany, for example, built up a floating debt during the early twenties, consisting of noninterest-bearing notes of unprecedented volume.

One means of reducing the interest load of the postwar period would be to "monetize" part or all of the war debt. This could be accomplished by

the purchase of bonds through the issuance of noninterest-bearing government notes. It could also be accomplished by the sale of new bonds to the federal reserve banks and the use of the proceeds to retire indebtedness held by individuals or commercial banks. The reserve banks are limited in their dividends to 6 percent on their capital stock and, if the balance were to go to the government, monetization could be accomplished without any cost in interest outlay. Such a procedure would be a departure from traditional national debt policy and might pave the way for inflationary practices. However, it is at least debatable whether, under critically difficult circumstances, the gain in tax relief would not warrant action of this character.

Forced and Contractual Loans. During the reign of Charles I of England, British citizens were forced to lend the king money. This amounted to a tax in all but name; since taxes required parliamentary approval, the term "tax" was avoided so that the king, with a semblance of constitutional procedure, could raise revenue without the consent of parliament. The high-pressure methods used in the sale of Liberty Bonds during the First World War have sometimes been compared with the tactics of Charles I.[24] Those who refused to take "their quota" were in many cases subjected to various degrees of public humiliation and violence. These tactics were not advocated or authorized by the government, but it did nothing to prevent them. During the Second World War, the tactics used to sell bonds involved less pressure, but this element was not entirely avoided. At the same time, the institution of "compulsory saving" came into vogue. This was introduced in Great Britain, Canada, and to a lesser extent in the United States, in the form of postwar credits for a part of income and excess profits taxes.

Coercion in borrowing may also take the form of the noninterest-bearing legal tender notes. In making such notes legal tender, the government uses its power of sovereignty to force the acceptance and circulation of its currency. Where such notes are redeemable in specie, or where they are so limited that confidence in them is maintained at a high level, they are freely accepted and no coercion is required.

Duration of Interest-Bearing Obligations. Public credit instrumentalities also differ in their time of maturity. Governments may borrow for a few days or many years. Many European bonds have been issued with no definite maturity at all. They are a perpetual obligation of the government as far as interest is concerned. In general, borrowing is usually classified as short-term, intermediate, and long-term.

When an individual or a corporation wishes credit for a short time, he or it customarily makes an arrangement with a bank which extends such a credit on a note. School districts and local units of government not infrequently use this same procedure. The federal government borrows for short periods through the sale to banks of treasury certificates or bills. These borrowings

[24] See Chapter I.

are used for interim financing, that is, for the purpose of having a ready supply of cash between periods of heavy revenue receipts and to cut down government deposits after the receipts. Thus, the federal government employs treasury bills and certificates in this capacity in anticipation of income tax revenues.

Treasury bills run for 90 days or thereabouts. The average rate on all bills in 1943 was 0.371 percent. Short-term certificates of indebtedness in 1943 were issued for various periods of from 1 to 7 days. They commanded an interest rate of ¼ of 1 percent.

The treasury note constitutes the government's intermediate credit instrument. The maturity of these notes seldom exceeds five years. During 1943 the interest rate ranged from less than 1 percent to 1.5 percent. These notes are frequently converted into long-term bonds. Both treasury bills and notes are purchased only by banks and other credit institutions.

The long-term credit instrument (both national and local) is the bond. The type of bond having widest circulation during the Second World War was the war savings bond. These were issued in several series, of which Series E was especially adapted to the needs of the small saver. These bonds were issued in convenient denominations ranging as low as $25. They carried a maturity of 10 years but might be redeemed at any time 60 days after issue, without notice, at stated redemption values. Series E paid no interest annually but, if allowed to mature, the interest payment would amount to 2.9 percent over the life of the bond, compounded semiannually. In event of premature redemption, interest would be paid according to a graduated scale, depending on the period during which the bond had been held. A table indicating redemption values appeared on the face of each bond. These bonds carried the signature of the purchaser and were nonnegotiable and not transferable. They might be purchased by individuals only and no one person could buy more than $5,000 maturity value ($3,750 purchase price) in any one calendar year.

Series F and G were similar but adapted more to the needs of larger investors. Both carried a maturity of 12 years. The interest return on Series F, if allowed to mature, was approximately 2.53 percent; on Series G it was 2½ percent. Series F paid no interest annually, but Series G bore interest payable semiannually by Treasury check. Limit on purchase in each case and of the two combined was $100,000. Both bonds were redeemable six months after issue date upon one month's written notice. If redeemed within from 1 to 1½ years after issue, the interest payable on Series F would be at the rate of .27 percent, and so on. These bonds were open to purchase by all classes of purchasers other than commercial banks.

Other coupon bonds of 10 years' maturity or thereabouts were issued at interest rates of 2 percent. For longer maturities the interest rate ranged to 2½ percent. All bonds were taxable as to interest under the federal income tax.

To care for the smallest savers, denominations below $25 were provided in the form of stamps. In suitable quantities these were convertible into bonds.

Beginning in 1941, the Treasury also offered tax-saving notes designed to encourage regular saving for taxes. Series A, in small denominations for small taxpayers, paid interest at 1.92 percent and Series B, for large taxpayers, paid .48 percent. The total amount of Series A which might be purchased by any one taxpayer was limited to $1,200. Substantial amounts, mostly of Series B, were purchased. Later, a single series of 3-year notes, without limit as to purchase and paying an average interest rate of 1.07 percent, were issued.

The savings bonds proved a convenient and attractive instrument for small savers but they were open to important objections. From the standpoint of the government, their redeemability gave them somewhat the same character as short-term obligations. Unfortunately, a very large proportion of these bonds were redeemed prematurely. In 1944, redemptions amounted to about one-fifth of sales. If the postwar period should be seriously threatened with inflation, the redemption feature of these bonds might prove embarrassing. Moreover, many investors prefer to receive interest currently, rather than at the maturity of the bond as in Series E and F, and some prefer the coupon style of payment. Nevertheless, the nonnegotiable feature discouraged purchase under pressure through borrowing from banks, a feature which characterized much borrowing during the First World War and one that proved quite inflationary.

On September 30, 1944, outstanding federal securities were divided as follows: bills, 8.65 percent; certificates, 16.24 percent; notes, 9.85 percent; savings bonds, 20.5 percent; other bonds, 44.75 percent.[25]

Term Bonds and Serial Bonds. Bonds differ not only in the time involved before their maturity, but also in the regularity or diversity of their maturity. An issue of term bonds falls due at the same time, whereas serial bonds have different maturities, arranged so that only a certain proportion falls due each year. Serial bonds predominate in state and municipal borrowing.[26]

Special Features of Bonds. Certain special features may be attached to a bond in order to make it more salable. Some European countries frequently attach a lottery feature to bonds by which a handsome prize is given to certain lucky numbers. This would be regarded in the United States as pro-

[25] *Federal Reserve Bulletin*, Nov. 1944, p. 1107.

[26] In European countries, particularly in an earlier period, governments offered their creditors annuities as a form of government obligation. Annuities so arranged are very much like those regularly sold by life insurance companies. They may involve payment over a specified number of years, or during the life of the annuitant. Ordinarily, principal and interest are returned to the creditor over the period of payment. Thus the annuity, as contrasted with the perpetual debt, involves the obligation to retire indebtedness.

The United States has not employed annuities in public borrowing, although something not so very different may be involved in the social security system. The beneficiaries of

moting bad morals. In the United States many bonds carry tax-exemption privileges which enhance their attractiveness for certain buyers.

Public bonds, like private ones, may be "callable," that is, they may be so issued that the government can redeem them at any time at a stated price. This feature is regarded as very favorable to the government, since it facilitates refinancing when the money market is favorable and new bonds can be floated at a reduced rate of interest. By the same reasoning it is not so favorable to the creditor and he may therefore require more interest. On the other hand, he may be induced to accept the callable bond, even with a low interest rate, if the bond is not callable for a certain period or except at a figure somewhat above par.

It can be said that, in general, governments should avoid attaching special privileges to bonds in order to make them more salable. (This is not to say that the terms of contract should not vary to meet the investment needs of particular groups.) The rate of interest should be the only "special feature" necessary to market government issues.

MANAGEMENT OF THE PUBLIC DEBT

Selection of Instrumentality. The management of the public debt involves many problems. One of these is the selection of the most appropriate credit instruments for the purposes at hand. For instance, it may be of great importance to determine whether long or short-term obligations should be used.

Short-term obligations have the advantage of being cheap (low interest) when the money market is favorable, but they have been thought to entail more risk for the government than obligations of longer term. Short-term obligations involve constant refinancing and in times of stringent credit this may be difficult and expensive. Moreover, they necessitate heavy reliance upon banks as a source of public credit. This is thought to involve special dangers of inflation. On the other hand, some use of banks to finance a major war appears necessary. Insofar as this is true, short-term financing probably is also justified. Under modern controls, there seems to be little danger of great difficulty in refunding short-term issues. The federal reserve system could be relied upon to relieve the stringency in such emergency. In an inflationary period, good monetary policy would call for the conversion of short-term to long-term credit and the transfer of ownership from banks to individuals. In a deflationary period, the opposite procedure would be in

this program may pay to the government a certain proportion of their current wages in the prospect of receiving principal and interest during their declining years. Payments to the government may involve a surplus above current outlays, which the government can use during such time as it is not required to meet its obligations to the aged. The system differs from the annuity as an institution of public borrowing mostly in that it is not contractual, that both employer and employee must contribute, and that the government is obliged to return principal and interest, only as the law provides and is maintained.

order. The reason for these propositions is that expansion of bank holdings involves an expansion of credit, and expansion of individual holdings does not. The latter may be financed out of savings.

The question may be raised as to whether the banks can continue to absorb an indefinite amount of new government obligations. The credit system is so elastic and so subject to government control that the answer to this question is probably in the affirmative. But it does not follow that it is wise to feed the banks such large quantities of securities for an indefinite period.

Mention has been made of the fact that different types of obligations appeal to and meet the needs of different investors. During war, when it becomes especially important to acquire large sums quickly by borrowing, it may be desirable to offer a "market basket" of investment opportunities all at once as a feature of a loan drive. Thus, in the fall of 1942, the Treasury offered ⅞ percent certificates, 1½ percent bonds, 2½ percent bonds, tax notes, and savings bonds.[27]

Terms of the Loan. In addition to the time factor, the financier must select the rate of interest to be charged and must determine whether the bonds shall be offered at a premium, at a discount, or at par. The higher the interest rate, other things being equal, the better the price at which the bonds can be sold. If both the interest rate and the sales price are set at too generous a level, the issue may be oversubscribed, which is good for government credit but involves a heavier burden of public debt than is necessary. On the other hand, the opposite failing, which leaves the issue undersubscribed, results in insufficient receipts and is bad for government credit.

During the First World War, the interest rate on successive issues of bonds rose from 3½ to 4 and finally to 4¾ percent. During the Second World War, interest rates apparently became stabilized at amounts previously indicated, varying with the maturity of the obligations. It has been said that during the earlier emergency the market told the Treasury what interest rate was necessary, whereas during the second struggle the tables were reversed. It is suggested that on the earlier occasion the Treasury did not realize how much pressure could be put upon the market. The change in circumstances may be due also to the lower interest rates to which people have become accustomed, to the increased domination of the credit system by the government, and to the increased volume of idle funds.

The low interest rate with which the Second World War was financed may involve serious problems in the postwar period. This might happen in an inflationary period during which the private demand for capital resulted in a strong tendency for interest rates to rise substantially. This would present something of a dilemma to the government. It might elect to try stabilizing the interest rate but this would cast aside a weapon of inflation control. It might elect to maintain the value of bonds by offering to pur-

[27] *National City Bank News Letter*, New York, Dec. 1942, p. 135.

chase them at par and then reborrowing at higher interest rates. This would be costly in terms of interest outlays. It might let its bonds depreciate but this would place a strain on the banks and would be unpopular with holders of long-term bonds. Fortunately, the large volume of short-term obligations and of nonnegotiable bonds involve no problem as to the maintenance of prices. If the choice is to peg interest, other factors would have to be relied upon to control inflation. These other factors include taxes and bank reserve requirements. Government obligations did depreciate materially after the First World War. All of these alternatives involve difficulties, but the trend favors controlled low-interest rates and the use of other tools to keep prices and business expansion within reasonable bounds.

Methods of Sale. European bonds are frequently disposed of through stock exchanges. In the United States, the federal reserve banks act as the fiscal agent of the government. They receive subscriptions for government issues from either private individuals or banks. United States savings bonds were formerly marketed exclusively through the Post Office Department, but during the Second World War a large number of commercial banks, credit unions, and other institutions were approved for distribution.

During the First World War, marketing was accomplished through highly organized "drives" with the aid of familiar devices such as division of territory, quotas, volunteer salesmen, and public meetings. During the Second World War, an important innovation was the payroll deduction plan, under which deductions were made directly by employers from the wages of employees and accumulated for the purchase of war savings bonds. The plan was readily accepted by employers and employees alike. By June 1942, 108,000 firms, employing 21 million workers, including 75 percent of all firms with more than 100 employees and all of the large firms of the nation, were participating.[28] The more general personal solicitation of the First World War had the advantage of the wider application of pressure and it was effective in raising funds. However, it was unpopular and was thought to involve an overdose of coercion.

State and local bonds are usually dispensed by sale to banks and security companies. These companies may buy the bonds outright and dispose of them if and as they see fit, or they may act merely as agents and sell them on a commission. In either event, competition should be used to secure the most favorable terms for the government. Some municipalities are too small to market their bonds effectively. In such cases the state can be of assistance in the marketing process.[29] Great Britain borrows money on its own credit to extend to municipalities for certain purposes. In the United States at least one state, Massachusetts, maintains a state municipal loan fund.

[28] *Annual Report of the Secretary of Treasury for the Year Ended June 30, 1942*, p. 27.

[29] At least one state, North Carolina, requires marketing through its central facilities, the Local Government Commission; see A. M. Hillhouse, *Municipal Bonds: A Century of Experience*, Prentice-Hall, Inc., New York, 1936, p. 465; see also Chap. XXVI.

Conversion and Refunding of Loans. As has been noted, callable bonds can frequently be refunded at quite a saving of interest. Skillful conversion so as to take advantage of a favorable money market is one of the principal opportunities for economy in the manipulation of the debt. During the thirties, the First and Fourth Liberty Loans were refunded with material savings in interest. The new bonds commanded an interest rate of only 2⅞ percent as compared with the rate of 4¼ percent on the bonds which were replaced. Refunding may occur without conversion to a lower rate of interest where short-term obligations are replaced by long-term obligations, or where matured bonds cannot be retired except with the issuance of new ones.

Should Debts Be Retired? Most people were "brought up" on the doctrine that it is good for an individual to pay off his debts but better yet not to acquire any in the first place. This doctrine is carried over in their code of government conduct. Nevertheless, there are also proponents of the view that governments should not seek to retire their debts.

A plausible argument for maintaining the debt is that the growth of wealth and population in a progressive state will tend to make the debt less burdensome. There is much historical evidence in support of this argument. The qualms of Smith and Hume that the propensity to borrow would lead to certain national bankruptcy seem not to have materialized, or at least would not have materialized except for the unprecedented extravagance of recent years. Macaulay was particularly impressed by the observation that debts which seem unbearable for one generation are easily shouldered by the next.[30] On the other hand, there are also many instances where the debt has grown much more rapidly than wealth or population.

Public debt, like taxation, may serve certain collateral or nonfiscal purposes. It provides a safe and liquid medium of investment; this is particularly useful for people with small savings, for banks as a secondary reserve, and for fiduciaries as a source of investment for trust funds. Insurance companies find government bonds a very desirable investment for part of their enormous resources. The widespread ownership of government bonds gives many people a stake in the government, a factor thought to make for stability. Alexander Hamilton offered this as one reason for federal assumption of the war debts of the states when the national government was organized. The much-controverted use of federal debt as an investment medium for the social security reserves illustrates its nonfiscal importance. On the other hand, it seems very doubtful whether governments should make their decisions concerning debt retirement turn on the nonfiscal consideration of investment opportunities. The modern corporation has created a great variety of investment opportunities. Productive government undertakings will involve a new supply of government bonds even if the decks are cleared of

[30] See C. F. Bastable, *Public Finance*, 3rd ed., p. 663.

the old ones. Finally, it seems that in this day it is hardly a matter of wiping out the debts entirely—it is a question of some retirement or none.

It is argued that debt retirement is deflationary; that is, that payment of debt, particularly to banks, involves the curtailment of bank credit. When banks lend to governments, they may do so by expanding the ratio of their loans to their reserves. When governments repay, the process is likely to be reversed. The volume of credit outstanding has an influence on the price level, which in turn affects business profits and the level of business activity. However, it is only on the assumption that the private demand for sound productive loans is insufficient to maintain an adequate volume of credit that governments are expected to maintain nonproductive public debt in order to keep up this volume. If governments must borrow in order to keep the capitalistic system expanding, they should do so for self-liquidating (or at least semi-self-liquidating) productive investments. In the case of retirement of bonds held by individuals, deflationary consequence will follow only if the payees have less propensity to spend than the taxpayers.

The advantages of paying off debts are, first, that it results in a saving in governmental expenditures for interest; second, that it strengthens the credit of the government so that it can better meet an emergency; third, that it may serve as a tool to cope with inflation. No measure in preparation for war is more sound and defensible than the single policy of paying off the debt. And the same could be said about preparation for a depression. Debt service may constitute a high fixed charge, which proves especially embarrassing when times are bad. Most of the British debt in 1914 was about a century old. Further reduction of this debt would have been an excellent preparedness program for Great Britain.

Obviously, in the postwar period the question of whether or not to retire the war debt will be answered in large part by the amount of national income we are able to maintain. If income reaches high levels with an upward trend, as during the twenties, the debt can be stabilized and probably decreased. To attempt debt retirement while large-scale unemployment continues might not only be unsuccessful but it might cause considerable damage. It would involve raising taxes during a depression period and this might aggravate the depression. It is far more important to achieve and maintain a high national income than to retire debt.

Means of Debt Retirement. Assuming that debts should be retired, the question arises as to the method of procedure. One of the earliest devices used for this purpose was the sinking fund. As the term was then used, it consisted of an actual fund invested in securities, usually in those to be retired. The fund was expected to accumulate both from the appropriations made to it for principal retirement and from interest on the public bonds held by the fund. This arrangement was at one time thought to be advantageous to the state because the fund earned compound interest and might thus accumulate on its own momentum. It now seems very obvious that the in-

terest earned by the fund is paid, as well as received, by the state and that the only source of debt retirement is in a surplus of revenues over expenditures. However, in 1772 a certain British clergyman by the name of Price, in his "An Appeal to the Public on the Subject of the National Debt," argued that the public debt is directly productive because it earns compound interest. His argument was so convincing to British statesmen that they borrowed at 5 percent, to retire through the sinking fund, bonds upon which the interest charge was only 4½ percent.

A sinking fund which consists of an invested sum of accumulated appropriations is still not unknown.[31] It is usually regarded by students of public finance as undesirable because it offers opportunities for mismanagement and is an invitation for raids by an unscrupulous legislature. The experience of municipalities with sinking funds of this sort has always been advanced as the strongest argument for serial bonds.

In modern times, however, the term "sinking fund" is applied to any regular plan of retiring term bonds. It may not be necessary to actually lay aside a fund for retirement. This objective may be accomplished by purchase, failure to renew short-term credit when mature, or by calling in part or all of the callable bonds. Bonds once acquired may be canceled rather than carried in a fund's portfolio.

As previously indicated, a popular method of debt retirement in municipal borrowing is the issuance of serial bonds, which mature from year to year in planned proportions. Serial bond maturity may be arranged to follow either of two plans of retirement. Equal payments on principal may be made each year, in which case the burden becomes steadily less because of the reduced interest factor. Or, required payment of principal may take into account the falling burden of interest, in which case the annual burden of the debt will remain constant throughout the period of retirement. This system appears the more logical, especially when consideration is given to the development of resources. It may be regarded as desirable to dispose of more than a proportionate share of the debt in the early years when interest in the project financed by the debt is at its height. Serial bonds constitute a less flexible method of debt reduction than the sinking fund, and herein lies both the strength and weakness of these two methods. A straitjacket discipline, which compels payment both in good and bad years, even when it is necessary to borrow in order to pay off debts in the bad years (and perhaps at a net loss in interest), seems both unwise and unnecessary. Actually, however, such a discipline has proved to be far the best and surest method of municipal debt retirement, and in some states it is required by state

[31] The most widely accepted practice favors the investment of sinking fund moneys in the bonds to be retired. However, in the case of municipalities there is frequently no opportunity for the purchase of these bonds, and in such cases, as in Michigan, provision is made for investment in other securities. See Carl H. Chatters and Others, *Municipal Debt Defaults*, Publication No. 33, Public Administration Service, Chicago, 1933, p. 30

statute. If sinking fund appropriations are made mandatory and require special action to repeal, they become practically as inflexible as serial bonds. The chief difficulty with sinking funds is in their management, which frequently requires the services of a skilled investment banker. If the flexibility of the sinking funds is desired, it would seem advisable to have these sinking funds, in the case of municipalities, supervised by some central agency of the state government.

In the use of term bonds, retirement appropriations may take a number of forms. One is the appropriation from year to year of any surplus which may be available. During good times and abundant revenues this might result in substantial retirement, but it is hardly a method of retirement. A second form is a continuing appropriation which requires affirmative legislation to revoke. A third is the designation of certain specific revenue sources for debt retirement. The federal government permits estate taxes, as well as foreign debt settlements (if there are any), to be paid in government bonds. Indebtedness may also be retired by means of a capital levy, a single heavy tax on wealth, more of which will be said in the following chapter.

During the 1920's the plan of debt retirement enacted shortly after the war was to retire each year 2½ percent of the bonds and notes outstanding, less foreign obligations to the United States; in addition, the interest upon retired bonds was to be added to the fund. From 1921 to 1937, $5,856,000,000 of the federal debt was retired through the operation of this sinking fund.[32] However, retirement proceeded considerably faster than the plan due to the specific appropriation of Treasury surpluses. This record of debt retirement has been described as "unsurpassed in the annals of public finance" and "a service of inestimable value for the depression years."[33] This high praise is probably well deserved, though even more rapid retirement could have been accomplished had the government made less sweeping reductions in taxes, especially in the upper income brackets. The belief that paying off a debt is impossible because it is too deflationary seems not to have troubled anyone during the prosperous twenties. During the thirties, when the federal government was accumulating deficits, the sinking fund provisions became nothing but a fiction, for any retirements through the sinking fund would only mean that the government would have to float additional obligations.

Means of Getting Rid of Debt Other Than Retirement. Besides the retirement of bonds through a sinking fund, serial bond retirement, or capital levy, there are several other ways by which governments slough off their debt burdens. One method is monetary devaluation. By increasing the quantity of money or reducing the gold content of the monetary unit, the prices of goods and services (their value in terms of money) are likely to rise. Since bonds are payable in money, the devaluation reduces the goods and services

[32] *Annual Report of the Secretary of the Treasury for the Fiscal Year Ending June 30 1937*, Washington, 1938, p. 438.

[33] H. L. Lutz, *Public Finance*, 3rd ed., pp. 777-780.

(in effect) which are due the bondholder. Most of the principal countries of Europe, as well as the United States, have devaluated their currencies at least once since the First World War. Usually there were economic factors other than the burden of the public debt which led to this devaluation; at any rate the result has usually been a higher level of domestic prices, and a corresponding reduction in the debt burden. As previously stated, the carrying charges of a debt can be eliminated by monetizing the debt. But the easiness of this procedure is its principal danger.

Clauses in government bonds requiring payment in gold have proved unavailing as a defense by creditors against the power of the state to devalue the currency. The United States Supreme Court did not directly hold that Congress could alter the terms of bond contracts which the United States government itself had issued, but it reached this result indirectly when it held that specific complainants had failed to establish damages.[34]

Another method of relief from debts is repudiation. This was used by the Soviet Russian regime following the Revolution of 1917. The Confederate states repudiated their debts, foreign and domestic, following the Civil War. Still another possibility is default, which differs from repudiation in that failure to pay in the former case is due to inability, and in the latter to unwillingness or refusal to recognize the validity of the debt. About 3,000 municipalities[35] and one state defaulted on debt principal or interest or both in the depression year of 1933. Forced refunding is a modified default in that creditors accept some compromise arrangement involving the issue of new obligations to be redeemed at a later date.

PRINCIPLES OF PUBLIC CREDIT

Effect of Internal Debt on National Wealth. For the nation at large, everybody's debt is somebody's credit. Government borrowing, except for the foreign debt, is "within the family." The family wealth cannot be reduced because some members borrow from others. In Great Britain, before the Second World War, about 25 percent of the national budget went for interest. But this interest was distributed to large numbers of people and constituted a substantial part of the income received by her citizens. Moreover, in Great Britain, as contrasted with the United States, interest on government obligations was generally taxable. For securities issued during and after 1941, the exemption privilege in the United States has also been eliminated.

It is sometimes argued that since the internal debt is "all within the family," it constitutes no burden at the time of its payment. But this ignores

[34] Perry v. United States, 294 U. S. 330 (1935).

[35] This, however, represents less than 2 percent of all municipalities and not more than from 3 to 5 percent of all municipal debt.

the fact that taxpayers and bondholders are not the same persons. Taxes that are paid for interest and principal all go back to the public, but it is not the same public that pays the taxes. In general, taxation tends to be more universal than bondholding.

Since servicing and retiring debt involves only a transfer from part of the national family to another part, there might seem to be no limit to the process. But the transfer itself involves the pain and waste of heavy taxation. Tax machinery has been known to stall under a great load of fixed charges. It is true that the government can always borrow or print money and, while there remain large amounts of unemployed resources, this may involve little danger of inflationary prices. However, it is not at all certain that any such program would not be wrecked by the fear it would create or that it would be proof against expenditures which were highly extravagant and wasteful.

Effect of Borrowing on Future Generations. There has been much argument among economists as to whether or not it is possible to shift the burden of a war or any other public outlay to future generations. The man on the street is likely to assume that long-time borrowing does shift the burden. But it is easy to demonstrate that, as far as the physical or "objective" burden is concerned, all (or nearly all) must come from the generation that fights the war. The present generation has the loss of the physical goods and services which might have been currently consumed had they not been diverted to war purposes. Exceptions can be made for deferred maintenance of capital and other items of a similar nature, but these are not what are usually thought of as the deferred costs. To put the argument another way, when a nation borrows from itself or within the family, it may have to tax future generations to pay principal and interest on the debt, but the future generations in turn receive this interest and principal and may, if they like, enlarge their consumption with it.

It has been contended that we should distinguish between the objective and the subjective cost of war. The subjective cost represents the sacrifice in psychic terms. Taxes involve more sacrifice than loans. In either case there is an abstention from present consumption on the part of the individual, but in the case of taxes the abstention is permanent and with no direct *quid pro quo*. In the case of loans there is a postponement rather than a final separation, and the individual receives a bond which adds to his power and security. In this we have an example that saving for many people involves no sacrifice. There can be no doubt that the postponement of taxes is a postponement of burden. A community may pay for a schoolhouse over a period of 30 years. If the bonds are sold in that community, it can be argued that the present generation takes the whole cost out of the scale of living it might have had. Actually, however, there will be a widespread feeling, and not an illusory one, that much of the burden has been postponed.

When Is It Legitimate to Borrow? When is it legitimate for a government to borrow? The answers are not very different from those which might be

made to a similar question concerning the propriety of individual borrowing. It is legitimate for an individual to buy durable goods on the installment plan. One cannot be charged with imprudence for buying a washing machine with a down payment and a promise to pay the remainder from month to month or year to year. Of course, it is true that the cost of the machine is very much increased as a result of this method of financing. It would be thought unsound for him to arrange payments for a longer period than the machine is expected to give service. Probably the habit of installment buying is conducive to freer and less carefully considered expenditures than cash payment. These same considerations are involved when a government contemplates paying for a new schoolhouse or city hall.

When a consumer buys an expensive durable good, he is likely to favor installment payment rather than cash payment because the latter would upset his budget. To an equal extent, the government is impelled by the same motive. To place the whole burden of an extraordinary expense upon the taxpayers in one year may badly upset the tax system and ruin the taxpayers' morale.

On the other hand, many people have never become entirely reconciled to installment buying. And there are critics who feel that government borrowing should be confined to "self-sustaining" public projects. This policy has been followed by at least one government in recent years; Sweden has avoided borrowing for durable goods which were not directly self-liquidating. It is certain that this program should not be carried to the point of ruling out credit for a small school district which requires a new schoolhouse. But it at least serves to remind citizens that borrowing for non-self-sustaining projects should be in conservative amounts.

It is legitimate for a private individual to borrow when going into the grocery business, and it is legitimate for governments to borrow for productive purposes, such as the financing of new public utility equipment. Public highways are not usually classed as public utilities, but they may be self-liquidating in the sense that road-users may be expected to pay for them with increased contributions of gasoline tax. Amortization should at least equal the depreciation. Private business shows poor strategy when it borrows too large a portion of its fixed and working capital. Some measure of reserve credit is an important business advantage and means a lower expense ratio for the business. Public business does not differ in this respect. If the bonds of the public business are secured not only by the earnings of the public business, but also by the general credit of the government, it may be less necessary for the government to keep its bond ratio low.

A private individual may be justified in borrowing when he is confronted with an unexpected emergency, such as the need for an expensive operation. Likewise, governments, too, are justified in borrowing to meet disasters such as war and flood and famine. There has been some doubt about the propriety of borrowing for relief, but this doubt is based mainly upon the un-

certainty that relief expenditures are of an emergency character. In other words, it is feared that a considerable part of the relief burden may be chronic. Since the development of public borrowing, wars have always been principally financed by borrowing.[36]

It is universally agreed that to finance regular and recurring expenditures by borrowing is unsound. As Mr. Micawber phrased it: "Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery. The blossom is blighted, the leaf is withered, and the God of day goes down upon the dreary scene, and—and in short you are forever floored." [37] This is as good advice for governments as it is for individuals. Both can get into a lot of trouble waiting for something to "turn up." Ordinarily it is inappropriate for the individual to borrow money to pay grocery bills and for governments to go into debt to pay for lighting the streets and heating the city hall. Usually the distinction between a special and a recurring item of expenditure will be the same as that between capital outlays and operating expenses. But sometimes, particularly in large cities, capital outlays may be recurring. For instance, a very large city has a continual addition to or replacement of school buildings. It is sound finance to pay for such capital outlays as part of the annual budget.

It is possible that governments may achieve sufficient discipline and aptitude for planning so that they can deliberately plan deficits in depression years and balance their budgets, not annually, but over the business cycle. This is a plausible and attractive theory, but it encounters difficulties because trade cycles do not repeat themselves regularly and their course is not predictable. Moreover, in the application of this theory there would be a strong inclination to borrow during hard times but to neglect raising the surplus revenues necessary for deficit payment when times are good. Of course, as has been previously stated, borrowing is warranted in any event in special emergencies such as a depression. The tendency of American states and their subdivisions to borrow "up to the hilt" when times are booming and everyone else is borrowing, and then to seek liquidation of their debts during depression, when tax payments are the most painful and socially undesirable, is just the opposite of the cyclical budget idea and far less defensible.

The principles of public credit applicable to state and municipal governments differ little, if any, from those which should be applied to an individual or a private business, but the federal government is in a somewhat different position. The federal government has monetary powers and is more free to use deficit spending as an instrument for economic control. It is argued plausibly that no nation need discontinue a war or allow its citizens to starve or to be without reasonable opportunity as long as it has engineering resources to meet such emergencies or chronic economic maladjustments.

[36] The problem of war finance will be considered in more detail in the next chapter
[37] Chas. Dickens, *David Copperfield*, Chap. XII.

The argument is convincing but it departs little, if any, from the principles of public credit stated above. The rule that deficit spending is proper for emergencies and for reproductive purposes is sufficient to support such fiscal or monetary programs as may be necessary in the public interest. But the federal government is in a position to apply this rule much more boldly than the states.

Pay-As-You-Go versus Deferred Payment. Probably because of native conservatism or a reaction to the many abuses of public credit, there is quite a following for the view that governments should always pay for what they acquire when they acquire it. The pay-as-you-go plan of finance has the advantage of being the least expensive and the most conducive to careful and well-considered expenditure. Public borrowing is conducive to extravagance because it dissociates the pleasure of public expenditures from the pain of paying taxes. Public borrowing is even less conducive to tax consciousness than indirect taxation. It is probably true that certain public outlays, such as the soldiers' bonus, would never have been undertaken had they been accompanied by current taxes. It can be said with assurance that the danger is usually in too free a use of credit rather than the contrary. Undoubtedly, the overuse and misuse of public credit has been the outstanding scandal in the field of public finance.

On the other hand, where quite irregular expenditures are substantial, it may involve unnecessary loss to the community to either delay the outlay or charge it all to current taxes. A large single-year boost in taxes would be very upsetting to the tax system. Canard's doctrine that new taxes are bad because they upset existing equilibria contains an element of truth which is conducive to support of borrowing in preference to highly irregular taxes. It is no more than good accounting sense to spread the cost of assets over the period of their usefulness. It can be said in conclusion that public credit is a necessary and legitimate instrument, but the danger of its abuse needs always to be emphasized.

Protection of Debtor. Government securities are regarded as a first-class investment, mainly because people have a great deal of confidence in governments. This trust rests upon the existence of high powers of taxation, the stability of government, the expectation of tolerably reasonable management of public affairs, and the future prospects of the resources in the area governed. Beyond his confidence in the power and willingness of the government to make good its promises, the purchaser of government securities ordinarily has very little protection. Not infrequently a strong nation will exercise more or less coercion, sometimes amounting to a receivership, in the affairs of a weak nation to ensure the collection of debts from the latter. This, however, has no sanction in international law and is condemned by many as imperialism. Here, as elsewhere in public finance, the underlying thought is apparently that the debtor must size up his prospects and run his own chances of loss.

The risks under these circumstances are not so great as might be supposed. In the case of an internal loan, since the creditors are among the constituents of the government, the government would not wish to antagonize them. These creditors are not entirely without political power. The more their number, the greater the security each has. In the case of either an internal or external loan, governments are usually jealous of their credit standing and meet their obligations, if they can, in order to qualify for future loans. The First World War debts may be cited as an exception to the above proposition, but the circumstances attending these loans were quite extraordinary; neither was the factor of willingness to pay entirely absent.

The creditor cannot, in case of a defaulted public debt, sue the state or the nation, or take over specific governmental assets.[38] In the United States, he is allowed to sue a municipality, but ordinarily his best defense in case of municipal default is to seek, through general or special legislation, a sort of state receivership under which the state will intervene in local affairs to re-establish local solvency.

In the last analysis, the best protection of the borrower and of public credit consists in peace, well-balanced prosperity, and intelligent government.

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[38] The eleventh amendment to the United States Constitution permits an individual to sue the state only with its consent. The constitution of New York State permits defaulted bondholders to sue the state. Paul Studenski, *Public Borrowing*, p. 43.

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Studenski, Paul, *Chapters in Public Finance*, Chap. XXXIV.

CHAPTER XXVI

Problems of Public Borrowing

INTERGOVERNMENTAL RELATIONS IN PUBLIC DEBT

State and Local Abuses of Public Credit

Whatever may be the opinion regarding the wisdom of federal borrowing, there can be no doubt that states and municipalities often indulge too freely in this easy means of financing and that they often violate sound principles and rules of procedure in the expansion of public indebtedness.

Excessive Debts to Improve Premature Subdivisions. A familiar form of credit abuse by municipalities occurs in the financing of real estate speculation on the outskirts of American cities. Land at the rural-urban fringe is likely to be taxed out of agricultural use into the hands of real estate agencies. The latter, seeking to make their holdings attractive to prospective buyers, induce the city to install public improvements. The improvements may be financed by general bonds or by special assessment bonds, the latter secured only by the property specially benefited. If the expansion of the suburb continues and the development meets with public approbation, the special assessment may be paid off; the bondholders will receive their interest and principal, and the city will enjoy an enlarged tax base. If, as frequently happens, the prevailing optimism turns to pessimism, or the fickle public turns against the new development, the city (or the subdivision, or both) is saddled with a large amount of tax delinquency and with bonds that are not backed by productive assets and likely to be defaulted.

One student of the subject, after an extensive study of prematurely subdivided areas in several cities, ventures the guess that the land involved is more extensive "than the total areas actually in use for urban purposes." [1] New Jersey has more than enough vacant building lots to accommodate another four million people.[2] It has been estimated that there is enough

[1] Philip H. Cornick, *Premature Subdivision and Its Consequences*, Institute of Public Administration, Columbia University, New York, 1938, p. 291.

[2] *Land Subdivision in New Jersey*, New Jersey State Planning Board, Trenton, 1938, p. 18.

land subdivided in Cook County, Illinois, outside of Chicago, to take care of population increases until 1960, assuming population continues to grow at the rate prevailing from 1920 to 1928. And in 1960 there would still be 25,000 lots to be disposed of.[3]

Debts Representing Chronic Deficits and Antiquated Improvements. Among the abuses of public credit, a very common one is the accumulation and refunding of chronic deficits in the operating budget. Another one of a somewhat similar character is the failure to retire bonds during the life of an improvement, with the result that debts continue long after the usefulness of the improvement has ceased. In 1934, of the $145,000,000 worth of refunding bonds issued, a large part were merely deferments of obligations.[4] Evidence is cited by Lutz that in New York City, "prior to 1914 it was a common practice to issue 40- and 50-year bonds to buy brooms, water pails, window shades, and even for digging holes in the sand at Coney Island and filling them up again. As late as 1929, the salaries paid by the board of water supply were being financed by 50-year bonds." [5] Thus, a considerable part of debt service is not installment buying, but payment for "dead horses."

Central Government Stimulation to Undue Borrowing by Municipalities. During the depression of the thirties, the central units of government frequently encouraged local units to go into debt or go in deeper. The latter would do this in order to take advantage of attractive offers for assistance in various public improvement programs designed to cope with unemployment. The programs had much to commend them. It is better to give idle men work than to feed them in idleness with nothing to show for the public outlay. But the programs were handicapped by the fact that many municipalities, during the boom era, elected to borrow rather than to tax and thus piled up more indebtedness than was warranted. In addition, the attractiveness of the federal grants persuaded some municipalities to make certain public improvements beyond their needs. It is recorded that one small city in 1933, with a tax delinquency of 43 percent and a per capita debt of $280, four times the average for its class, was persuaded by the prospect of a P.W.A. loan to build a pretentious schoolhouse and raise its per capita debt to $320.[6] Good sense of either local or federal officials should have vetoed such a project.

Self-Denying Clauses in State Constitutions. The abuse of public credit during an earlier era of American history led several states to write into their

[3] Herbert D. Simpson, "Real Estate Speculation and the Depression," Supplement, *American Economic Review*, Vol. XXIII, No. 1, Mar. 1933, p. 164. The experience of Florida from 1922 to 1926 probably produced the greatest crop of boom bond troubles of all times.

[4] Frederick L. Bird, "Municipal Credit in the United States," *Taxation and Public Policy* (edited by Paul Studenski), p. 121.

[5] H. L. Lutz, *Public Finance*, 3rd ed., p. 804.

[6] Frederick L. Bird, "Municipal Credit in the United States," p. 120.

constitutions provisions forbidding state borrowing except perhaps "to suppress insurrection or repel invasion." Some states are denied by their constitutions all authority to engage in works of public improvement. By constitutional amendment or otherwise, the construction and maintenance of highways is usually an exception from this restriction. Only eight states can borrow freely at their own discretion, and some, such as Michigan, cannot borrow even in anticipation of taxes.[7] This self-imposed discipline seems to be an unwarranted and extreme reaction to the excesses and follies of the "wildcat" era. It should not be necessary to hamper a government with such restrictions and deprive it of its legitimate powers in order to prevent abuses.

In the present conditions of state finances, when reliance upon the very stable property tax is rapidly diminishing and more "cycle-sensitive" taxes such as the income tax are taking its place, it is particularly important that states have some powers in the field of public credit. Unfortunately, it is impossible to say that we have reached the stage of collective intelligence and self-control where governments can be given freedom without danger of abuse. But the remedy does not seem to be the extreme one applied in these state constitutions. Moreover, that states should have so circumscribed their own use of credit while allowing their subdivisions substantial freedom in borrowing is not to be explained on rational grounds.

It is generally accepted that there is an important general interest in the maintenance of municipal credit. If one municipality loses its financial head and later must default, all other municipalities suffer because their credit standing is weakened. The state, therefore, has a serious responsibility to guide and control its municipalities in their credit operations.

In this connection it may be observed that municipalities, as a rule, have very limited tax systems. They depend almost exclusively upon the general property tax and, although this has usually proved a fairly flexible and dependable source of revenue, it does have some limits, as illustrated by the fact that it broke down very conspicuously during the depression of the thirties. Experimentation with tax rate limitation laws has not added to the flexibility of the tax, particularly where taxes to service debts, new or old, are included within the limitation.

State Control of Debt Limitations. The most widely practiced form of state control consists of statutory and constitutional limits upon the indebtedness which any municipality may incur. This limit is usually stated in terms of a ratio to the assessed valuation of the municipality. However, debt limitations have often had many loopholes and have been otherwise ineffective. In some states the percentage has been set too high. The range in the various states is from 2½ to 20 percent[8] of assessed valuation. Usually

[7] J. W. Sundelson, *Budgetary Methods in National and State Governments*, Special Report No. 14, New York State Tax Commission, Albany, 1938, pp. 22-23.

[8] Frederick L. Bird, "Municipal Credit in the United States," p. 122.

the limitation is applied to specific units only, whereas the taxpayer may be called upon to service debts for a variety of overlapping governments. Frequently, local assessments are subject to considerable manipulation and, of course, vary widely in relation to true taxable wealth. In several states, special assessment bonds are not included in the debt limits at all.[9] The remedy seems to be in making the debt limit an over-all one and setting it sufficiently low to be effective. However, the over-all limit requires an agency to apportion new debt among the overlapping municipalities, a task which is by no means simple.

A major difficulty with debt limitations is that they, like tax limitations, constitute a highly inflexible control. Whether a municipality should go further into debt depends largely upon the circumstances of time and place. Certainly the purpose of the debt should be considered. Debt for improvements which have a reasonable prospect of self-sustenance should not be included within any arbitrary limits; in some cases no exception is made at present for such debts. A ratio of debt to assessed value is not a plausible basis for limitations. It ignores the tendency to manipulate assessments and revenues from sources other than the property tax. A ratio to average annual revenues would be more appropriate. For these reasons, review by a state administrative agency is preferable to any form of arbitrary limit set by the legislature.

Other State Restrictions on Municipal Indebtedness. The negative controls exercised by the state cover considerably more than quantitative limitation. Municipalities are frequently required to observe certain rules of good practice in their debt policies, such as retiring the debt within a reasonable period and over the life of the improvement. In addition, they may be required to issue bonds of the serial type only, and to levy taxes sufficient to liquidate the debt, thus providing for the automatic retirement of obligations.[10] This type of control comes closer to preventing abuse without undue interference with local autonomy than arbitrary limitation of the amount of debt. But unless such negative controls have a certain degree of administrative flexibility, they may not fit local situations. Moreover, they offer protection against only specific types of abuses.

State Receiverships and Assumption of Debts. Some states have set up machinery to take over the financial affairs of municipalities when the latter are unable to meet their financial obligations. It is thought that an outside authority may be more impartial than a regularly elected official in adjusting the claims of creditors, taxpayers, and those interested in municipal services. Not being dependent upon popular approval for office, the outside authority may show more courage than a local authority.

[9] This is the case in Florida, North Carolina, Ohio, and New Jersey, where special assessment borrowing has led to disastrous results (Frederick L. Bird, *op. cit.*, p. 123).

[10] Clarence Heer, "Effective State Control of Local Expenditures," *Proceedings of the National Tax Association Conference*, 1931, pp. 418-425.

The first recent application of state control along these lines took place in 1930 when Massachusetts, by special enactment, created a receivership for the city of Fall River. A commission was placed in charge of the city's financial affairs and continued in this role until the defaulted obligations were paid.[11] New Jersey and several other states have set up regular machinery for such receivership under statutes. A municipal finance commission in New Jersey proceeded to supervise and control the finances of several municipalities. This type of control is probably necessary and desirable, but it is criticized as "locking the barn door after the horse is stolen."

There is considerable precedent, too, for state assumption of debts of municipalities in distress. This may be better than default, but it is a last resort. It weakens local responsibility and is unfair to more conservative municipalities.

Supervision of Local Debt by a State Commission. By all odds the most constructive and promising innovation in state control is the North Carolina Local Government Commission, which has been in operation since 1931. The work of the Commission is divided into four parts: approval of applications for local bond and note issues, approval of refunding and readjusting operations, supervision of sinking funds, and auditing reports from municipalities. During the depression period of widespread municipal defaults, the work of refunding and readjusting was the most important.[12] An expert staff is employed to keep the Commission informed and to investigate prospective new issues. The Commission rarely overrides local opinion on questions of need, but it frequently exercises restraint on the ground of inability to carry an additional load. Interest rates are said to have responded favorably to this kind of supervision and to the assistance rendered in the marketing of securities.[13]

The principal merits of the North Carolina Commission are that it gives state control a positive as well as a negative aspect and makes the machinery entirely flexible. Several of the Canadian provinces (Saskatchewan, Alberta, and Manitoba) have successfully applied this type of program.

Positive State Assistance. There are many types of positive assistance which the state can give municipalities in the management of their debts, with or without a special department for that purpose. The state can furnish municipalities with facts concerning composite and comparative indebtedness. These facts have been scarce and difficult to procure. Expert advisory service may be made available. Manitoba and British Columbia have made state

[11] Arnold Frye, "State Receiverships of Insolvent Municipal Corporations," *National Municipal Review*, Vol. XXV, No. 6, June 1936, p. 319.

[12] B. U. Ratchford, "The Work of the North Carolina Local Government Commission," *National Municipal Review*, Vol. XXV, No. 6, June 1936, p. 323.

[13] Wylie Kilpatrick, *State Supervision of Local Finance*, Public Administration Service Publication No. 79, Chicago, 1941, p. 38.

funds available for municipal borrowing.[14] Massachusetts also has a program of this kind.[15] Others use state trust funds for this purpose and some assist their municipalities in marketing securities.

Adaptation of State and Municipal Credit Program to Federal Fiscal Policy. Municipal financing has been criticized on the ground that it is usually badly correlated with federal fiscal policy. When federal policy seeks to check business and credit expansion, states and municipalities may continue to borrow heavily and may lighten local tax burdens. When federal policy seeks to encourage expansion, states and municipalities may be liquidating debts and imposing new and regressive taxes. Considering the limitation of state and municipal financial powers, not too much in the way of a countercycle fiscal policy can be hoped for. To expect municipalities to act in unison for an over-all objective would be much like expecting all private industry so to behave. Nevertheless, states and municipalities can do more than they have to facilitate federal fiscal policy. More general consciousness of the problem would itself promote such a program. Legislation to facilitate the accumulation of reserves, and debt retirement in good times, would be helpful. More flexible debt limit provisions would be conducive to sound procedure during depressions.

Conclusion. There are those who oppose state control of municipal borrowing on the ground that it interferes with local autonomy. One can say with assurance that there is more justification for control of the North Carolina type than for arbitrary limitations on local taxes, debts, and public expenditures. Moreover, the North Carolina system, seeking as it does to keep municipalities out of debt trouble, is better than the type of commission which merely takes over their governments when they go into default. The general interest in the maintenance of municipal credit appears to warrant legislation and machinery on the North Carolina model. Such machinery should be used with much discretion so that some sense of independence and responsibility remains with the municipalities.

Federal Control and Assistance. A significant step in the field of federal control over local indebtedness was made in 1934 with the passage of the Federal Municipal Bankruptcy Act. This law permitted an insolvent municipality or other political subdivision of a state to petition a United States District Court for a readjustment of its debts. A plan approved by the court and by two-thirds to three-fourths of the creditors (the required number differing with the type of the district) was to become binding upon all creditors. The act was declared unconstitutional,[16] but another similar act, passed to replace it, has been sustained.[17]

[14] A. M. Hillhouse, "Lessons from Previous Eras of Default," *Municipal Debt Defaults* (ed. Chatters), Publication No. 33, Public Administration Service, Chicago, 1933, pp. 17-18.

[15] A. M. Hillhouse, *Municipal Bonds: A Century of Experience*, p. 331.

[16] Ashton v. Cameron County Water Improvement District, 298 U. S. 513 (1936).

[17] United States v. Bekins, 304 U. S. 27 (1938).

The purpose of these acts, as in the state receivership statutes, was to provide an arbitrator to balance the interests of creditors, taxpayers, citizens, and government employees. Ordinary creditors find themselves unable to enforce their rights without a considerable degree of local cooperation. A small minority of creditors ought not to have power to block a promising settlement. In such circumstances, some agency of central government, federal or state, can be of great assistance to all concerned in the municipality's financial difficulties.

Federal aid has rarely taken the form of federal assumption of state debts, although this did occur after the Revolutionary War and to a certain extent after the Civil War. The exemption of interest from state and municipal securities from the federal personal income tax has aided, to some extent, in the marketing of these securities. Large federal relief expenditures supported state and municipal credit indirectly. Loans to state and local governments from federal corporations and agencies were very large, particularly in 1933 and 1934. The Reconstruction Finance Corporation has been the most important lending agency, supplying funds to other governmental corporations as well as directly to private industry and to state and municipal governments. Federal loans to banks, railroads, farmers, and home owners have been of indirect aid to state and local finances, particularly in reducing tax delinquencies.

DEBT VERSUS TAXES TO FINANCE WARS

How the World Wars Were Financed. The First World War was financed largely through credit. Only in Great Britain and the United States was a substantial part of the cost (a quarter to a third) met out of taxes.[18] The financial difficulties of the postwar period were attributed mostly to the heavy reliance on borrowing to pay for the war. During the Second World War, a much larger proportion of a much larger expense was financed with taxes. Nevertheless, up until 1945, considerably less than half of our total war cost was being met by taxation. Throughout the war, many expressed the opinion that the proportion should have been larger.

In 1944, it was calculated that half of the total resources of the United States was being devoted to waging the war. From Pearl Harbor to 1944, war expenditures had amounted to about $208.7 billion. During this same period, nonwar expenditures amounted to $16 billion, making the total outlay more than $224 billion. Of this amount, about $87 billion, or 39 percent of the total bill, had come from revenue. During the fiscal year 1944, 46 percent had come from revenue.[19]

[18] E. R. A. Seligman, *Essays in Taxation*, 10th ed., Chap. XXIV.

[19] Address by Secretary Morgenthau, "War Finance and Economic Stabilization," *Bulletin of the Treasury Department*, Nov. 1944, p. A-3.

Use of Taxes as Opposed to Loans in Financing War. There has been much argument concerning the advantages of financing wars by taxes rather than loans. For the exclusive or major use of taxation, the following arguments are commonly advanced:

1. It is said that the war itself creates extensive windfall profits and income which taxation may recapture. These war gains are regarded as a specially fit subject for taxation because of their fortuitous character. Moreover, many feel that no one has a moral right to profit from human slaughter.

2. It is thought that war patriotism somewhat lubricates the tax system, making possible the collection of certain taxes, particularly direct taxes, to a degree not possible in peacetime. War patriotism facilitates administration, decreases political resistance, and mobilizes public opinion behind the tax system. The state can capitalize upon these favorable circumstances to secure a high yield from wartime taxes. But there is also a matter of distribution involved. It is argued that war taxes are more likely to be direct and to give greater weight to ability to pay than peacetime taxes.

3. It is argued that those who bear arms for their country are entitled to some equivalent (or near equivalent) sacrifice from those who stay at home and perhaps profit from the war. It is proposed that the country raise the funds in time of war from those who have the means, just as it raises its soldiers from among those who have the ability to fight.

4. It is also contended that future generations should be freed from the burden of financing past wars and that it is particularly unjust to ask those who fight a war to help pay for it later on.

5. It is argued that heavy war taxation may serve to accomplish the nonfiscal purpose of preventing further wars. This argument rests upon the proposition that if no one made any profit from wars, there would be fewer of them. In other words, heavy war taxation is advocated as a way to help make war unpopular.

6. The contention is made that war borrowing is responsible for war inflation, which in turn is responsible for windfall profits and much economic dislocation. Wartime inflation, because of government borrowing, is likely to occur through the expansion of purchasing power and spending which it involves. This argument and the problem it raises will now be considered in some detail.

The Problem of Wartime Inflation.[20] The fundamental cause of inflation in wartime is not difficult to explain. On the one hand, a flood of purchasing power is released by heavy government spending and, on the other, a shortage of civilian goods is created by the diversion of energy from peace to

[20] The term "inflation" used here and elsewhere in this book is not a very precise term. It is often used to describe a time of generally rising prices. But during the late twenties, a period commonly described as inflationary, prices showed little, if any, tendency to rise. Probably a good working definition of the term "inflation" is: An increase in money, or money substitutes, or purchasing power, which threatens present or future economic stability.

war production. The combination of excessive purchasing power and a shortage of goods produces a disequilibrium, the natural result of which is a general rise in prices. People with money to spend bid against each other for the short supply of goods and services available.

An extreme inflation deprives those who have long-term credits, or other long-term contracts, of some or all of the value of their assets. In this respect it is not unlike a special and extreme "capital levy." Or it can be thought of as a heavy tax on credits without benefit of graduation. Both inflation and the deflation which is likely to follow it bear heavily upon the wage and salary earner; inflation because wages lag behind prices, and deflation because it involves widespread unemployment. The active entrepreneur and speculator may gain from inflation, though both are likely to suffer during deflation. The principal beneficiaries in the process are the debtors who gain what the creditors lose; that is, they are delivered from their debts. As entrepreneurs and debtors, farmers are probably likely to gain, at least temporarily, from inflation.

A war can be financed mainly from the following sources: (1) taxes; (2) loans from individuals and business concerns other than banks; and (3) loans from banks. Taxes are usually not inflationary since they absorb as much purchasing power as is created by their expenditure. But taxes are not all alike in their effect on inflation. Some of the differences among them have been discussed in previous chapters. Loans from individuals and businesses other than banks may be voluntary or compulsory. In either case they are counter-inflationary if they result in new saving (absorption of purchasing power); they have little effect on inflation if they involve only the transfer of existing investments or ordinary savings to the government; they are inflationary if they are financed indirectly by bank borrowing. The last of these effects can be (and during the Second World War was) largely avoided by making war bonds nonnegotiable and ineligible as security for bank loans. Direct loans from banks are the least painful way to pay for a war. The banks in effect "manufacture the purchasing power out of the ozone." But it is this means of finance which is also most inflationary.

The financial policy of the United States during the First World War was one which involved and provoked a high degree of inflation. The government disposed of huge quantities of bonds at par and at what then seemed like a low rate of interest. Many of these bonds were sold to banks directly. In addition, large quantities were sold to individuals who could not or would not pay for them out of savings. These people found the banks ready and willing to extend their credit to almost any kind of risk which offered government collateral for security. Moreover, the government maintained a relatively low rate of interest charged member banks by the federal reserve banks. This helped market the bonds but also made it possible for business to borrow freely. Thus, in order to finance the First World War, the government

found it necessary to manufacture huge quantities of credit, which was then converted to purchasing power. The policy was the same in effect as though the government had printed and distributed many billions of dollars of fiat money. The result was high prices, large profits, feverish activity, and a dislocation of business which several postwar reactions were required to correct.

The government and the public entered the Second World War quite conscious of the dangers of inflation and firmly resolved to avoid them if possible. Some advocated a heavy taxation program to accomplish this objective, and others thought that price control and rationing were the most promising way to attack the problem. The program actually chosen was a combination of the two, although it is probably correct to say that more reliance was placed upon the direct controls than upon fiscal policy. Nevertheless, taxes were increased sharply, collection at the source was introduced, and voluntary bond sales were promoted vigorously. From Pearl Harbor to the fall of 1944, 39 percent of total federal expenditures came from taxes. The remainder was borrowed from banks and other private sources, the latter contributing somewhat more than half. The tax program was considerably less drastic than that of Canada and Great Britain, where from 45 to 55 percent of war expenditures came from taxes. The direct-control programs encountered plenty of difficulties as to enforcement, administration, and popular acceptance. Costs of living and prices have been held to limited and tolerable advances, but the controls have been under constant pressure and it remains to be seen whether they will be retained long enough to prevent a further substantial price rise.

INFLATION AS A METHOD OF RELIEF FROM DEBTS

Inflation as a means of relief from debts has been mentioned several times. To accomplish this relief, inflation must involve a large expansion of money or credit, carrying with it a large expansion of purchasing power and an increase in prices. This may occur in several ways; the simplest and most direct consists of printing and issuing large quantities of irredeemable paper money. This method was used by Germany during the twenties. Another way in which inflation may be inaugurated is by devaluation of the monetary unit in terms of gold. A third method, used by the United States during both World Wars, is the issuing of huge quantities of government bonds, most of which are paid for either directly or indirectly through a wide expansion of bank credit.

Popular fear of inflation is based considerably upon the disastrous experience of Germany and Russia during the twenties. Both countries underwent what has since come to be called a "hyper-inflation." The paper circulation in Russia reached the inconceivable total of 768,000,000,000,000,000 rubles, and

in Germany 74,954,803,000,000,000,000 marks.[21] Prices responded to this enormous volume of currency, as would be expected. As the inflation ran its course, redemption of the currency or any check to its increasing volume became hopeless. The well-known results were the elimination of all internal long-term indebtedness and a complete loss of long-term credits. This was followed by a new start with a more limited currency.

"Deliberate inflation" as a means of monetary and business-cycle control is quite a different phenomenon from forced inflation as a means of financing repeated budgetary deficits and of escaping from the throes of debt. The use of inflation to reduce the burden of indebtedness is a desperate remedy and a last resort.

RESERVES TO AVOID INDEBTEDNESS

It has been suggested by some that a farsighted financial policy for a municipality or a state will seek to build up a reserve, not only to retire existing debt but to finance a regular capital program from interest on the fund and perhaps, going further, to finance future extraordinary capital outlays. It is said that the reserve idea is as sound for a government as it is for a private corporation or an individual. A reserve, of course, would place the government in a position to use the power of compound interest in its favor rather than to its detriment. But it requires unusual discipline and self-restraint for an existing administration to levy taxes in advance of current needs for the benefit of some other future administration. The city of Milwaukee undertook, some years ago, to build up such a fund and designated certain sources of revenue for the fund. An attempt was made to give the fund a trust status by the solicitation and receipt of small gifts for it. This program weathered the depression and the city now has sufficient assets in its reserve to retire its entire indebtedness. The plan projects a retirement of all the city's debt and eventual surplus financing.

As previously indicated, it was long the time-honored practice for governments to build up a reserve fund in preparation for war. Germany maintained a reserve in a fortress at Spandau up to 1914 and Italy had a reserve on hand to finance its war against Ethiopia. At least one modern writer on public finance defends this practice,[22] but most have regarded it as antiquated. The war reserve involves the problems of reserves in general in somewhat greater measure. If the reserve is in gold, its creation and maintenance deprives business and industry of its monetary supply; that is, it is deflationary. In this respect it is reminiscent of the monetary difficulties created by the independent treasury system formerly used in the United

[21] Richard T. Ely and R. H. Hess, *Outlines of Economics*, 6th ed., The Macmillan Co., New York, 1937, p. 354.

[22] Adolph Wagner, *Finanzwissenschaft*, 3rd ed., Vol. I, Heidelberg, 1883, pp. 169-177.

States.[23] If the reserve is invested in securities, difficulty will arise in disposing of the securities at the time when they need to be turned into cash. Finally, it seems doubtful that it would be politically feasible to build a war reserve which would be more than "a drop in the bucket" in financing a first-rate war.

There has been some discussion about the feasibility of building reserves for unemployment. It is proposed that reserves be built up when times are good, to be expended during depressions. The unemployment compensation systems of the states now have very substantial accumulations. This is equivalent in some respects to an attempt to avoid public indebtedness by building up a reserve in anticipation of an emergency. It may not be impossible to make reserves of this sort serve a useful purpose in this role. But it seems very probable that the principal functions of an unemployment compensation system will be to create an interest among employers in regularized employment, to place some of the incidence of unemployment upon business, and to pay as a matter of right a temporary "dismissal wage" to unemployed workmen. If the reserves were large enough to be very useful in coping with a depression, they would probably cause complications in the process of conversion to cash and purchasing power at the proper time. As a means of financing the welfare problems of a depression, unemployment reserves are likely to prove disappointing.

THE CAPITAL LEVY AS A MEANS OF DEBT RETIREMENT

Nature of Capital Levy. Capital levy is a form of taxation designed to appropriate to the state not merely a part of the income from capital but a part of the capital itself.[24] Usually, though not necessarily, it has been coupled with the problem of the national debt and has been advocated as a means of debt retirement. It is not a new proposal; discussion of the capital levy as a means of reducing or extinguishing debt goes back at least as far as 1714, when it was discussed by Archibald Hutcheson in his tracts on finance. It was defended by Ricardo in some of his writings and speeches, but rejected by John Stuart Mill on the ground of impracticability.

The Proposed Capital Levy in Great Britain. British financial conditions following the First World War were such as to invite proposals for a capital levy. Many had made large fortunes out of the war. In spite of progressive income taxation, the net increase in private capital was estimated at £4,180,000,000 (approximately $21,000,000,000) for the years 1914-1919.[25] Coupled

[23] See Chap. XXVII.

[24] B. S. Chlepner, "Capital Levy," *Encyclopedia of the Social Sciences*, Vol. III, 1930, p. 190.

[25] Estimate by the Board of Inland Revenue, *Report from the Select Committee on Increase of Wealth (War)*, H. M. Stationery Office, London, 1920, p. 236.

with this condition was the huge increase in the public debt, so that, in the years immediately following the war, public debt charges consumed 46 percent of the total yield from all taxes in Great Britain.[26] At that time Great Britain faced the prospect of paying her obligations to the United States without much assurance that payment by her own creditors would be forthcoming. There were some proponents for a tax on wartime increases in wealth on the ground that those who profited from the war should be required to pay for it. Others favored a levy on all wealth, holding that it was better to have the painful ordeal of debt elimination over with one operation than to endure the chronic bleeding of the debt service. It was argued that the levy would take advantage of high postwar prices, relieve the lower income classes of high excise taxes, and improve the prospects for the social services. The British Labour Party espoused this program, which received substantial support from many leading economists. As the proposal took on more specific form, it called for a graduated tax on the property of individuals, with the first £5,000 (approximately $25,000) exempt. The levy remained in the discussion stage and it was largely forgotten during the depression of the thirties. But the idea is being revived; it is now once more proposed to reduce the carrying charges of the debt—this time, the one incurred during the Second World War.

Experience in Other Countries. The capital levy was generally adopted in the central European countries, with varying degrees of success. In Poland the revenue derived from the levy was slight. The Hungarian law was marked by widespread evasion. In Italy the payments were to extend over a period of 20 years and in effect became a surtax on funded income. In Germany the levy was applied with more success. There the taxpayer was granted an exemption of 5,000 marks and an equal sum for his wife and each child after the first. The rates were graduated, starting with 10 percent on wealth of 50,000 marks or under (beyond the exemption) and ranging to 65 percent on wealth in excess of 7,000,000 marks. Corporations were to pay at a uniform rate of 10 percent. Provision was made for installment payment with a minimum of 5 percent (equivalent to interest) per annum plus a 1.5 percent amortization payment.[27] In practice the program in Germany became more of a supplementary income tax than a capital levy. It was at best a minor source of income, furnishing 18 percent of the total net revenue of Germany in the fiscal year 1920-21. The later results of the experiment were more or less obscured because of the rapid depreciation of the mark. With the complete collapse of the currency in 1923,[28] the tax was abandoned altogether.

Czechoslovakia is credited with the most effective program in the admin-

[26] Hugh Dalton, *The Capital Levy Explained*, Labour Publishing Co., Ltd., London, 1923, p. 10.

[27] B. S. Chlepner, "Capital Levy," p. 191.

[28] Alzada Comstock, *Taxation in the Modern State*, Longmans, Green and Co., New York, 1929, p. 201.

istration of the capital levy. Its levy was paid over a period of three years, and in special cases a two-year extension was granted. The substantial sum raised from this source was used to issue currency and meet other costs of setting up the new state.[29]

Arguments for the Capital Levy. The arguments for the capital levy as a means of relief from debts have been suggested in the explanation of the postwar British movement in support of this institution. Chief among the arguments for the levy was that much of its burden would fall upon those who were enriched by the war and the accompanying inflation. The saving in interest on the debt was an important consideration. It was said, in addition, that the levy represented but a capitalization of ordinary taxes which might be anticipated as an alternative, and that it would clear the way for expenditure for social purposes which might perhaps be impossible without it.

Difficulties with a Capital Levy. Like the excess profits tax and the income tax, the capital levy is weakest on its administrative side. What most of its proponents have in mind may be thought of as an exceedingly heavy nonrecurrent property tax, based upon net worth rather than gross property and levied against natural persons only (corporations excluded) with, like the inheritance tax, a graduated scale and an exemption. Although the tax might be equitable, it is very difficult to apply.

The application of the tax to wealth acquired during, or as a result of, war would be particularly troublesome to administer. It is difficult enough to isolate war profits when they occur, and it would be much more so after several years had elapsed.

Medium of Payment. Among the practical difficulties is the medium of payment. If all payments are to be made in cash, a large amount of forced liquidation may be necessary, which may result in disturbing echoes in the security and real estate markets. If the state is to accept securities or other assets in lieu of cash, the question of which assets to accept will arise. If only certain types of assets are acceptable, not all the taxpayers will be relieved and the burden will fall quite unequally upon those who are forced to liquidate. If all assets are made acceptable, the state will have a great variety of assets to dispose of and administer. If payment on the installment plan over a considerable period is permitted, this may relieve the situation, but the original purpose of the levy is sacrificed. The levy is then likely to become merely an extraordinary income tax upon "unearned" income.

Appraisal. A third difficulty concerns appraisal. Nearly all tangible assets are assessed annually in the United States under the property tax and occasionally under the inheritance tax. But the work of appraisal under the property tax is notoriously bad. Where a tax is "stepped up" to the degree that is

[29] Frederick Kuh, "Taxing Capital in Czechoslovakia," *The Nation*, Vol. CXVIII, Mar. 19, 1924, p. 305.

contemplated in the capital levy, it becomes of much greater importance to base it on an accurate appraisal.

Constitutionality. In the United States the capital levy would encounter constitutional barriers. Were the federal government to contemplate using this instrument, even in an emergency, it would be confronted by the probability that it would be held a direct tax and available for use only if distributed among the states according to population. The states, on the other hand, have uniformity clauses in their constitutions which would generally prohibit any graduated tax upon property.

Conclusion. The case for and against the levy must be weighed in the light of particular situations with regard to time and place. It also must be weighed in comparison with alternatives. One alternative is to avoid postwar situations which invite a capital levy by imposing heavier taxes during the war. Some of the proposals in Great Britain contemplated a sort of retroactive war income and profits tax. The principal advantage in retroactive imposition of such taxes is that it cannot interfere with war production. A second alternative is to pay off the debts gradually by means of indirect taxes. A third is to pay by means of graduated income and inheritance taxes. This alternative utilizes the principle of installment payment which the levy itself may necessitate for administrative reasons. This alternative is perhaps less equitable after a war than a levy on war acquisitions. A fourth alternative is inflation or default. The least that must be said for the capital levy is that it is not the worst of these alternatives. Moreover, the proposal for a capital levy recalls the idea of a periodic personal net worth tax, which might merit consideration for a place in more revenue systems.

FOREIGN PUBLIC DEBT

International debt obligations directly involving governments are of two kinds: those in which both the debtor and creditor are governments and those in which only the debtor is a government. In the case of the latter, problems of collection, as far as the creditor's government is concerned, consist in determining how far it should go in helping a private creditor to collect. How much aggressive protection should a nation give to the loans of its private citizens? How much should it interfere with hostile legislation and administration in the debtor countries? How much right has the creditor nation to take over and manage the financial affairs of a debtor in default? Do private creditors of one nation have any legitimate security for their credits in another nation other than its good will?

Pan-American Fiscal Relations. In practice the United States has quite frequently sought to protect by force, and threatened force, not only its own but also European creditors against default in South and Central American countries. This has gone to various degrees of interference, including the

imposition of governments, with their maintenance ensured by the presence of military troops, although opposed by the great majority of people in the debtor countries.[30] In 1925, one writer observed that the United States exercised financial control over more "backward nations" than any other country.[31] A common practice for governments with weak credit is to pledge a specific revenue source as security for a loan. Thus, Salvador refunded its national debt in 1923 and obtained the credit in the United States by pledging as security 70 percent of its customs receipts. Bolivia pledged the entire receipts of its customs to New York bankers in 1922.[32] This procedure sometimes involves a considerable degree of international interference. To satisfy its creditors, China for years submitted to an international control of its customs. The United States has discouraged and disregarded clauses in credit agreements to the effect that the creditors will not seek the aid of their government in enforcing their claims.

Regardless of one's reaction to these imperialistic policies, there can be no doubt that private loans abroad are vested with a public interest that is not attached to domestic loans. By tacit understanding with investment bankers during the First World War and since, large private loans abroad are more or less censored by the State Department at Washington, and such loans are not floated if the Department indicates its disapproval. It should be possible to provide a reasonable degree of security for foreign loans and freedom in the movement of capital, without the domination and interference with national rights which has at times attended the collection of foreign debts. Possibly a nation should require its citizens to take their own chances in the foreign investment field (particularly where the credit agreement so stipulates), but better still would be the inauguration of international machinery for fair enforcement and agreements to submit disputes to international arbitration.

The present much-discussed Bretton Woods proposals involve a degree of international cooperation in foreign borrowing not hitherto forthcoming. They provide for international sanction and censureship of certain loans; an attempt to confine these loans to productive purposes and to keep interest charges reasonable; the machinery for international settlement of issues involved in collection. The program attempts in a sense to bring foreign frontiers within the economic boundaries of highly developed countries. Foreign loans must play an important part in future international relations and they can play an important role also in maintaining a balanced economy. Sound economic prosperity must be based on an attempt to raise living standards everywhere. The program represents a very hopeful aspect of postwar economic reconstruction.

[30] B. H. Williams, *Economic Foreign Policy of the United States*, McGraw-Hill Book Co., New York, 1929, Chaps. III, IV, VI, IX.

[31] Raymond L. Buell, *International Relations*, Henry Holt and Co., New York, 1925 p. 397.

[32] B. H. Williams, *Economic Foreign Policy of the United States*, pp. 186-187.

War Debts and Reparations. The United States emerged from the First World War with large sums due it from its allies. The latter, in turn, had reparations due them from their defeated enemies. From the First World War to the depression of the thirties, the questions of policy involved in these international obligations sorely perplexed the public. An ethical question concerned the propriety of collecting from those who had participated in a "common cause." An economic question concerned the willingness of creditors to accept goods in payment and the high tariff policies which blocked such means of transfer. Formerly the enemy was kept in doubt for many years as to the ultimate total of its obligations, and the large sums involved were alleged to discourage its moral and economic recuperation. It is now generally agreed that the postwar management of international obligations was one of the worst chapters in a story of badly bungled foreign relations in the period between the wars.

Fortunately, during the Second World War the "lend-lease" system was substituted for war debts. Under this system, goods and services were freely exchanged among the allies with an understanding that repayment would be made, if at all, in the specific goods provided (if they remained intact at the close of the war), or in such other goods as might be satisfactory to the parties involved. The final chapter of this experiment remains to be written, but the situation at the close of the war appears much more hopeful than it was in 1919. It seems likely, however, that the dispute over war reparations is due for repetition. It is being argued now by some that reparations would be an unsound policy economically because they would create unemployment in the recipient nations and have the opposite effect in debtor countries. This is an economic version of the rule that it is more blessed to give than to receive. Certainly we cannot expect reparation payments while we refuse (by our tariff policy) payment in goods. But it seems more questionable to argue that we cannot accept gifts from abroad without upsetting our own economic balance. Nevertheless, this may be the answer, unless domestic policies are so arranged that an adequate market can be maintained in spite of an unfavorable balance of trade. This "screwy" dilemma is avoided by the Russians, whose complete control of the economy ensures an adequate market. With equanimity, they anticipate substantial reparations, much of them in kind. Whether large reparations are desirable as a matter of their effect on the morale of vanquished peoples who pay them is another question, a negative answer to which seems justified by recent experience.

SUMMARY OF PUBLIC DEBT

Public borrowing assumed great importance in public finance with the development, particularly during the eighteenth century, of constitutionalism in government, the surplus with which to make loans, public sanction

of credit, and wide powers of taxation. Since then, this institution has been widely and sometimes intemperately employed by most governments. It has usually been the policy in the United States to pay off debts, especially those contracted for emergencies; but this has generally not been true in Europe, where the reduction of debt burdens has been left mainly to rising wealth and population or to the more drastic weapon of devaluating the currency.

There are many instrumentalities which may be used for borrowing. They differ, among other respects, in their time of maturity, according to which they are classified as bills, notes, and bonds; they differ also in their plan of maturity, with two principal classifications, term bonds and serial bonds; and they differ in certain special provisions, such as with and without a callable feature. During the Second World War, the most popular issue was the nonnegotiable war savings bond.

Managing the public debt consists, among other things, of choosing proper instrumentalities. It also consists of converting and refunding loans to the best advantage. In the postwar period, it may be difficult to maintain the prices of bonds in the face of a lively demand for private credit and rising interest rates. It is the traditional policy in the United States to retire debts, but such a program would be unwise in the face of postwar unemployment and a low national income.

Many issues may be raised under the heading, "principles of public credit," among the most interesting of which is the question of whether it is possible to shift the real burden of a current outlay from the present to future generations. If it be accepted that the burden of a debt lies principally in paying taxes to meet it, the answer to the above question must be in the affirmative. The question may also be asked: When is it legitimate for the public to borrow? The answer probably is not very different from what it would be if the same question were asked concerning individual borrowing; it is legitimate to borrow to pay for a durable good, for productive capital, and for emergencies. In the case of the federal government as distinguished from that of states and municipalities, an unbalanced budget may be used wisely to avoid the deflationary effect of increased taxes during a depression and to alleviate depression unemployment. Even the states and municipalities can to some extent follow the lead of the federal government with countercycle fiscal programs.

Among the abuses of public credit, the one most conspicuous in our recent experience is the excessive municipal borrowing to finance improvements in premature subdivisions. Many states impose limitations and prohibitions upon municipal borrowing, but a more constructive and positive form of control is provided in North Carolina by a state department with supervisory powers over municipal borrowing. The self-denying clauses in state constitutions, prohibiting state borrowing, are hardly a control and not explicable on any ground except that they are a blind reaction to excessive indulgence. During the depression of the thirties, the federal govern

ment through its Reconstruction Finance Corporation aided municipal financing both directly and indirectly.

A point of much controversy in the field of public debt concerns the relative merits of borrowing and taxing as alternative means of paying the immediate cost of a war. Strong arguments can be presented for the extensive use of taxes during war periods—especially that such taxes are more likely to be equitable than those levied to pay off debts and that war taxation is less likely to involve inflation than its alternative. Wars may be financed by taxes, borrowing from individuals or corporations other than banks, and borrowing from banks. The last of these three is particularly inflationary. During the Second World War, as during the First, banks were heavily relied upon to finance the emergency. But during the Second World War, direct controls have been relied upon to keep prices in bounds. Whether these controls will be retained long enough to avoid postwar inflation remains in doubt.

Reserves to meet emergencies and to avoid borrowing are an old idea with new applications. They encounter monetary difficulties and the political danger of raids upon the reserve.

The capital levy, a heavy single personal tax upon property, involves many difficulties of administration and in finding a satisfactory medium of payment. Nevertheless, it is probably better than several alternatives, such as repudiation or the heavy and prolonged imposition of indirect taxes.

Insistence on the payment of war debts and reparations in the face of high tariffs aggravated the difficult foreign relations which characterized the period between the World Wars. The lend-lease system adopted during the Second World War contemplates payment in acceptable goods only, and affords hope that the difficulties of the last postwar period may be avoided. Also very promising are the Bretton Woods proposals for international co operation in the extension and collection of certain loans.

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CHAPTER XXVII

Fiscal Administration

NATURE OF FISCAL ADMINISTRATION

In considering public revenue, public expenditure, and public borrowing, the discussion at many points has involved problems of administration. In the case of the property tax, for instance, the subject is so bound up with administrative problems that only the most theoretical or superficial treatment could be given without extensive consideration of administration. There are problems of fiscal administration, however, which involve the fiscal system as a whole and are not touched in any treatment of its parts.

In its broadest aspects, fiscal administration includes the procedure through which a determination is made of the amount and direction of public outgo and intake; it also includes the machinery of executing these decisions. More specifically it includes budgetary planning, the collection of public revenue, the management of public loans, and the custody of public funds. It will be impossible to discuss these functions exhaustively, but some indication can be given of the problems in this field and their significance.

BUDGETS

Introduction

Budgetary procedure is sometimes regarded and treated as an aspect of public expenditure. However, any system of financial planning which makes even a pretense of being useful must involve consideration of revenue as well as expenditure and the correlation between the two. Budgetary procedure may also involve public borrowing, a natural result of unbalanced budgets and sometimes an accepted feature of balanced ones. Budgeting involves legislation as well as administration in the narrow sense. All things considered, the subject seems most properly treated as a phase of fiscal administration.

General Purpose of Budgeting

Governments, like individuals, cannot pass an intelligent judgment upon either a particular item of expenditure or a possible source of revenue without keeping one eye constantly focused upon the whole picture of possible expenditure and possible revenue. Most items of expenditure that offer the community a new or expanded service are desirable, but their cost must be balanced against other claims upon the public revenue and against the resources of the government. All taxes may appear undesirable in themselves but, balanced against the services they make possible, the decision may be in their favor. It is much easier to make ends meet if both expenditures and revenues are planned a considerable time in advance. The planning requires some responsibility and leadership. After the plan is agreed upon, discipline and technique are required to carry it out. The purpose of budgets is to facilitate this process.

Historical

The necessity of a budget seems so obvious that one wonders at the recency of its inauguration in the United States. The budget was an essential part of the British parliamentary system two centuries ago and has been in operation in France for over a century. Among the important nations, only the United States waited until the third decade of the twentieth century to inaugurate an integrated plan of budgetary procedure. Alexander Hamilton, with all his skill and understanding in financial matters, seems to have overlooked this important feature of federal machinery. The financial institutions created in the early years of the Republic were not easily replaced or soon overcome.

During most of the history of the United States, federal finances have been characterized by a distressing lack of co-ordination. Appropriations proposed in Congress were not referred to any single committee, but might be considered and recommended for adoption or rejection by many committees —as many at times as 29. These appropriations were not gathered together in one bill. Revenue measures were proposed in a separate bill or bills and referred to still other committees. Very little machinery existed to keep administrative agencies within their allowances. With so little planning and discipline, it was not surprising that many retroactive appropriations had to be made in what were called deficiency bills, nor that two great American institutions, the "pork barrel" and "log-rolling," flourished.[1] In the states, budgetary reform has been of recent origin also, but in some form it has now permeated to all levels of government, although not all units.

[1] By the "pork barrel" is meant legislation of special interest to a particular local district and by "log-rolling" is meant an exchange of support among legislators for such measures.

Creation of the Bureau of the Budget in 1921 was a major step in the direction of efficient and effective management of the financial affairs of the federal government. For the first time it was made the duty of the President to prepare the annual federal budget. The Budget Bureau was created to assist him in the preparation and execution of the budget. It was placed in the Treasury Department, with a Director of the Budget to be appointed by and directly responsible to the President.

Under the Reorganization Act of 1939, the Budget Bureau was transferred into the new Executive Office of the President. In addition to the usual financial powers, it was given the function of co-ordinating and clearing all legislation sponsored by federal administrative agencies. Financial support and staff were much expanded. Thus the Budget Bureau came into its own and now functions at the center of administrative strategy. It is henceforth to play a major role in planning economic debt, revenue, expenditure, and operating policies.

Although the new system gives the President much greater power over federal finances than he previously possessed, his power still is subject to important limitations. Congress might disregard the Administration's budget entirely and pass its own program. Only through effective control of his party can the President hope to get his budget, without substantial changes, enacted into law. Of course, the President might use his veto power but it could be overridden and circumvented by riders.[2] Complete responsibility and harmony in the federal financial program is precluded by the separation of powers,[3] which, however, is a basic feature of government in the United States.

Much also remains to be done in providing Congress with adequate machinery for expenditure control. Sufficient expert personnel is not available to secure information as to expenditures. It would probably be a mistake to build a legislative rival for the executive budget, but some access to information independently derived seems desirable as a check. Congress is also without adequate means to ensure that its legislative mandate is carried out. It is and always has been asked to ratify some spending retroactively.

What Is a Budget?

The term "budget" is used to describe a considerable number of different steps in fiscal procedure. Often it is used to designate a proposed or adopted financial plan. It is also used to designate a document which states the plan. Sometimes it is employed to describe a bill or several bills which the legislature considers and an act or acts which it passes. Occasionally the term is

[2] A rider is an item (sometimes more or less extraneous) inserted into a bill in the hope of getting the former accepted along with the latter. The opponents of the rider are persuaded to accept it rather than kill the entire bill.

[3] Under which the branches of government (executive, legislative, and judicial) have a more or less independent status and check each other's acts.

applied to cover a message which the executive delivers to the legislature. Functionally it is always, however imperfect, an instrument of financial planning and of education for the legislature, the administrative officials, and the lay public.

Survey of Budgetary Procedure

There are three well-recognized steps in budgetary procedure: preparation of the tentative budget; determination of a final or accepted budget; and execution of the budget as accepted.

The prevailing practice is to place the responsibility for drawing a tentative budget upon the executive official of the government—the president, governor, mayor, as the case may be. The tentative budget is based upon the previous year's expenditures, requests of department heads, and the judgment of the executive. The first published draft may contain a column for each of these three sets of figures. Both in drafting the budget and in making preliminary recommendations, the executive usually has the assistance of a financial advisor; in Great Britain, a cabinet officer, and in the United States, usually a "budget director." Frequently, preliminary hearings are held at which department heads explain and support their requests. It is very important for the budgetary authority to make a thorough examination and study of the departmental requests. Department heads are likely to regard their own function as the only one of importance and are usually expansion-minded. If the budgetary authority merely accepts the departmental requests or estimates, he is shirking one of his main functions. He should also prepare or gather estimates concerning the prospective yield of existing and proposed taxes, and the expenditures should be considered in relation to the taxes and vice versa. Once a tentative plan has been determined, it should be presented to the legislature (or Congress) in the form of a budgetary message. It should be printed and published as a document to serve as a basis for education and discussion.

The tentative budget is then ready for consideration by the legislature. It is introduced in appropriate legal form, and frequently in much less detail than in the budget document, by the budgetary authority himself or by a legislative committee or individual legislator. It is then referred to one or more (usually several) committees for consideration in detail and for public hearings concerning its provisions. The bill (usually several bills) is then referred to the legislature itself with the committee's or committees' recommendations for action. The legislature may have full or limited power to alter the tentative budget (as will be explained in more detail later). The legislature then acts upon the budget. In the United States, budgets, like other legislation, require executive approval to become law, except that the legislature may sometimes pass a bill over the executive's veto, usually only with a two-thirds majority vote.

Once the budget or the appropriation bill has become a law, it is referred to administrative officers for enforcement. In many governments, public officials do not take the budget seriously and habitually spend more than it allows. This results in deficits which sometimes run to a substantial proportion of the annual budget. The budgetary authority could be very useful at this point, and the statutes should authorize him to require at least quarterly reporting on proposed expenditure of funds by each agency. His approval should be required before such expenditure could be legally made. In this way departments would find themselves able to continue operation within their appropriations in the final months of the fiscal year. Wisconsin provides penalties of fine and imprisonment for any public official who contracts or creates "either directly or indirectly, any debt or liability against the state . . . without authority of law therefor. . . ."[4] While an appropriation is a mandate not to spend more than the amount specified, it is not an order to spend all the funds made available. The budget authority and the department heads should seek to conserve public funds not needed to accomplish the purpose for which they were appropriated.

It is generally agreed that the accounts of the government, like those of the private corporation, should be subject to periodic audit and that the audit should be performed by a party who has no responsibility for, or direct interest in, the government's accounts. In some states this duty is performed by independent state officers. In some it is performed by the secretary of state. In the case of the federal government it is performed by the Comptroller-General. There should be, in addition, a current audit of all bills and payrolls, and other requests for funds, in order to forestall irregular and illegal transactions. Preferably this audit, as distinguished from the periodic one, should be under the executive. The continual audit is for the purpose of checking up on the administrators by the executive. The periodic audit is a check on the executive himself.

In some states the state tax commission is given the power to audit the accounts of any municipality, either upon request or upon its own motion. It also is required to make available to municipalities a uniform system of accounts. These provisions have proved highly beneficial to municipalities.

Problems of Budgetary Procedure

Responsibility for the Budget. As previously stated, the rule is to place the responsibility for preparing the budget upon the executive, a procedure which is quite universally approved among the critics. Public opinion ordinarily holds the chief executive responsible for the financial success or failure of the administration, although he may have little control over either the receipts or the expenditures. It is thought that the executive is in the best position to view the financial problem as a whole and to assume the re-

[4] *Wisconsin Statutes*, 1937, 20.75.

sponsibility for the success or failure of a financial program. Nevertheless, executive responsibility for the preparation of the budget is by no means universal. In many states and cities, the budget is prepared by a committee of the legislature. In some jurisdictions it is formulated by a board composed of administrative or of legislative and administrative officers. Usually, in cases of board responsibility, the executive is a member of the board.

The role of the executive in the budgetary process may be a matter of degree even with an "executive budget." In some of the "totalitarian" countries, the budget was adopted by executive decree with no further formalities. Within democracies, it is under the cabinet system of government as exemplified in Great Britain that the widest responsibilities and powers are allowed the executive. The prime minister through his subordinate cabinet officer, the chancellor of the exchequer, prepares the budget, defends it in Parliament, and resigns in case Parliament refuses to accept it in substantially the form approved by the executive and his advisors. This logical procedure centers responsibility for both the financial plan and its administration and makes prolonged deadlocks between the legislature and the executive impossible. In the United States the executive budget is limited by "checks and balances" created in the constitutional separation of powers. Under the city manager form of municipal government, a situation somewhat similar to that of Great Britain may be found, but even in this case harmony between the legislative and executive departments may not be fully preserved. Under the American theory of government the law is supposed to be framed by the legislature, subject to some advice and checks by the executive (including, of course, the veto), and executed or carried out by the executive, subject to some advice and checks by the legislature. Under these circumstances, both divided responsibility and deadlock are possible. Divided responsibility may result from the legislature's refusal to accept the executive's budget. The legislature, as a rule, may modify the recommended budget very materially and pass supplementary financial legislation of its own. The governor (or President) has the general veto to protect himself and sometimes the much more effective specific veto. But his defenses are negative rather than positive. In turn, the legislature may not secure what it wants in an appropriation bill because of the veto, and, of course, it has no power to carry out the legislation it passes.

Looking toward a greater concentration of responsibility, Maryland in 1916 provided in its constitution that the legislature could not change the governor's budget except to delete or reduce items. Separate appropriation bills might be introduced and passed by the legislature, but they must provide the revenue to finance them.

The Specific Veto. One of the most feasible and defensible means of centering responsibility for the budget upon the executive is to give him the specific veto. This means that he can veto specific items of an appropriation bill. It is a safeguard against "riders," and it affords an opportunity

for the exercise of selective economy. The federal Constitution gives the President a general but not a specific veto power. However, the latter is common among the states. In addition to the power to strike specific items, the executive might well be given the power to reduce them.

Comprehensiveness of Budget and Unity of Treatment. It is a well-accepted rule among critics of budget-making that budgets should present a complete financial plan and that they should be considered and acted upon as a whole. It is only thus that revenues and expenditures, services and no services, expansion and contraction in the sphere of government, can be properly balanced.

By far the most important violation of the rule of comprehensiveness and unity in budgetary procedure is that which confines the budget to expenditures and takes no account of revenues. This is particularly common in the United States. In Great Britain the budget is a tax program as well as an expenditures program. The Chancellor of the Exchequer is responsible for tax collection and is in the best position to make estimates of revenue receipts and to project a revenue program. This he does as part of his budget, and the two aspects of the government's finances are constantly considered in relation to each other. In the United States the budget features expenditures primarily and includes reference to revenue only incidentally.[5] Revenue bills are introduced separately from appropriation bills and are referred to different committees. Ordinarily the same is true in the states. Usually not all the appropriations are included in a single bill. For the greatest unity and comprehensiveness of treatment, the budgetary program should include revenue as well as expenditure measures, should be confined to one bill, and should be referred to a single committee (under the bicameral legislature, preferably a joint committee).

Budgets are also criticized because they omit important aspects of the financial picture even on the expenditures side. Among the items most frequently omitted are the assigned revenues and corresponding expenditures (as where motor vehicle tax revenue is earmarked for highways), the receipts and expenditures of commercial and industrial enterprises, the financial status of independent funds, expenditures, and appropriations on capital account, and debt operations. Ordinarily all of these matters have a fairly important bearing on the financial plan to be considered, and where this is true they should be included either directly or in collateral statements.[6]

[5] J. W. Sundelson, *Budgetary Methods in National and State Governments*, Special Report No. 14, New York State Tax Commission, Albany, 1938, p. 288.

[6] This was well expressed by President Roosevelt in his budget message of 1936: "The use of such budgets (supplemental) permits the receipts and expenditures of each of these units to be clearly and completely presented in gross figures and in balanced form, as has not hitherto been done. By following this method, the net figures for each unit, which may be either appropriation needs or surplus receipts, are calculated and then carried to the general budget summary. Thus the financial requirements of these units are definitely tied into the general budgetary plan. The annexed budgets are therefore not in any sense independent or multiple budgets but simply integral parts of the Government's general

Intelligibility of the Budget. Budgets are frequently criticized on the score that they are not intelligible to the layman. Some supplementary comment on the financial plan is helpful. A good summary of the budget is also needed. It should always be remembered that the budget is an instrument of education and a feature of planning and that both of these arts require ingenuity, imagination, and good sense.

Classification of Public Expenditures. There are many ways of classifying public expenditures, all of which have usefulness in the complicated task of public accounting. Expenses for social services are obviously distinct from those for public enterprises, and the two should be presented independently. A functional classification is useful to show amounts spent for various types of services such as schools, highways, protection, and debt service. Grants and shared taxes are governmental transfers to other governments and should be distinguished, among other reasons, so that they will not be double-counted in adding up total expenditures of several units of government. A further classification is needed to distinguish outlays for payroll from those for operating costs (including supplies and equipment), capital outlay (covering the purchase of and additions to real estate), and debt service (consisting of interest and debt retirement). Transfer expenditures—sometimes called "one-way transactions"—should also be distinguished. These include public assistance and old-age insurance, special payments to farmers, pensions, and debt retirement.

Detailed versus Lump-Sum Appropriations. There are several sets of alternatives which may be employed in an appropriation act. One has to do with the detail which should be incorporated into the act. It is possible to provide either a lump sum to each department of government, with no further specification, or to provide a great amount of detail in the appropriation act. For example, an appropriation for a state university might provide a lump sum for maintenance and operation, or it might specify how much of the money is to go to each of the colleges, departments, functions, or even personnel at the university. The best practice might be to require a large amount of detail in the departmental estimates and to submit all of this detail in the tentative budget, but to submit relatively little detail in the appropriation bill. This allows administrators greater freedom and flexibility in the expenditure of their allotments. No one would advocate carrying the lump-sum practice to the point of a single lump-sum grant to the administration; some middle ground must be recommended. If the executive or the legislature wants to ensure that specific use be made of moneys appropriated to specific departments, it must be indicated in the appropriation bill. For example, it may wish to direct the university to spend $10,000 for teaching the Polish language. In such a case the detail must be specified. Certain recent federal appropriations for relief and public works have been criticized

budget" (*The President's Committee on Administrative Management*, U. S. Gov't Printing Office, Washington, 1937, p. 144).

on the ground that they were too general. Unless Congress is in a better position than the administration to direct the specific use of the money, the general nature of such appropriations is commendable.

Terminating versus Continuous Appropriations. Appropriations may also be terminating or continuous. The difference lies in the fact that, under the former type, allowances expire at the end of a specified period unless they are re-enacted, whereas under the latter they continue until the act is repealed or amended. Under this system, budgetary legislation is confined to changes in the previous year's appropriations. Continuing appropriations have been severely criticized on the ground that they escape the periodic criticism of the legislature and make the financial picture incomplete. The criticism is not necessarily valid, however. In some states with continuing appropriations, all departmental allowances are included in the tentative budget and are considered, heard, and discussed by legislative committees along with the other budget requests. The fact that not all the allowances appear in the appropriation bill itself does not seriously circumscribe legislative opportunity for criticism. The advantage of continuing appropriations is that they safeguard institutions of great importance against legislative wars and deadlocks. Under the American system of government these deadlocks are always possible, and it is not unreasonable to conclude that security for state institutions is at least as important as any small loss that might result from a lack of critical legislative attention to specific appropriations.

Definite versus "Sum-Sufficient" Appropriations. Another problem in the appropriation bill is that of definite or "sum-sufficient" appropriations. The former involves a specified sum of money for a given purpose, whereas the latter appropriates such sum as may later prove to be needed for a given purpose. Sum-sufficient appropriations from the general fund are regarded with disfavor by budget directors because they do not permit an exact calculation of the amount the public treasury will need to expend. Some protection from unannounced raids on the general fund may be provided by conditioning sum-sufficient expenditures upon the release of money by the chief executive. Such appropriations are sometimes necessary where it is impossible to predict in advance what the financial requirements of some governmental project may be. For example, in Wisconsin the legislature itself is given a sum-sufficient appropriation because many of its expenses are contingent upon the length of the legislative sessions.

Lapsing versus Hold-over Appropriations. Finally, appropriations may lapse at the end of the fiscal period or be held over to some later date. In the former case, all unexpended balances at the close of the fiscal year are reassigned to the general fund. In the case of a hold-over appropriation, the funds once allotted may be expended by the specified authority without restriction as to time. The lapsing appropriation is conducive to accurate accounting and calculation, but it sometimes results in the "padding" of expenditures during the closing days of the fiscal year. This latter can be

avoided to some degree by the administrative supervision of allotments by the budgetary authority. In Wisconsin, state expenditures for highways are hold-over appropriations. During the depression of the thirties, moneys appropriated for highways were not spent in full, due to the need of supporting the general fund into which highway revenues go and from which such expenditures are financed. Highway expenditures thus have an accumulated lag of several millions of dollars, but legally none of this money has been lost to the highway department.

Under the federal law, the outstanding balances of appropriations must be available to meet obligations incurred during the fiscal year and for a period of two years thereafter.[7] The President's Committee on Administrative Management strongly recommended that all unencumbered balances of annual appropriations lapse not later than three months after the end of the fiscal year to which they relate.[8]

Revolving Appropriations. Many governmental receipts flow into revolving funds which are appropriated directly to the agency through which they were earned. Thus a state university may receive back, in this manner, its earnings from student fees, dormitories and commons, and athletic events. These appropriations may or may not be continuous, or "hold-over." The revolving funds serve a useful purpose in enabling a state agency to operate more or less independently like a corporation. These funds are sometimes inadequately accounted for, however, and they are also criticized on the score that they becloud the picture of the volume of funds with which an agency operates.

Flexibility in Budgetary Enforcement. It is impossible to predict perfectly the needs of the various departments over long periods of time. A number of states have biennial budgets, and Alabama has a four-year budget.[9] The less detail specified in the budget, the less need there will be for revision in the execution of the budget. Some provision for intradepartmental transfers, with approval of the budgetary authority, is not infrequently allowed. Certain jurisdictions allow interdepartmental transfers also, but this is less common. A growing practice is to make an appropriation to a contingent fund, from which allotments can be provided to care for unforeseen emergencies. Effective administrative supervision by the budgetary authority is an important factor in preventing unnecessary "emergencies" which may occur through imprudent expenditure of appropriations.[10] Some municipali-

[7] *The President's Committee on Administrative Management*, p. 144.

[8] *Ibid.*

[9] The biennial budget period prevails in most states and only in a small minority are there regular one-year budgets. However, this does not mean that all features of budget systems are related to two-year periods. Many states maintain the fiction of annual budgets. Merely the planning and voting are done every other year (J. W. Sundelson, *Budgetary Methods in National and State Governments*, pp. 56-57).

[10] Some states have permitted their executives to revise budgets after their enactment either to make sure of staying within uncertain revenues or for other reasons. In some

ties provide for a change in budgetary allotments by a two-thirds vote of the council.

Extraordinary and Other Multiple Budgets. In 1933 the federal government divided its budget into two parts, one of which was labeled "ordinary" and the other "extraordinary." The intention was to finance the ordinary budget from current revenues and the extraordinary budget by the use of public credit. The plan has been abandoned, however, and the budget is now presented as a unit. The divided budget was defended on the ground that it called attention to the emergency character of certain public outlays and encouraged certain economies in one field at the same time that expansion was contemplated in others. However, it is a device which can be used to mislead the public and is amenable to considerable manipulation. It has led to grave confusion in France, where the public is often bewildered by the fact that budgets are both balanced and unbalanced at the same time. If used with honesty and candor, it may have a legitimate place during emergency periods, but its use is discouraged by students of budgetary problems. Nevertheless, something certainly is to be said for budgeting which recognizes government as a positive force in reviving, stimulating, supporting, and preserving the private economy, and which throws into sharp relief the therapeutical expenditures on the ailing economic system.

A budgetary change quite in keeping with the trend of the times would be one which draws a clear line between investments, particularly in self-liquidating projects, on the one hand, and operating expenses on the other. This is now the subject for experimentation in Sweden. It leads logically to the proposition that governments should have a balance sheet (of assets and liabilities) as well as an operating statement (of expenses and income). This very important and plausible innovation would open up a large new field in budget-making.

Need of Research. It has previously been mentioned that the executive must possess some independent knowledge in order to pass competent judgment on the tentative budget. For this purpose he usually has the assistance of a budget director. The President's Committee on Administrative Management was impressed by the very limited appropriation and staff allowed the budget director in light of the fact that "economy and efficiency require constant investigation and reorganization of administrative structure." For this reason it has been suggested that the budget director be provided with an appropriation and a competent staff with which to conduct independent studies of the efficiency and importance of public agencies. Whether it is advisable to attempt making an efficiency expert out of the budget director

cases, the governor has been given discretion to eliminate or reduce items that, in his opinion, involve extravagance, waste, or mismanagement. This is much like a specific veto with no opportunity for legislative review. Some of this may be necessary to avoid deficits but, in general, it represents a dangerous delegation of power. Shorter budgetary periods and more careful budgeting should reduce such delegation of power to a minimum.

is not yet established. However, it is doubtful if the average budget director, even if he has the advantage of long tenure, is able to pass an intelligent independent judgment upon the merit of alternative budgetary claims with no other resources than hearsay evidence and general knowledge of men and functions. It is bad economy to permit department heads, usually interested in only one governmental service, to "write their own ticket," but it is equally bad to cut all their requests horizontally. However, it is even worse to base decisions of this kind upon whim and caprice.

The independent audit serves as a check upon the propriety of government expenditures, but there is no similar check upon their efficiency and importance. Many questions of government outlay are matters of popular, legislative, and executive choice. But wise choosing is facilitated by adequate knowledge. Just what form the investigational activities of the budget director should take and how they can be pursued effectively remains to be proven. But that more of this type of research can and should be done is apparent. Developments in this direction represent an important field for progress in budgetary procedure.[11] The Estimate Division of the federal Budget Bureau is expected to maintain a continuous scrutiny of the "concrete value of departmental activities." At the municipal level, techniques for comparing costs and standards of service among cities are badly needed.[12]

Balancing the Budget. Many critics have observed that by far the most important rule in budget-making is to balance the budget. Several state constitutions provide that the state must raise taxes enough to defray current expenses.

In the chapters on public debts, however, it has been suggested that it may not always be desirable to pay all the expenses of government from current revenues. Ordinarily, debts should be confined to irregular expenses, such as those on capital account. Where this rule is followed, debts may not be incompatible with a balanced budget, according to one definition of that term. Some have argued for balancing of budgets over a period of years corresponding with the business cycle. Others hold that "planned deficits" are required to stimulate business during the low ebb of the business cycle. This may happen automatically if tax rates and exemptions are kept at a constant level during a business cycle. Still others believe that the government should make large investments, more or less in the nature of capital

[11] The State of Washington made some experimentation in this field when it provided the executive with a Department of Efficiency to investigate other departments. It was contended that the governor used the Department of Efficiency for political purposes, especially in his conflicts with other elective officials. Governor Hortley frequently sent this director of efficiency into their offices to make investigations. "In each instance the investigation was looked upon as a 'financial attack upon the official and created deep resentment.' At the same time, adverse popular feeling was stirred up against the department of efficiency, which led to its abolition in 1935" (A. E. Buck, *The Reorganization of State Governments in the United States*, National Municipal League, Columbia University Press, New York, 1938, p. 248). Some other states have had similar experiences.

[12] Mabel Walker, *Municipal Expenditures*, Johns Hopkins Press, Baltimore, 1930.

expenditures, to keep its men and resources employed. These investments might be partly or fully self-liquidating over a period of time. All of these problems go beyond the field of fiscal administration into the field of fiscal policy. More attention will be given to these problems in the next chapter.

THE CUSTODY OF PUBLIC FUNDS

If all public revenue could be timed to reach the government's hands at the exact moment it were needed, the custody of public funds would be a negligible problem. But with imperfect timing, the government frequently has considerable sums on hand which must be kept until needed. Obviously, this creates problems as to safekeeping, interest payments on both active and inactive accounts, and the possible disturbance to the money market as a result of withdrawing money and credit from the channels of private trade.

When taxes were paid in kind, as in the ancient civilizations, the public treasury consisted of warehouses. Some rulers used the public warehouses not only to store the revenue collected in advance of government needs but also to protect the consumers at large against famine. As taxes came to be paid in cash, it was possible to continue the warehouse idea and actually to provide a storehouse for coin or bullion. But when taxes came to be paid predominantly in credit, the storehouse idea gave way and governments chose to carry their excesses in the form of bank balances with a government bank or one or more selected private banks.

Custody of Federal Funds

The history of the custody of federal funds is characterized by repeated change, much controversy, and considerable color. It will be given here in brief summary only:

Prior to 1791. Federal funds were deposited in the various state banks, of which only three or four were then in existence.

1791-1811. Funds were deposited in the First Bank of the United States. Over $100,000,000 of public money was received and distributed without loss.[13]

1811-1816. Funds were deposited in various state banks; suspension of payment by some of these banks during the panic of 1814 created dissatisfaction with this procedure. Nearly 100 state banks in different sections of the country had been selected as depositaries of federal funds. In 1814 all of the banks south of New England suspended specie payment. The panic was preceded by a flood of state bank notes of uncertain value. A strong demand arose for a new federal bank to re-establish an orderly currency.

[13] J. J. Knox, *History of Banking*, Bradford Rhodes and Co., New York, 1900, p. 38.

1816-1833. Federal funds were gradually withdrawn from state banks over the heated protest of the latter and were deposited in the Second Bank of the United States, created in 1816. The federal bank proved to be a safe depositary and no federal funds were lost during this period. However, the bank itself was a first-rate political issue. Jackson interpreted his re-election to mean popular disapproval of the Second Bank and, when Congress approved the extension of the bank's charter, he promptly vetoed the bill.[14]

1833-1840. After the order in 1833 for the removal of the public deposits from the Bank of the United States, money collected from customs and other sources of revenue was no longer paid into the Second Bank, but was deposited with selected state banks. The latter were called "pet banks" by the opponents of the administration.[15]

Because of the large surplus of federal revenues on hand, an act was passed early in 1836 to distribute it to the states. The surplus amounted to $37,468,-859. Of the 788 state banks then in the country, the 88 "pet banks" were the larger banks and held approximately $70,000,000 of the $128,000,000 of net deposits in state banks. Of the $70,000,000 in deposits, the "pet banks," by order of Congress, were to repay over $37,000,000 in four quarterly installments or over a period of nine months. The first and second quarterly installments were met with difficulty, but, in May of 1837, the pressure on the banks for the redemption of their notes in species became so great that, with the exception of five or six institutions, they all suspended payment. During a single year, an ebb in the flow of public revenues and the inability of state banks to meet their obligations transformed an embarrassing surplus in the federal treasury into a serious shortage of funds.[16]

The dissatisfaction with federal banks and the proved failure of state banks as government depositaries created support for a new institution and system of deposit—the independent treasury.

1840-1863. The Independent Treasury Act became a law on July 4, 1840. Under this act, vaults and safes were provided in the Treasury in Washington, and sub-treasuries were established at New York, Boston, St. Louis, and Charleston. Strenuous opposition to the act resulted in its repeal 13 months later but without the substitution of other legislation.

"From August 13, 1841, when the first Independent Treasury Act was repealed, until August 6, 1846, when the same act was re-enacted, the Treasury funds were paid in and paid out very much as if they had been under the Independent Treasury Law, and after 1846, the Independent Treasury system was exclusively in operation until the passage of the National Cur-

[14] J. T. Holdsworth and D. R. Dewey, *The First and Second Banks of the United States*, Senate Document, No. 571, U. S. 61st Congress, 2nd Session, 1910.

[15] On November 1, 1836, 88 of these banks located in 24 states with a capital of $77,-576,449 held public deposits amounting to $49,377,986; their ordinary individual deposits were only a little over $25,000,000 (J. J. Knox, *History of Banking*, p. 80).

[16] *Ibid.*, pp. 81-85.

rency Act in February, 1863." [17] The Treasury financed the Mexican War loans directly and without the aid of the banking system. The independent treasury provided safekeeping for government funds, without question, but it was subject to the criticism that the fluctuating governmental balances upset the private money market. On several occasions bonds were purchased at a considerable premium in order to make funds in the treasury available for private use. During the early Civil War period, aid from the banks in floating large war loans was solicited; this was the first step away from the exclusive use of the independent treasury system.

1863-1913. The financial problems of the Civil War period led to the creation of a system of banks sponsored and chartered by the federal government and eligible for the deposit of federal money. Although the independent treasury system was continued, it was practically a dead letter during the war and never recovered its former prominence. During the period following the war, greater and greater reliance was placed upon the national banks.

1913. The federal reserve system, including a group of central banks sponsored by the federal government, was created and became the government's special instrumentality for assisting it in financial operations. However, the member banks were and are still used as depositaries and the independent treasury system was also retained until 1920.

The new use of banks as depositaries makes it possible to eliminate the segregation of large quantities of idle funds for long periods. However, the government may still tie up considerable bank credit, which is equivalent in modern times to money. By the issuance and cancellation of short-term treasury bills or certificates, credit balances are stabilized and the disturbance of the money market is reduced to a minimum.

Custody of State and Local Funds

State and local governments have usually relied upon banks as depositaries, though some states have experimented with an independent treasury. Local governments could hardly afford the luxury of their own vaults. Custody involves the problem of (1) selection of banks, (2) interest to be charged, (3) maximum quantity to be deposited in any one bank, (4) adequate security to be required.[18] Banks should be selected by competitive bidding with assurance against favoritism; interest should be one of the elements in the competition; deposits should be limited to the capital of the bank or perhaps half of the capital; adequate security should consist of reserves, collateral, or a surety bond. During the depression of the thirties, municipalities encountered great difficulty with their public funds. Many banks were unable to procure surety bonds for public deposits. A consider

[17] *Ibid.*, p. 89.
[18] Jens P. Jensen, *Government Finance*, p. 547.

able number of states proceeded to enact systems of state compulsory public deposit insurance.

During the early history of the states, many treasurers regarded the interest on public money as one of the perquisites of office to be pocketed by the officeholder or turned over to the political party which helped to secure his election. One treasurer in Wisconsin, for example, when asked by a legislative committee what he did with the interest on public money, replied that he disposed of it "in accordance with the practice of his predecessors." From 1878 to 1899, an average monthly balance of $800,000 in state funds was maintained by Wisconsin, from which the state received no interest. During the 1890's the state inaugurated its "Treasury Cases" to recover the interest which had been misappropriated by several past treasurers. The state won its case and a considerable part of what was due to it was collected.[19] As evidence of improved morality in the conduct of public affairs, it should be said that this open breach of public decency now rarely occurs.

AGENCIES FOR ADMINISTRATION OF TAXES

Administration and collection of specific taxes have been discussed at many points in this treatise, and a short account of the situation in general is all that can be attempted here.

Federal Agencies

The principal agency of fiscal administration in the federal government is the Treasury Department. It collects the revenues of the federal government through two important divisions, the Bureau of Internal Revenue and the Bureau of Customs.

The first of these divisions assesses and collects the main federal taxes, including the excises and the income and death taxes. In addition it determines and publishes the rules (regulations) for general application in tax cases, and it hears and determines administrative appeals. The volume of its work has increased to about forty times that in 1913. During 1938 the Bureau adopted a progressive program of decentralization so that hearings and determination of disputes could be conducted in regional offices. This has proved of great convenience to the taxpayer; it has reduced considerably the delay in settlements; and it has saved expense to the government as well as the taxpayer. It is judged by competent authority[20] as the most important reform in federal tax administration in many years. The complaint still per-

[19] Floyd F. Burtchett, *Development of the Fiscal System of Wisconsin, 1900-1925*, unpublished doctoral dissertation, University of Wisconsin, Madison, p. 75.

[20] Roswell Magill, *The Impact of Federal Taxes*, Columbia University Press, New York, 1943, p. 200.

sists that the personnel of the Bureau is judged and promoted on the basis of additional taxes assessed rather than fair treatment for the taxpayer. This and other phases of government-taxpayer relations are exceedingly difficult aspects of the Bureau's work. Political appointment of collectors and part of their staffs is also singled out for criticism.

The judicial aspect of tax administration is very important. Tax controversies are by far the largest single category of cases heard by the Supreme Court. The Tax Court (formerly Board of Tax Appeals), with sixteen judges, handles much of the appeal traffic, but its jurisdiction is neither complete nor exclusive. Because of divided jurisdiction in tax cases, annoying conflicts of decision arise. It has been suggested [21] that this situation could be relieved to some extent were the Tax Court given jurisdiction in cases involving claims to refunds of income and estate taxes, as well as in cases involving deficiencies. Delay in litigation has been reduced, but the average period required to carry a case to decision by the Supreme Court is still nine years.

State Agencies

Most of the states have some central tax administering agency variously known as a tax commission, tax board, tax department, department of finance, department of treasury, or board of equalization. Florida and Texas have comptrollers that serve as their central financial executives.[22]

The tax commission or commissioner is the prevailing form of state tax agency. In the past the most common form of commission consisted of three members, although in some states the number ranged from one to seven. There has been a strong trend in recent years toward the single administrator. Some states have a commissioner plus a board of tax appeals to relieve him of his more judicial functions. Other states centralize responsibility by providing for a director who is given charge of strictly administrative duties, and the commissioners remain free to handle the judicial matters. Usually the tax commission (or commissioner) are appointed by the governor, but in several states they are elected. Terms of office range from two to six years and pay from $2,500 to $12,000.[23]

Originally the tax commission functioned mainly in the property tax and public utility tax fields. The commission was expected to "equalize" assessments between districts so as to provide a fair division of the state property tax and eliminate competitive underassessment. In addition, it was usually given powers of supervision over local assessments, though frequently with inadequate implementation to make these powers effective. One of its major responsibilities was that of assessing railroads and more or less other public utility property, either under the ad valorem tax or some tax in lieu thereof.

[21] *Ibid.*, p. 210.
[22] *Tax Systems*, 1942, pp. 112, 116.
[23] *Ibid.*

It was also given the power to act as a lay court of first appeal in property tax cases. In some states it was given power of reassessment on its own motion and of removal of local assessors.

Most of the property tax functions are still retained by the central tax agencies, but, in addition, these agencies in many states have taken on a wide range of added responsibilities. The reason usually given for the relative success of the Wisconsin income tax (1911) was its centralized administration in the hands of the state tax commission. All states with an income tax now entrust its administration to the central tax administering agency.

Other state taxes, such as business taxes, sales taxes, inheritance taxes, and motor vehicle taxes, are quite commonly administered entirely or partly by the state tax administration. Not uncommonly, too, the administration is strewn over a large number of other agencies such as the state treasurer, secretary of state, state auditor, highway commission, and so on. There is a strong consensus supporting the centralization of state tax administration in a single department. This includes the collection of state taxes as well as their assessment. Collection is as much a part of tax administration as is assessment and should not be separately administered.

State Supervision of Local Finance. Some state supervision of local finance is universal, but the agencies, forms, and degree differ widely from state to state. The agency employed in many states is the tax commission or state department of finance. An innovation likely to grow is the independent finance supervisory agency, such as the North Carolina Local Government Commission and the New Jersey State Department of Local Government. These agencies hear local petitions concerning alleged illegality of procedure, supervise reporting, budgeting, auditing, and borrowing practices, and in some cases have discretionary power over budgets or debts.

Financial reporting and publication in many states are notorious for gaps, unstandardized terminology, and incomplete coverage, although substantial progress has resulted from federal and state efforts in this field. Accounting procedures for local units are made available in some states and prescribed in others. Accrual and cost and capital-accounting techniques are applied to some extent but are in a very rudimentary state of development. States frequently make available their services for auditing local accounts, supervise private auditing agencies, or make state service mandatory.

State control of local budgets and expenditure may require only the following of certain prescribed procedures, but in some cases it extends to appellate power or requirement of state approval. The most publicized of controls passes under the name of the Indiana plan, inaugurated by that state in 1921. Under the "plan" any 10 taxpayers can appeal to the state tax commission for review of a local budget, and the commission, after a hearing, can order changes in the budget. Since the inauguration of tax limitation in Indiana, budgetary appeal has become of secondary importance in that state,

but the original Indiana system has been taken over by Iowa. New Mexico requires the tax commission to approve all local budgets and gives it power to make changes at its discretion. In general, state control of local discretion in spending has been criticized as contrary to home rule and the development of local self-discipline and responsibility. Where it is limited to correcting abuses, it can fill a legitimate function.[24]

Criticism of State Tax Commission—Inadequate Powers and Implementation. The state tax commission or tax department is frequently given insufficient power, financial support, and protection against political interference. In the property tax field, where authority is particularly desirable, the state agency is often handicapped by inadequate powers. In this field it should have the power to make the state assessment or equalization (sometimes left in the hands of an ex-officio board of state officials) and the responsibility for aiding the counties in making the county assessment or equalization where the original assessment is in charge of town, village, and city officials. The commission should and frequently does have the power of supervision over local property tax administration and should be equipped with a sufficient staff (which it usually does not have) to supervise effectively. It should have complete authority to assess interdistrict utility property (usually not granted). Insofar as tax litigation is concerned, the commission should be given the power to act as an administrative "court" to hear property tax appeals before they are carried to the regular courts of law. It should have authority, at least upon petition, to order and make a reassessment, re-equalization, or a revaluation of property.[25]

Where these powers are granted, they must be backed by adequate financial support to make possible a staff that can carry them out. The states are almost universally delinquent in this respect. Most states could have much better property tax administration if they were willing to pay for it. The same is true to some extent of other taxes. Larger outlays for administration in the case of these other taxes can be supported on the ground that they will more than pay for themselves in increased tax collection for the state.[26]

[24] Wylie Kilpatrick, *State Supervision of Local Finance*, Public Administration Service, Publication No. 79, Chicago, 1941.

[25] While there is no standard definition for the three terms here used, they may be distinguished as follows: Reassessment is a new assessment of all property in a district, re-equalization is a new assessment of districts as such, and revaluation is a new assessment for an individual property owner.

[26] Recent experience of tax commissions employing income tax and sales tax field auditors has demonstrated the monetary value of effective staff employees. Wisconsin income tax auditors were responsible for the collection of $6,774,454 in additional taxes during the three years, 1934-1936. The added expense involved in this collection amounted to 6 percent of collections. For every dollar invested in auditing personnel, there was returned about $17 to the state. This takes no account of the fact that much additional tax undoubtedly resulted indirectly because of the existence of the auditing program. The cost of administration stated above is not to be interpreted as that of administering the entire law; it is only the cost of assessing and collecting the most elusive of income tax obligations.

It goes without saying that an effective merit system in the choice, promotion, and tenure of employees is exceedingly important for good administration. A property tax or income tax staff chosen for political reasons, or turned out of their positions for the same reasons at about the time their experience is becoming an asset, is certainly fatal to satisfactory results. In this connection it may be recalled that only a minority of the states provide for a merit system by statute. Both within and without these states, personnel management differs considerably in quality from state to state, but the average, to say the least, leaves much to be desired.

Greater cooperation among the states and between the states and the federal government would facilitate good state and local tax administration. Some progress has been made along this line in recent years, but more is in order. The federal government now makes income tax information available to the state and local officials. The states frequently exchange information valuable in the administration of gasoline taxes and the special excise taxes. Organization of state officials into national associations has created an interest in cooperation among states. However, such a small matter as the date for the assessment of property still varies over most of the months of the calendar from state to state. This stands, and probably will continue to stand, for a long time as a monument to the independence of states in tax administration and the failure of the states to cooperate.

Most tax commissions were originally charged with the duty of publishing a periodic report, and it was hoped that important educational objectives would be achieved thereby. A few excellent reports have been forthcoming from a few commissions; but, in general, reports have been pitifully meager and of almost no educational value. A few statistics without interpretation are thrown together to produce a so-called "report."

What constitutes the best machinery for state tax administration is not entirely established. The three-man commission with the six-year term was popular at one time and afforded distinct advantages. It gave each governor (assuming the prevalent two-year term) an opportunity to leave his impress upon the personnel of the commission with at least one appointment. It made possible a nonpartisan or at least bipartisan commission, since the requirement was frequently established that not more than two members should be of the same political party. It promised an appeal to high-class men who might reject an appointment with more limited tenure; and it tended to prevent the waste of the experience of men trained on the job. Much of the tax commission's work is of a judicial or quasi-judicial character, and for this it was said that three heads are better than one.

As an alternative to the type of organization just considered, some states (for example, Massachusetts) have preferred a single commissioner and a separate board of tax appeals. The commissioner has the administrative and the board, the judicial function. Whereas the commission form has fre-

quently resulted in divided responsibility and authority, the alternative centralizes these features in a single head. However, any arrangement which provides a single administrative head must grant him either long tenure, in which case the governor may have no control of the personnel at the head of one of his principal administrative departments, or short tenure, in which case experience and willingness of good personnel to accept the office may be sacrificed. This type of organization has worked well in Massachusetts, where a very competent commissioner has been able to work quite harmoniously with many governors of different parties and temperaments.

The tax department with a single head directly responsible to the governor and with all other employees protected by civil service status—perhaps the most logical arrangement—makes for a permanent well-trained staff and provides the machinery for carrying out the policies of the party in power. It sacrifices experienced men at the top and the "three heads" to deal with judicial problems.

Other possible arrangements include a commission, full-time or part-time, and a director, selected by the governor or the board, either with or without civil service tenure. A type of organization which happily is disappearing is the ex-officio board under which several state officials, such as the secretary of state, the state treasurer, and so on, meet in their spare time to direct tax administration (such as there is).

It seems fairly clear that administration as such ought not to be under divided authority. A question which cannot be answered with assurance is: Should the administrative function be separate from the judicial? If the answer to this question is affirmative, several others follow: (1) Should the judicial function be handled by a board in preference to an individual? (2) What is the proper dividing line between administrative and judicial functions? For example, into which category should the assessment of railroads be placed? And (3) who should appoint the administrator and for how long? It is quite possible that the best arrangement in one state will not fit the needs of another. For example, the volume of litigation may determine whether or not it is advisable to have a full-time board of tax appeals. Nevertheless, there is hope that the large amount of experimentation with different administrative machinery now being made among the states will eventually make the answers to these administrative problems fairly clear.

It seems fair to say that, on the whole, the high hopes which were associated with the original three-man-commission administration have been somewhat disappointed. It was hoped that the nonpartisan or bipartisan arrangement with long tenure would draw experts and scholars to the tax commissions, or at least that high-caliber men would become outstanding leaders on the job. There have been good appointments to the commissions and effective work has been done by some appointees. But for every appointee able to make a contribution, there have been probably a half dozen

whose principal interest was an easy job at fair pay. On the whole, the tax commission of the old type has not distinguished itself for vigorous and aggressive action.

Local Agencies

Below the state level, county and municipal treasurers usually collect the property tax, while the assessment is made by a separate and independent assessor. Collection of property taxes by municipal officials is, in many places, notoriously weak. The system could be improved upon were municipal financial officials chosen by civil service or appointed rather than elected. Likewise, it appears that collection in some jurisdictions could be greatly improved were it centralized in the county or at least the county and the large cities. Considerable administrative problems center about the local property tax assessor. These, however, are more appropriately treated in the chapters on the property tax.

SUMMARY

The federal government did not have a budget worthy of the name until the Bureau of the Budget was created and placed in the Treasury Department in 1921. It has since (1939) been made an independent department directly responsible to the President. Congress still retains power to modify the President's financial proposals, although it lacks the necessary facilities for procuring adequate information and for ensuring that its legislative mandate is carried out.

Budgetary procedure includes the drawing of the tentative budget, preferably and usually by the executive; consideration of appropriation and tax bills by the legislature; enforcement by administrative officials; and a periodic audit. Even with an executive budget, the budgetary procedure under the American form of government gives the executive much less power and responsibility than under the British system.

Budgets should be comprehensive; often they offend in this respect by omitting the taxation side of the financial picture, and they may also omit important expenditure matters. A middle ground between detailed and lump-sum appropriations appears desirable. Continuous appropriations are criticized on the ground that they reduce legislative scrutiny of expenditures, but they do offer protection against legislative deadlocks. Multiple budgets are confusing but they may be desirable to draw attention sharply to distinct objectives of certain classes of expenditure.

The custody of federal funds has undergone an interesting historical evolution, including the use of state banks, federal banks, independent deposit, and the federal reserve system. The problem is one not only of safekeeping

but also of avoiding disturbance to "the money market." Local government deposits in banks are often protected by deposit insurance.

Agencies of federal tax administration include the Bureau of Customs and the Bureau of Internal Revenue. The latter has an exceedingly heavy load to carry. Recently it has been improved by a decentralization of its machinery and the extension of the merit system to cover more fully its personnel.

It is assisted by a Tax Court that handles much, but not all, of the appeal cases.

At the state level, state tax departments, with many variations as to composition and form, are the principal agencies of tax administration. Not infrequently they are given inadequate power or staff to supervise property tax administration properly, and other state agencies are given the responsibility for administering certain other taxes. The trend is toward the centralization of authority in the hands of a single commissioner, but it is still not entirely established that this will prove more satisfactory than the three-man commission, originally predominant. In addition to tax administration responsibilities, tax departments often supervise local finances and accounts, a field in which there is much room for improvement.

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CHAPTER XXVIII

Fiscal Policy and Prosperity[1]

INTRODUCTION

With the close of recent hostilities, the objectives of public finance have become more complex and ambitious than they were after the last war. During the thirties we began the practice of viewing most specific economic measures to ascertain their over-all economic effects. This was not new, perhaps, except in degree, but the change in degree was revolutionary. At least this was the case with public finance, which was elevated from a mere government "meal ticket" to an instrument of grand economic strategy. Even though conditions after the war may not resemble those of the thirties, public finance is likely to retain its new sphere of interest. Intense concern for employment opportunity has been maintained during the prosperous forties, when, in spite of manpower shortages, apprehension has continued as to how and where men employed in the armed forces and in the war industries would find jobs after the war. From now on, each policy of public finance is likely to be called before the bar of public opinion and asked the question: "Do you seriously impede enterprise, employment, and production?" If the answer is affirmative, and if there are alternatives that do not offend in this manner, the policy will probably be selected for discard.

The objectives of fiscal policy are, first of all, to maintain a high and increasing national income. However, *what* we produce is important as well as *how much*. The future economy will and should be judged mainly by the essential goods and services—such as housing—that are made available in satisfactory quality and quantity to larger numbers of consumers. Employment opportunity is also a major consideration. Prolonged and wholesale unemployment carries so many drastic consequences for so many persons that it is hardly to be tolerated in the future.

[1] Based in part on *Postwar Taxation and Economic Progress*, a manuscript to be published by McGraw-Hill, New York, 1945.

THE SUBJECT MATTER OF FISCAL POLICY

Fiscal policy, broadly defined, is almost as extensive as statecraft. It includes policies of banking and currency control and of foreign trade, investment, and exchange, which cannot be considered here. It includes tax measures that will least impede production, debt and budget management, and public spending. Some of these have received considerable attention in this book. They are reconsidered in this final chapter with special attention to their bearing as a system upon the critical problem of postwar production and employment.

RELATION OF TAXATION TO PRODUCTION

Taxation as a Stimulus to Industry and Thrift. Some of the early writers thought that taxation judiciously used might serve as a stimulus to private production. Thus David Hume, in his essay on taxation, and J. R. McCulloch, in *On Taxation and the Funding System*, argued that taxes which are moderate and laid on gradually may stimulate industry and frugality. McCulloch argued that during the Napoleonic Wars the necessities of the times were the mother of both industry and invention, and that people who found their accustomed standard of living challenged by taxation immediately undertook to defend their standard by redoubling their efforts. (It is interesting to observe that similar claims were made with regard to the First World War period, but the explanation more often given now is that the war created an adequate market or outlet for productive capacities.)

McCulloch supported his contention that taxation may have a stimulating effect with his famous illustration concerning the Scottish stills: Before 1786 the duties on spirits distilled in Scotland were based upon quantities produced. Because of administrative difficulties in this system, the basis of taxation was changed to the size of the still. The rates were adjusted so that, at the prevailing productivity of stills, the tax burden on producers and the revenue received by the government would not differ greatly from what they had been previously. Almost immediately, however, two ingenious distillers hit upon the idea of lessening the depth and increasing the diameter of the still. In this way a larger surface would be exposed to the action of the fire and the contents could be run off in considerably less time. Applying this idea, the distillers found that they could distill in a few hours what had formerly required a week. Although kept a close secret for a time, this idea eventually became common knowledge and was generally applied by all distillers. In order to maintain its revenue, the government was obliged to raise its rate of tax. However, the government act provoked new improvements in

the construction of stills, which now had to be followed by another raise in tax rates. Action and reaction of this sort continued, with the distillers always a step ahead of the government, until the productivity of stills had increased to 2,880 times what it had been originally.[2]

Commenting on this example, Bastable observed that it was not the tax itself but the possibility of avoiding it which prompted the burst of ingenuity on the part of distillers.[3] Most writers have been inclined to doubt McCulloch's conclusion or at least to emphasize its limited and exceptional application. These writers usually hold that it is the rewards people receive that keep them working, saving, and risking; that taxation cuts into these rewards and thus weakens incentives.

Incentive Taxation Proposals. Many ingenious plans have been submitted which would use taxation to reinforce incentives rather than to undermine them. It is proposed, for example, that businesses should contribute to government according to their idle capacity and employees.

The proposals to apply a graduated tax rate inversely to the payroll or the volume of employment are numerous and assume many forms. Among the few cases of actual experience with special tax concessions to new investment or expanded employment is that of Germany under the so-called "Papen Plan," inaugurated in 1932.[4] A premium was offered for each newly employed worker (increasing the previous labor force), to be paid in tax certificates acceptable for the payment of certain future taxes and subject to discount for procurement of immediate cash.

The plan was launched with high hopes and was accepted with enthusiasm by German businessmen. But instead of the expected recovery, unemployment again increased after being stationary for two months. A law in April 1933, liquidated the premium for employment except in a very few cases.

It was said of the plan that on the surface it "was ingeniously constructed and seemed to justify confidence in its working." [5] Reasons cited for its failure were principally that German business was too monopolistic to allow it to succeed; the hope that one concern would expand heavily to obtain an advantage over its competitors proved unwarranted. Moreover, little attention was given to consumer demand and this weakness may have accounted for the diffidence of business. The assumption that German budgets of the period could be balanced in spite of this additional strain proved an overestimation. It is not inconceivable that a subsidy program could start a wave of optimism in private business, but the uncertainties and problems involved are of serious proportions.

One of the most popular patterns of incentive taxation is that which pro-

[2] J. R. McCulloch, *Taxation and the Funding System*, pp. 151-152.
[3] C. F. Bastable, *Public Finance*, 3rd ed., p. 286.
[4] Gerhard Colm, "Why the Papen Plan for Economic Recovery Failed," *Social Research*, Feb. 1934, p. 82.
[5] *Ibid.*, p. 88.

poses to tax idle money. Both currency and deposits withdrawn from the productive process and awaiting better terms might be subject to a special levy.[6] It is proposed in effect that the currency will become a "calendar currency," on which will be printed the value of the notes at a series of dates. Or currency might be periodically issued and recalled at a devaluated figure when it reaches a certain excessive volume.

The application of an "idle-money tax" to banks would involve serious difficulties. Were savings deposits exempt from the hoardings tax, the result would probably be an impressive expansion of savings deposits and a reduction of demand deposits. But banks might then convert time deposits into a device much like demand deposits. The volume and frequency of withdrawals to meet current payments would be much greater than now. The banks would not be able to place as large a portion of their time deposits into long-term investments. They would have to maintain a high degree of liquidity in their time-deposit account. In more ways than one, the hoardings tax could injure the functioning and security of the banking system. Moreover, one can hardly tax a bank for not loaning up to the limit of its capacity.

It seems highly doubtful that the economic virtues can be called into existence by negative treatment. People work enthusiastically, develop new ideas, and risk their fortunes on new enterprises when they have confidence in the future. That kind of confidence can hardly be engendered by taxing pessimism and showing the potential investor two ways instead of one in which he can lose his resources. A heavy tax on idle property (the property tax) during the thirties resulted neither in payment of taxes nor in the use of the property; it resulted in heavy tax delinquency. Industry is a creative endeavor and it flourishes with the enthusiasm of its participants; such enthusiasm cannot be generated by the application of a whip. Moreover, any notion that hoarding is more than a symptom of the economic problem seems quite illusory.

To question the value of incentive taxation gadgets is not to minimize the importance of so ordering taxation that it impedes production as little as possible. Nor is it to say that this important aspect of taxation has not been neglected or underemphasized. However, the approach to the problem taken by John A. Hobson and others,[7] namely, that which calls for the selection of taxes according to their incidence and the sensitivity of tax bases, seems the most promising. This view provides strong support for income taxes, death taxes, and land taxes. The form of these levies as well as their amount is

[6] A. Dahlberg, *When Capital Goes on Strike*, Harper & Brothers, New York, 1938, Chaps. VII-VIII.

[7] J. A. Hobson, *Taxation in the New State*, Harcourt, Brace & Howe, New York, 1920. See also R. H. Tawney, *The Acquisitive Society*, Harcourt, Brace & Howe, New York, 1920; T. N. Carver, *Essays in Social Justice*, Harvard University Press, Cambridge, 1915; J. R. Commons, *Institutional Economics*, Macmillan, New York, 1934.

important. For instance, a tax system which levies heavily on gains, with little or no allowance for losses, would be suspect. The exemption of interest on government bonds (the safest kind of investment) is not conducive to risk-taking. The morale of the taxpayer is important, and administrative and statutory practices and provisions which impress the taxpayer as obviously unfair should be avoided.

Taxation and the Business Cycle. Following the First World War, taxes were repeatedly revised downward during the prosperous twenties. In the depths of depression we changed the trend and began "getting tough" with the tax system. On the theory that increased taxes are deflationary and decreased taxes inflationary, our historical procedure was the exact reverse of what it should have been.

It is true that the tax instrument does not lend itself readily to the objective of cyclical control. "Control demands quick action, and tax bills do not go through Congress quickly and smoothly, as recent events demonstrate. Moreover the collections lag far behind the legislation." [8] It has been proposed, to avoid some of these limitations, that the taxing power be delegated to an administrative agency. But this is mainly of academic interest and hardly likely to appeal to Congress. However, if tax rates are not increased during a depression, taxation will automatically be reduced because of the shrinkage in the tax base. This in itself might exercise a beneficial countercycle influence. It is the sort of countercycle tax policy which is likely to prove most practical. It does involve the difficulties of a cyclical budget, about which more will be said later.

It would be logical to go a step further and recommend that tax rates be reduced during a depression and increased during prosperity. The change to stable tax rates would represent, however, a substantial step forward, especially in view of the fact that most of the taxes likely to be used by the federal government in the postwar period are decidedly "cycle-sensitive."

Taxation and the Balance Between Saving, Consumption, and Investment. In recent years there has been a strong trend toward the view that depressions and unemployment are caused by a persistent tendency for rich countries to save more than is required as new capital for their industries. The ready answer to this contention formerly was that tendencies toward a redundancy of savings were speedily curbed by falling rates of interest. But it has become evident that the amount of savings does not readily respond to changes in interest rates. Saving is rather determined by the national income, the distribution of that income, and the need and willingness of people to provide for their futures.

In modern societies, individuals will save for various personal reasons, such as future security, future consumption wants, estates for their heirs, and so on, regardless of the magnitude of investment outlets. The inclination to

[8] Mabel Newcomer, *A Tax Policy for Postwar America*, New York University Institute on Postwar Reconstruction, New York, Nov. 10, 1943.

save has been fostered by decades of thrift education. And yet the great majority of people have never had sufficient savings to attain their objectives. Were individuals to save as much as they are exhorted (and properly) to save, or were the social security system to assist them in doing so generally, the problem of oversaving would be much more serious.

There are economists, too, who are convinced that the business cycle and unemployment are to be explained mainly in terms of maladjustments between business costs and prices and that oversaving, underconsumption, and underinvestment have little to do with the problem. These critics emphasize particularly the tendency of wages to be forced "too high" by labor unions. Also there is a tendency for some prices to get out of line with others. On this view the remedies would be to break up unions, urge restraint upon labor leaders, and attack monopolies.

It is not clearly established that oversaving *is* a chronic problem in a highly developed and highly productive industrial economy. As recently as the twenties, few people considered oversaving any problem at all. Yet the outlets for savings may have been little more promising at the end of the last war than they are now. It was during the thirties that the oversaving theories came into prominence. This was the period of low business confidence and very low new investment. However, the oversaving hypothesis has enough plausibility to warrant a tax system that would tend to correct rather than aggravate the problem should it turn out to be real.

The supply of savings can be reduced by progressive taxation. The demand for them can be increased by tax policies which make investment attractive and which ensure a good market. To foster investment by support of incentives works on the theory that expansion in anticipation of demand is of great importance. Probably such expansion must play a decreasing role in the future, but the transition can be eased to some extent. To foster consumption works on the theory that expansion follows demand and that this will be especially true in the high-consumption economy we are now approaching.

Modifications in the tax system which will reduce saving, foster a broad market, and encourage the demand for savings (investment), all at the same time, are not easy to devise. However, it is possible to proceed with all these factors in view, and some changes can be recommended that would support all these interests. A fair tax system, even though a rigorous one, is obviously required.

The problem of securing a large and steady flow of private investment is certainly one of the most difficult in economics. Investment (at least replacement) sometimes follows consumption, although it often precedes demand and creates purchasing power. Expansion may be a function of acceleration in demand rather than one of demand itself. There may be overinvestment as well as underinvestment. Recommendations looking toward

adequate and stable investment include stable tax rates, a rational tax system, carry-over of losses, and accelerated depreciation allowances (in times of stress).

PROBLEMS OF BUDGET AND DEBT

A problem of great concern for the whole economy is that of postwar budget policy. Should this policy seek annual surpluses in order to start paying off the huge national debt? Should we seek merely to avoid annual deficits and thus prevent the debt from becoming any larger? Should we tolerate some deficits in bad years, aiming to balance the budget over a period of years (cyclical budget)? Or should we go in for deficit spending as a regular policy, hoping thereby to bolster a "stagnant economy"?

Several considerations must be weighed in answering these questions: (1) Business confidence is an important element in industrial expansion and such confidence would probably be considerably strengthened by a *successful* budget-balancing or debt-retirement policy. (2) Raising taxes and lowering exemptions in bad years tend to aggravate depressions. (3) Budget-balancing will not be too difficult if the national income can be maintained at near to wartime levels. (4) Debt reduction would increase the capacity of the nation to borrow for future emergencies and would decrease fixed charges in the budget.

Placing the heaviest emphasis upon (2) and (3) above, it can be recommended that we seek to balance the budget during years of good employment only; that we strive for a surplus during the best years; that we aim at least to balance the budget over a period of years (the cycle); and that we hope for such prosperity that the debt can be substantially reduced. Whether we should go further than to balance the budget over the postwar years depends on how successfully we achieve high economic levels during these years. These high economic levels are more important than debt retirement, but it may be possible to achieve both.

It is true that a cyclical budget-balancing program involves important political difficulties. The objective assumes a broad perspective and discipline on the part of Congress which might not be forthcoming. It would be "easy" for Congress to incur deficits during the years of low production, justifying this conduct on the ground that such deficits would have a wholesome economic effect. In the years of large output, the corollary of this action might be ignored on the ground that still greater production would be possible and should be realized before any attempt were made to obtain a budgetary surplus. This tendency could be counteracted to some extent by improved budgetary techniques. For example, a technique used by Sweden might be copied—that of carrying forward in the current budget from year to year budgetary deficits that are cyclical in nature.

Although the problems of balancing the budget over a series of years are

undoubtedly impressive, they are at least not greater than those of attempting a budget balance "come hell or high water." Such an attempt might not only cause serious economic disruption but it might fail to accomplish its objective where a more imaginative fiscal program might have been successful. No program of budget-balancing which overlooks the importance of the national income is well advised, even from only the narrow aspect of balancing the national budget. It is necessary to take some risks (public as well as private) if the common objective of balancing the budget is to be realized.

PUBLIC SPENDING

Deficit public spending for public works can be anticipated if and when the economy falls short of providing adequate employment opportunity. The public has come to expect of the economy (and rightly) both a high standard of living and ample opportunity to earn a livelihood. It would prefer jobs in industry to another W.P.A. (even with improvements), but the latter is regarded as the minimum to be expected. Since deficit spending is a necessary relief measure in times of much unemployment, it is somewhat academic, perhaps, to argue the question of whether it is a useful tool with which to lift an economy out of a deep depression. At any rate, it can be said that the nature of its use can greatly effect the likelihood of economic improvement.

First, it should be emphasized that all other reasonable efforts to revitalize business ought to take precedence over deficit spending. The use of stable tax rates as a countercycle device involves many problems but probably fewer than deficit spending. One of the main problems in the use of the latter device is that of maintaining enough confidence and morale in private business so that the effort in creating purchasing power is not nullified by a decrease in the velocity of its utilization. The selection of expenditures, budgetary techniques, and the administration of the programs are all important factors in avoiding this result. The expenditures should be creative but, so far as possible, in areas not in direct competition with private business. As much stress should be placed on providing additional wealth as upon providing employment. Budgetary techniques should keep the public informed as to the nature of the outlays and should encourage the selection of self-liquidating, or at least economically creative, outlays. Administration should stress a dollar's worth of service for a dollar's worth of expenditure.

A large potential field for public outlay in such lines as housing, public health, transportation facilities, and river development, offer attractive possibilities for public investment. If these projects are to be financed by borrowing and are to be investments in any true sense, each one must be budgeted and amortized like a bank loan. They must be planned with care and

discipline so that direct collections from those who receive direct benefits from the projects, plus indirect collections from an enlarged tax base, can and will create a closed circle of outlay and income.

RELATION OF PEACETIME TO WARTIME FISCAL POLICY

The issues of fiscal policy discussed above were the center of public attention during the prewar period. They are likely to come to the fore again during the postwar era. Industry, particularly heavy industry, has expanded greatly during the war, and additional manpower has been developed. After the war, the stimulus of deferred consumer demand and rehabilitation requirements will probably be sufficient for a time to sustain "full employment." But our economic problems have been only postponed, due to the war, and they are certain to confront us again.

FISCAL POLICY DURING THE WAR

During the war, however, we have encountered economic problems different from and mainly opposite to those which plagued us during the thirties and which are likely to recur in the postwar period. A critical problem has been that of avoiding inflation caused by the disparity between abundant purchasing power and a shortage of civilian goods. Some aspects of this subject, particularly those associated with borrowing, have been discussed in previous chapters. Here we shall consider the problems involved in the selection of a wartime tax system.

Principles of Wartime Taxation. Major attention should center on the principles selected to determine a wartime tax system. First, it is suggested that the taxation of subsistence be avoided. This principle is based more on considerations of efficiency than on those of equity. A sensible nation does not skimp the food rations of its army, and in a modern war the country's productive personnel as well as its regiments are "in the army" in the broad sense. However, subsistence is a flexible term and allowances may need to be considerably lower than those of prewar.

Secondly, the war tax system should be of the maximum assistance in avoiding inflation. This is a matter of absorbing purchasing power and affecting the will to spend. Some taxes may result in a mere transfer of existing or ordinary savings to the government. This is not objectionable but it helps little in the absorption of new purchasing power, which is necessary to avoid inflation. Of course, this principle and the preceding one may conflict, in which case a compromise must be made or one must be selected for priority.

For example, it is contended by some that subsistence must be taxed if inflation is to be avoided.

The third qualification for a wartime tax system is that its administrative cost be at a minimum in terms of manpower and materials.

Finally, the system should be as equitable as possible.

If the amount as well as the kind of war taxation is to be considered, then a fifth principle, perhaps the most important of all, should be added. This is that as large a proportion of the cost of financing a war should be met by taxation as is consistent with the effective prosecution of the war, including, of course, the subsistence and morale necessary for the latter objective.

Application. No attempt will be made here to discuss in detail the application of these different principles to particular taxes. Some discussion of this application will be found in the chapters treating the specific revenue sources. The income tax is excellently adapted to the allowance of an untaxed subsistence and, as always, it is unexcelled as to equity. Its efficiency as a counterinflation measure improves as its base is broadened and current payment is introduced. As to effects on inflation, the sales tax has a broad base and the additional advantage that it is applied to the act of purchasing, which needs to be discouraged. As usual, this tax is weakest where the income tax is strongest. Both taxes offer important administrative problems. Business taxes are very productive but they aid less than most others in the prevention of inflation.

A unique wartime proposal was that of a personal over-all spendings tax. This would operate much like a personal income tax except that income and capital spent for consumption would be the base of the tax instead of net income. By allowing an exemption for subsistence, it would meet one of the objections to a sales tax. However, it is not free from administrative complications.

Compulsory Saving. Soon after the beginning of the Second World War, John Maynard Keynes suggested[9] compulsory savings as a source of war finance. Keynes proposed to graft this institution on to the net income tax; part of the levy would be covered by a postwar credit. By graduating the credit downward, the stake of small income recipients in the national debt could be increased. The payment of certain private obligations (debts and insurance) could be accepted in lieu of the income tax covered by postwar credits and this would relieve those who have heavy "fixed commitments." Keynes was of the opinion that the postwar credits would help solve the problem of postwar deflation, especially if their payment were well timed. He proposed a capital levy to help finance the repayment.

As previously indicated, the compulsory saving device has been applied conservatively in Great Britain and Canada and still more conservatively in the United States. It is superior to voluntary borrowing in that it secures a

[9] J. M. Keynes, *How to Pay for the War*, Harcourt, Brace and Co., New York, 1940.

better distribution. However, it need not displace voluntary borrowing entirely. Of course, it leaves an aftermath of debt and is no substitute for adequate taxes.

A tie-up between compulsory saving and a sales tax is another wartime proposal with considerable following. With the payment of the tax at time of a purchase, a savings stamp might be issued. Some proponents of this system have proposed a subsistence exemption, but this would make its administration very difficult.

On balance, the personal income tax, modified and strengthened by collection at the source and some compulsory saving, seems the strongest candidate to carry the major role of wartime financing.

CONCLUSION

We know too little about the postwar era and about the science and art of fiscal planning to predict with assurance what future role the latter will play. But it is safe to say that the conscious manipulation of taxation, debt, and public spending, to maintain prosperity and keep the economy on as even a keel as possible both in peace and war, is no mere passing phase of present and recent periods. This sort of economic control may prove our major defense against a highly regimented economy with its many dangers and loss of values.

Perhaps the greatest challenge to students of finance, whether of war or peace, lies in the full employment and prosperity which war causes. If we can shift the economic system into high gear to defeat a foreign enemy, why can't we do the same against domestic enemies such as malnutrition, poverty, and disease?

Attitudes concerning taxation will be important in the postwar period. We should hear more about our responsibilities and less about our rights. Real peacetime patriotism, slow and steady burning, will be required.

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APPENDIX

Public Finance Literature

By Joseph Rosa

The emergence of public finance institutions did not wait for the development of a body of systematic thought in the field. On the contrary, as in all phases of intellectual inquiry, man's incipient reflections upon the subject arose as a result of the appearance of the institutions. This does not mean that the two, practice and thought, have existed apart. Rather, they have been in a process of interaction, the one affecting the course of the other. The phantasy-thinking of yesterday often becomes the standard by-word and usage of today. Although a crystallization of speculations into something resembling a science of public finance has been of comparatively recent date, desultory theorizing and comments on the subject have appeared since antiquity. Thus we find that coextensive with the growing importance and development of fiscal practices, especially since the close of the Middle Ages, have been the prolific literary contributions, which to a certain degree are a manifestation of the extent of interest in the public purse and its management. To deal even superficially with this profusion of literature is so gargantuan a task that the following pages will attempt to present only a brief bibliographical discussion—one that will serve as a convenient framework of reference for the student wishing to go into the subject more intensively.

ANCIENT AND MEDIEVAL VIEWS

The traditional treatment of public finance literature begins with the ancient Greeks, although in a modern sense their writings scarcely merit the appellation. They consist for the most part of sporadic comments woven into discourses on ethics and political science. In this they only reflect the minor role which the city-state's finances played in comparison with the political life, which was the primary and common concern of all citizens. It was probably of some importance that, except for the wealthy, the Athenian citizen was not much affected by the burdens of his city, for its expenditures were

defrayed largely from taxes levied on foreigners (the export and import duties paid by the merchants, who were mostly foreigners), from "protection-money" paid by its allies, income from the state monopolies (mines) and from court fees and fines. The latter, together with the personnel of the courts and the Athenians' passion for litigation, were the butt of Aristophanes' effective satire, the *Wasps*. Of the other works from this period in which there are occasional allusions to public funds and expenditures, the best known are Plato's *Republic* and *Laws* and Aristotle's *Politics*.

The closest approximation to a special treatise on public finance in ancient times was Xenophon's *Ways and Means to increase the Revenues of Athens*. The author of this work would enhance not only the receipts of the city but also the general prosperity of its citizens by having it maintain a body of slaves [1] and a merchant fleet, both for hiring out. But even more important, he would have the city made attractive to the foreign merchants, thus facilitating its commerce and thereby increasing its receipts from the resulting customs, rentals and harbor dues.

Those who belittle the theorists' contribution to the development of institutions can find a great deal of satisfaction in their own theory by surveying the course of public-finance practices and thought in the Roman world and the Middle Ages. They will find little thought, for following the Greeks, there was for almost eighteen centuries a gaping hiatus in articulate ideas which might be classed as doctrinal of public finance. The Romans' contribution to economic thought in general was through their achievements in the fields of law and administration. With respect to the Middle Ages, the over-all sway of the Church in spheres of intellect, but even more, the lack of immediate problems of public finance were in general effective deterrents to reflection on the subject. With the exception of the most advanced commercial cities, the feudal organization of society precluded any great need for public funds; the private domain of the king and feudal dues provided for most of the expenditures. As for the theorists of the period—mostly churchmen—their thoughts were not of this world.

THE MERCANTILE PERIOD

With the break up of the feudal system and the development of strong centralized governments, public revenues and expenditures assumed a more important role. Prevailing notions of political and economic superiority led to rivalry among the States, which in turn necessitated large outlays for military and naval expenditures. The income from the public domain and the royal prerogatives no longer sufficed to meet the growing burden, so that there was more and more occasion to resort to taxation. Coextensive with

[1] "The glory that was Greece" rested upon an economy of slave labor.

the altered political and economic conditions there was also a renewed interest among men of learning in mundane matters, and thus the changing scene, particularly the current issues, came to be reflected in the literature of the period. Probably the most significant of the earliest of this literature was the work of Jean Bodin who in 1576 published a comprehensive treatise, *Les six livres de la république*, on political philosophy.

This work included a substantial contribution to public finance. It presented a good account, including a classification, of the public receipts and expenditures of the period. In accordance with the predominant views of his time, Bodin favored demesne or patrimonial revenues and other direct incomes of the State as superior to taxes, although he admitted the propriety of indirect taxes, and even of direct taxes in times of emergency.

Following in the wake of Bodin, there has been an intermittent crop of literature on economic and political subjects. This writing is usually classified according to the general similarity of ideas which predominate in the works of the authors at various times. Thus the economic literature of the period, including that of Bodin and his contemporaries and that of the following two centuries, is generally labeled as mercantilist. But in vain would one search for a definite economic doctrine, and a resulting public finance theory, that would be common to all the writers included under this designation. Unlike, let us say, the marginalists of the past sixty or seventy years, in whose writings the basic ideas of a doctrine is common to all, the mercantilist writers represent at least the germ of practically every shade of economic opinion held before or since. Their unity in political outlook was much closer, though by no means unanimous, a factor which in itself is significant in the development of economic thought, and particularly in that of public finance, because if there was any fairly general agreement among them, it was certainly in their belief of the need of subordinating all economic activity to the welfare of that nebulous entity, the State. They discussed economics as such, but only with regard as to what was advantageous or disadvantageous to the government (the prince). They all believed in a favorable balance of trade and a dense population, the former because it enabled the State to have a convenient means (money) of commanding power and the latter as a supply for cannon fodder, and because it enhanced the productive (and therefore the exporting) capacity of the country. Public finance was an essential part of this scheme of things—but only as another means to achieve the "prosperity of the State." In the terminology of today it can be said that the mercantilist period, both in practice and thought, is a classical example of the employment of taxation for non-fiscal purposes.

The mercantilist writers were still inclined toward the feudal theory that the king should live on his own income, but they were aware of the necessity of raising revenues for him by other means. Thus Thomas Mun, one of the many merchant pamphleteers of the period, wrote in his *England's Treasure by Forraign Trade* (1664) that all taxes "seem to be a rabble of oppression,"

but they are necessary. He preferred excise taxes because they could and would be shifted on to the rich, which would have a salutary effect on their over-indulgent living. Mun was aware of the influence of institutions on public revenues, and pointed out that the differences in sources in the various countries were due to different customs and laws. His sentiment which favored sparing the poor from taxation was quite common among the mercantilist writers, but it had a very practical aspect—the assumption that the poor had nothing to tax. Francis Fauquier, in his *Essay on Ways and Means* (1756) expressed this very aptly as a "Maxim," namely, "The Poor do not, never have, nor ever possibly can, pay any Tax whatever. A Man that has nothing can pay nothing, let Governments try what Expedients they please to force him to it." [2] This theory of shifting, however, was not generally accepted by the writers of the period. One of the best-known mercantilist nonsubscribers to this theory was Sir William Petty. Although opposed to regressive taxation, he was very much in favor of excise taxes because he thought that everyone should pay some taxes; he held no brief for the prevailing practice of exempting the poor from certain levies. Furthermore, he thought that expenditures were a good test of one's riches. Petty's views on taxation and public expenditure, as set out in his *Treatise of Taxes and Contributions* (1662), differed with several of the accepted notions of public economy. Unlike many of the mercantilists, he held that direct land taxes were superior to revenue from "crown lands." Customs were advocated for regulation rather than revenue. To the usual public undertakings in the field of public expenditure, he would add education, support of orphans, maintenance of highways, bridges and harbors, as well as have the State provide public works for the idle.

The aforementioned views on fiscal practices by no means exhaust all the opinions of the writers who dealt with some phases of public finance during the period under discussion. Beginning with John Locke's letter to a member of Parliament on *Some Considerations of the Consequence of the Lowering of Interest, and Raising the Value of Money* (1692), his advocacy of a single tax on land found an echo in many of the tracts evoked by the excise controversy of his and succeeding generations. John Asgill's tract, *Several Assertions proved, in Order to Create another Species of Money than Gold and Silver,* followed shortly (1696), and Jacob Vanderlint's often quoted pamphlet, *Money Answers all Things* (1734), was written during the heated controversy over Walpole's excise scheme. Another theory of taxation, not entirely novel, but one that anticipated more modern methods of levying taxes, was proposed by two contemporaries of Locke, Pierre Boisguillebert in his *Détail de la France* (1697) and *Factum de la France* (1707), and Marshal de Vauban in his *Dixme Royale* (1707). Both of these writers were highly critical of the impoverished condition of the agricultural population in

[2] Francis Fauquier, An Essay on Ways and Means for raising Money, London, 1756. Edited by Jacob Hollander, the Johns Hopkins Press, Baltimore, 1915, p. 21.

France, and placed the blame for it on Colbert's ultra-mercantilist policy of regulation and taxation. Boisguillebert favored direct in place of indirect taxes, suggested the abolition of internal tariff walls, and advocated a tax of 10 percent on incomes. Vauban's proposals were much in the same vein, but he has come to be better known because his book was suppressed by the authorities. He stressed the burdensome aspect of a tax when it is unequally applied, referring to the exemption of the privileged classes from taxation in France. He is also well known for the doctrine that everyone should pay taxes, holding that since everyone must have the protection of the State, and since the king cannot protect his subjects without the necessary funds, it is everyone's natural obligation to contribute taxes in proportion to his income. This income tax was to be at a rate of 10 percent and was to replace the many prevailing taxes; in the case of agricultural produce payments were to be in kind. However, he also approved of some excise taxes.

Another French writer whose contributions to economic literature diverged a great deal from mercantilist theories was Montesquieu. Writing in a period when as a reaction to mercantilism a more liberal ideal, based on "natural law," was in ascendancy, Montesquieu did more than any other single person to carry this principle into what might be regarded as the social sciences. His *L'Esprit des Lois* (1748) was much more of a work on political theory than economics; nevertheless, his ideas on economic subjects, and perhaps his method even more, had a strong influence on his contemporaries and late eighteenth century writers, including Adam Smith. His reason for taxes was the same as Vauban's, namely, the protection of one's property. "The revenues of the state," he says, "are a part of his property which each citizen gives in order to be sure of the other part, or in order to enjoy it in comfort." [3] Unlike Vauban, however, he was inclined toward progressive taxation.

Although most of our ideas of mercantilism have been shaped by English and French writers of the period, its literature was not confined to England and France, but also flourished to some extent in other countries of Europe. Mercantilist thought was coincidental with the growth of commerce, especially on international lines. It was England's vigorous pursuit of commerce and the important position which the growing merchant class was carving for itself in the social and political life of that nation which probably accounts for the abundance of English mercantilist literature. Generally, the tracts and pamphlets appearing during the period were evoked by the exigencies arising from this extension of commerce. There was less of this in France, and what there was developed differently. Monarchical absolutism held sway there throughout the period. This was even more true of the German-speaking countries where no merchant class and parliamentary government sullied the "state-making" phase of mercantilism. Unlike the

[3] Quoted from E. R. A. Seligman, *Progressive Taxation in Theory and Practice*, Publication of the American Economic Association, 1908, p. 163.

English writers, many of whom were laymen, the German *Cameralists*,[4] as they are commonly known, were public administrators and academicians. They were writing on public finance as far back as the sixteenth century, although from an economic standpoint the nature of their treatment was not as advanced as that of the English. More in the way of illustrating their extreme political complexion than as contributions to public finance thought, Wilhelm von Schröder's *Fürstliche Schatz-und Rentkammer* (1686) and Wilhelm von Hornick's *Oesterreich über Alles, wann es nur will* (1684), may be cited. Both of these writers were in the service of the Austrian rulers and were absolutists of the first water. To them the prince and the people were one organic unit, the State, of which the prince was the embodiment. Naturally there was no room here for ethical and legal problems of taxation; the will and welfare of the prince were all that mattered. On the other hand, the people were not to be oppressed with heavy exactions because that would discourage the industrious, and would thus be against the interest of the prince. An outstanding cameralist contribution to public finance literature made its appearance about the middle of the eighteenth century in Johann Heinrich G. von Justi's *Staatswirtschaft* (1755) and *System des Finanzwesens* (1766). In these books Justi more or less systematized cameralistic science and interpreted it in the light of his own, perhaps less absolutistic, theories. He was partisan to public revenue from the public domain and the State monopolies, but was, nevertheless, aware that it no longer sufficed the needs of a State in his time. Therefore he suggested levying excises and taxes on immovable goods and persons. In levying these taxes, he offers certain maxims to be followed by the ruler, maxims which are comparable to the famous "canons" of Adam Smith whose work he anticipated by more than twenty years. In his earlier work he also gives a detailed precept of fiscal administration and notes that, "If a European state wants to have influence, it must devote at least two-thirds of its revenues to the military budget." [5]

THE PHYSIOCRATS

During the eighteenth century, the acute resentment aroused by the tax system of the *ancien régime* resulted in a voluminous contribution to tax literature in France. Much of this was of more fundamental nature than the writings of the English mercantilists. Boisguillebert and Vauban at the beginning and Montesquieu in the middle of the century have already been referred to. Their appraisal of the impoverished condition of the French

[4] Camera means chamber, hence the king's "inner chamber" advisers, or cabinet officers. The Cameralists were primarily active civil servants of the mercantilist monarchies of Germany and Austria—more important in the latter because Austria was a unified state under the Hapsburgs, whereas Germany was a geographical term only.

[5] Albion W. Small, *The Cameralists*, University of Chicago Press, Chicago, 1909, p. 391.

agricultural class and their espousal of the doctrine of natural law provides a picture of the setting out of which grew a new school of economic thought, known as Physiocracy. The Physiocrats were only a small group—largely aristocrats—but for a short time before and during the French Revolution they had considerable intellectual influence. François Quesnay's *Tableau économique* (1758), which was the foundation of the doctrine, and his *Second problème économique* (1767-8) give as the central core of the system a natural order in which agriculture takes the leading role. Agriculture is the source of all wealth; it is the surplus (*produit net*) arising here which provides the revenues of the State, as well as the subsistence of the non-agricultural class. Since in the last analysis the State's revenues come out of this surplus, the Physiocrats would have substituted a single direct tax (*impôt unique*) on the landowner for the troublesome indirect taxes, which they held were shifted on to him anyway. This tax, however, would not be a burden on the landowners, or anyone for that matter; it was an essential part of their theory of distribution that a share of this *produit net* goes for the support of the government, and in selling and buying land the capitalized value of this share is not exchanged because it belongs to the government.

The Physiocrats were also ardent supporters of free trade. *Laissez faire* in economics was essential to the proper functioning of their scheme of things, and Turgot, who was one of the best-known followers of this school of thought, as Minister of Finance (1774-1776) made an unsuccessful attempt in his famous *Six Edicts* to carry some of these new ideas (though not the *impôt unique*) into effect. Turgot's main ideas appeared in his *Réflexions sur la formation et la distribution de la richesses* (1766), but he also wrote on various aspects of taxation specifically, for instance, on direct and indirect taxation, taxes on the landowner and consumption and on the effect of indirect taxes.

ADAM SMITH

With Adam Smith a new epoch begins in the doctrinal development of economics. For almost a century and a half professors of the science, statesmen and, indeed, "practical business men" have looked upon him as the source of economic wisdom. When Smith wrote his book he had a wealth of information from which to draw; for over a hundred years economic tracts had been appearing more and more frequently in England and in France where he had been in direct contact with the Physiocrats. He drew upon most of these sources to produce his *Wealth of Nations* (1776), a work that was not only the most comprehensive and probably systematic treatise on political economy up to his time, but one that also expressed the economic philosophy of the business class which was just coming into its own. In the fifth book, which gives an extensive treatment of public finance, he reviewed at considerable length the fiscal practices of England and other countries

both during his time and in earlier periods. He offered a great deal of advice concerning these matters, advice which was taken seriously by ministers and Parliament. He expressed preference for direct taxation of land and houses, such taxes to be equally distributed according to value. His chapter on the public debts, incurred due to large-scale wars, is an indication of the growing importance of this phase of public finance. In place of the extensive trade restrictions of his time he advocated a simple system of moderate tariff for revenue, as well as the elimination or reduction of taxes on the necessities of life, such as salt, leather, soap and candle. On the theory that furthering the individual's self-interest also takes care of the interest of the community, he was in favor of a limited system of public expenditures and, like the Physiocrats, a role of non-interference for the State, a role which has since passed under the name of *laissez faire*. And finally, it would probably be irreverent to close with Smith and not mention his oft-repeated "canons" of taxation. These were principles he offered as guiding stars for statesmen in levying taxes. Reference has already been made to the fact that von Justi anticipated these by many years. Also, they have been scattered through English economic literature from Petty down.

SCOPE OF MODERN LITERATURE

Since Adam Smith public finance literature, along with other writings of economic and political nature, has been very substantial both in quantity and quality. The "science" seemed to have arrived and its general scope has remained largely as Smith marked it out. The developments which have taken place, especially since the seventies and eighties, have been in the refinement of particular aspects which were made to conform with the changed economic conditions and the new approaches to economic analysis. Such, for instance, has been the role which the income tax has taken in modern fiscal practice, and the marginal analysis which has given us ponderous tomes on incidence and equity in taxation. No attempt will be made here, nor would it be possible within such limited space, to classify this literature according to subject matter or the niceties of economic theory. The last sixty years at least might properly be characterized as a period of specialized literature. But it would be even more justifiable to classify nineteenth and twentieth century public finance according to the scope or role which the various authors ascribe to the field; that is, whether the author deals with public finance from the point of view principally of private economic considerations, as a sort of step-child to economics, or from the point of view that it formed an essential part of our political, social and economic system. The former includes the classicists, like McCulloch, and the marginalists, as represented by Lindahl, while the latter takes in the adaptation of the method of the historical school to public finance, as was done by Wagner, and the

more modern schools, such as the institutionalists, radicals and totalitarians. With many exceptions, the classical and marginal schools regarded taxes as a price, either on benefit or cost basis, for services rendered by the government, with emphasis on the careful use of the levy so as to not disturb the prevailing distribution of wealth and income. The other schools would use taxes as a vehicle for economic and social reform. This distinction is not a very happy one though, particularly as it applied to the later marginalists; there is considerable overlapping because there are many marginalists who advocate taxation on the ability-to-pay or sacrifice principles, while among the radicals, e.g., Dalton, who would have taxation employed for non-fiscal purposes, not a few use the marginal analysis. And even Mill favored taxation on the ability-to-pay principle and, as will be seen, some use of taxation for non-fiscal purposes.

BRITISH WRITERS OF THE NINETEENTH CENTURY

The best-known works in the economic writings of the first half of nineteenth century England are David Ricardo's *Principles of Political Economy and Taxation* (1817) and John Stuart Mill's *Principles of Political Economy* (1848). Both of these treatises devote a large portion to taxation. Ricardo's contribution was mainly on the theory of distribution and incidence. Mill concerned himself a great deal with the philosophy of justice in taxation, the meaning of ability to pay, and the question of proportional versus progressive taxation. His sympathies leaned toward progressive taxation, but he concluded that it was impractical. Nevertheless, he advocated an exemption of a minimum of subsistence, which is the entering wedge for the progressive system. In his later works he advocated a wider diffusion of wealth through the regulation and taxation of inheritance and through the appropriation to the government of future increments to land values. McCulloch, another writer on public finance, devoted an entire treatise to *Taxation and the Funding System* (1845), in which he vigorously and acutely defended proportional as opposed to progressive taxation, and advocated as ideal a system of indirect taxation.

In the second half of the century numerous specialized tracts were published, particularly on the income tax and free trade, subjects very much in the public eye at that time. Toward the end of the century several works on the history of taxation made their appearance. Probably the best known of these was Stephen Dowell's *History of Taxation and Taxes in England*, published in 1884 in four volumes. The specialized literature of the field was also enriched during this period with a flood of publications on local government in England. Among these were: Cannan's *History of Local Rates in England* (1894), Palgrave's *Local Taxation of England and Ireland* (1871), and Goshen's *Local Taxation* (1872).

But the most comprehensive work at this time in England was written by C. F. Bastable, whose systematic treatment of the entire field of *Public Finance* (1892) was regarded as standard for many years both in England and America. Bastable was generally under the influence of conservative English thought in finance, and even at this late stage was a strong opponent of progressive taxation. Not so, however, his contemporary, F. Y. Edgeworth, who contributed no major work to the literature, but some of whose articles on the subject (collected in *Papers Relating to Political Economy*) have become classic. The best known of these is his *Pure Theory of Taxation* (1897) in which he gives a highly abstract analysis of incidence and propounds (though does not advocate) the theory of least aggregate sacrifice as the ideal principle of taxation.

CONTINENTAL LITERATURE ON PUBLIC FINANCE

The German writers of the late nineteenth century were probably the most prolific in public finance literature. As in the entire field of economics, their writings leaned heavily toward the historical approach, and much of what we know of the subject in ancient times and the Middle Ages was the result of their thorough scholarship. Although they delved deep into history, they did not avoid the controversial aspect of their subject. In the first half of the century this was especially characteristic of Rau's *Grundsätze der Finanz wissenschaft* (1832), a work which, although by no means original, was an excellent interpretation of the prevailing financial theories and practices. Rau was greatly indebted for his theory of finance, as well as for his economic theory in general, to Smith's *Wealth of Nations.*

Only a few of the outstanding works which made their appearance during the "historical" period can be mentioned individually. Lorenz von Stein's *Lehrbuch der Finanzwissenschaft* (1860) may be cited as an example of the subject treated from the point of view of administration. The author was a political scientist and his contribution to public finance was incidental to his work on administration. The works of Friedrich Julius Neumann are important partly for the influence they exerted on the German tax system in its transition from impersonal to personal taxation. Neumann's works dealt chiefly with personal taxes, particularly the progressive income tax, of which he was one of the strongest exponents [*Die Progressive Einkommensteuer* (1874); *Die persönlichen Steuern von Einkommen* (1896)]. He is also well known, however, for his painstaking effort in classifying the public revenues. Gustav Cohn was another of the better-known writers of the period. His importance was due less to what he said than to the manner in which he said it. His contributions were mainly to the principles of equity, in which discussion he gives a good account of the minimum of subsistence doctrine and ably defends progressive taxation. To English-speaking students he takes on

an added importance because his *System der Finanzwissenschaft* (1889) is one of the few major German works which have been translated into English (*The Science of Finance*, 1895, translated by T. B. Veblen). Mention may also be made here of the works of Emil Sax, the Austrian economist, who in his *Grundlegung der theoretischen Staatswirthschaft* (1887) made one of the first attempts to build a taxation theory on the edifice of the new value theory espoused by his compatriots (Böhm-Bawerk, Menger, etc.).

Probably the outstanding contribution of this period was the four-volume work of Adolph Wagner. Wagner is perhaps best known for his attempt in his *Finanzwissenschaft* (1871-1901) and other works to combat "the liberal contempt of government" and to enhance the role of the State. He held that the State is in the process of a steady evolution toward wider and wider functions, and so he would have it take over certain sectors of production which private industry cannot conduct in the public interest, such as land and houses in cities, as well as the means of transportation. Moreover, in order to carry on this activity, he urged that the financial policy of the State be shaped to conform with the needs of such undertakings. He supported progressive taxation as a conscious attempt on the part of the State to improve the distribution of wealth.

Following in the tradition of German scholarship, public finance has continued to enjoy the sustained attention of the students in Germany, as is evidenced by the numerous tomes they have devoted to it. Ever since the *Cameralists*, the German writers have emphasized the relationship of public finance to many phases of the social sciences. To some extent this was true even of Rau, who was greatly under Adam Smith's influence. Wagner, as observed previously, was a classic example of the non-"pure" economist. In a large measure this can also be said of the more modern German writers, many of whom, as a result of political upheaval, are now scattered beyond the boundaries of Germany. Two, Fritz Karl Mann and Gerhard Colm, are at present pursuing their studies in the United States. Mann's most recent work, *Steuerpolitische Ideale* (1937), is a fine example of an institutional view of taxation. A comparative study of tax policies in the past three hundred years, it depicts each as characteristic of the particular political system which employs it. Colm's best-known work is his *Theorie der Staatsausgaben* (1927), in which he emphasizes the socio-economic effects of public expenditure. His more recent work, *Economic Consequences of Recent American Tax Policy* (1938), under joint authorship with Fritz Lehmann, deals more specifically than the title reveals with the effect of high taxes on the availability of private capital for investment.

Unlike the Germans, the French economists of the nineteenth century were very much under the influence of classical English economic thinking. Strongly individualistic, they were opposed to social aims in tax legislation, and in general favored proportional taxation. Leroy-Beaulieu, whose *Traité de la science des finances* (1877) remained the outstanding work in the field

for over a generation, was probably the most representative of this group. Although disagreeing with some theories of the classical school (e.g., rent), he had many of their prejudices as to the State's activity. He held that a tax is a price paid for services received from the State, and as such he saw no reason why the wealthy, through a progressive tax, should pay a higher price for the same service than the poor. René Stourm, another typical member of this group, is best known for his book *Le budget* (1889). A civil servant and in the Ministry of Finance for some years, the author was especially qualified to discuss his subject from a practical angle. Because of his capable presentation, it was long a leading treatise on the subject. It appeared in English translation in 1917.

E. Allix's *Traité élémentaire de science des finances* (1907) and Gaston Jèze's *Science des finances* (1896) are indicative of a more modern trend in French public finance thought. Both of these works have been revised several times and have performed good service as guides to French fiscal practices and thought. Jèze, who is a jurist still writing, has probably been more free from classical influence than most French students of public finance. Not only is he in favor of progressive taxation, but also advocates taxation that takes the individual's economic capacity into account.

Little known in English-speaking countries, especially in America, is the literature written in languages other than German and French. Since the late nineteenth century the Italians, Dutch and Swedes have probably been more productive in the field of theoretical public finance than any other group of economists. Italian scholarship had a long history to look back upon, but around the seventies and eighties it was newly stimulated by the influence of the flourishing German universities. Imbued with historical learning, the returning Italian scholars nevertheless followed the Austrians in their field of speculation, and thus it is they who have done the most in utilizing the marginal analysis in the economics of taxation. One of the earliest among this group was G. Ricca-Salerno, whose *Scienza delle finanze* (1888) gives a brief but lucid presentation of fundamentals based on the marginal theory. Here also belong U. Mazzola's *I dati scientifici della finanza pubblica* (1890) and *L'imposta progressiva* (1895), C. A. Conigliani's *Teoria generale degli effetti economici delle imposte* (1890) and a series of articles included in a posthumously published collection, *Saggi di economia politica* (1903), Graziani's *Instituzioni di scienza delle finanze* (1897) and *Manuale della scienza delle finanze* (1893). The last two writers were pupils of Ricca-Salerno, whose footsteps, by adhering to the Austrian school, they were closely following. Conigliani's first and principal work was a highly theoretical discussion of the shifting and incidence of taxation. Graziani's *Manuale* (revised) is still one of the standard Italian treatises in the field, and, unlike many of the better Italian writers, he treats the subject in a non-mathematical language.

Two other Italian economists who have an especial importance for

English-speaking students are Eugenio Rignano and Antonio de Viti de Marco. Rignano owes his fame to his contribution on the theory of inheritance taxation (*The Social Significance of the Inheritance Tax*, 1920; English translation, 1924). He believes in taxing inheritance according to the "degree or time of acquisition," and proposes eventually to appropriate the entire remainder of the estate. De Marco's first study in public finance, *Il carattero storico dell' economia finanziari*, appeared in 1888, and ever since then he has been considered the leading Italian theoretician in the field. The substance of his views on the subject has recently been publishd in a new edition of his comprehensive work *First Principles of Public Finance* (1934, in part published in English, 1936). This is a novel and highly abstract treatment of the subject based on the marginal analysis. According to the author the science of public finance is distinct from that of private economy because collective wants, with which the former concerns itself, are not comparable with private wants. Moreover, "Public Finance is a *concrete* science—that is, it must be brought down finally to real phenomena. Economics, on the other hand, is an abstract science, in that it states its problems by isolating the particular principle whose laws it seeks—that is, by *abstracting* from other circumstances that complicate it in historical and political reality." [6] Public consumption and production of goods, however, are carried on by the same forces which characterize the process in private economy. Thus, while public finance is independent of economics, it must employ the same method of analysis as the latter, namely, the application of the theory of value to public economy. It is from this analysis that the voluntary exchange theory arises; that is, the view that taxes are prices paid for services which the State can furnish at more reasonable prices than private economy.

Opposed to de Marco's approach to analysis, and that of a group which might be called his school, are those who emphasize the political aspect of public finance—and who in this respect fit in rather nicely into the Fascist political scheme. This group, whose leading exponent is Benvenuto Griziotti, believes that public finance should be employed as an instrument in carrying out the political objectives of the State. It does not regard taxes as prices but as a device of distributing the cost of public services according to a politically desirable arrangement.[7]

Another group of economists, similar in many respects to the Italians, who have made outstanding contributions to public finance literature are the Dutch. The similarity between the two extends not only to the subject of their speculation, but also to the fact that because of language difficulties their works very largely remain inaccessible to the great majority of students. Like the Italians, the Dutch writers made their finest achievement in theo-

[6] Antonio de Viti de Marco, *First Principles of Public Finance*, p. 36.

[7] Maria Louisa Boggeri and J. Wilner Sundelson, "Italian Theories of Fiscal Science," *Political Science Quarterly*, Vol. liii, No. 2, June, 1938, pp. 249-267; Griziotti's views are presented comprehensively in his *Principii di politica diritto e scienza delle finanze* (1929).

retical speculations by applying the marginal analysis to taxation. In fact, they were precursors of the former, as they accepted the utility theory of value from Jevons even before the Austrians made their conquest of the Italian scholars. The earliest of their writings was by N. G. Pierson whose two volumes on *Political Economy* were translated into English in 1902 (Vol. I) and 1912 (Vol. II). It is in Volume II that he deals with public finance. Pierson's influence was mainly local, but nevertheless noteworthy. As Minister of Finance, he modernized the tax system of Holland by substituting personal taxes for the many impersonal levies which characterized the old system. Cohen-Stuart is known to English-speaking students chiefly through Professor Seligman's interpretations. Like many of his compatriots, he treats public finance, as well as economics in general, in the language of mathematics, and is known mainly for his attempt at constructing a utility curve as a basis of progression in taxation.

In the Scandinavian countries the Swedish economists have been doing a great deal of work in theoretical economics. In taxation literature their outstanding works are Knut Wicksell's *Finanztheoretische Untersuchungen* (1896) and Erik Lindahl's *Gerechtigkeit der Besteuerung* (1919). Both of these are abstract marginal studies in taxation equity; Lindahl reaches the conclusion that just taxes are impossible without a just distribution of wealth and political power.

MODERN BRITISH PUBLIC FINANCE LITERATURE

Some of the best modern works in public finance have been done by the British writers, T. A. Hobson, A. C. Pigou, Hugh Dalton and Sir Josiah Stamp. Hobson and Pigou have written mostly on other phases of economics, but each has devoted one volume to public finance exclusively. In addition, both of them have dealt with the subject in connection with their other studies. Hobson's name in the field is usually associated with the surplus theory of taxation, in which he says that there is an element of surplus in the return to all factors of production, and unless taxes are levied upon this surplus rather than what he terms a necessary cost, production will be discouraged (*Taxation in the New State*, 1919). Pigou's *Study in Public Finance* (1928) deals with several special phases of the field, many of which, particularly those treating governmental finance by borrowing and the effects of public expenditures have also been considered by the author in his other works. But especially noteworthy are his chapters on taxation which include probably the best discussion there is on taxation equity in English. Pigou, however, is even better known for his studies on the tariff and its effect on the "national dividend," a subject on which he published a small but a highly penetrating and lucid treatise, *Protective and Preferential Import Duties* (1906). Dalton and Stamp have written extensively on various aspects

of government finance. Stamp's *Principles of Taxation* (1921) and *Wealth and Taxable Capacity* (1922) are only two of his many major works, but they are indicative of the nature of all his contributions to tax literature. The *Principles* is a series of lectures in which he discourses on the accepted maxims of taxation from the point of view of an administrator. His work on taxable capacity is an excellent illustration of the possibility of adapting statistical methods as an aid in the formulation of tax policies. Dalton's *Principles of Public Finance* (1923) is a comprehensive work on the subject. Although the author's views on economic and political questions are decidedly advanced, his treatment of public finance shows little of such indication. He is somewhat skeptical of current ideas of equity in taxation since they cannot be proved. Among other writings in the field, Dalton also writes on the capital levy and the budget. Mention should also be made of the works of John Maynard Keynes. Although usually classed as a monetary economist, his opinions concerning the strategic importance of governmental expenditures in the business cycle have been very influential, especially in the United States.

AMERICAN PUBLIC FINANCE LITERATURE

The recentness of American public finance literature, and the many allusions to it in this book, makes further reference largely unnecessary. A few observations should suffice. For many years much of the best American writings on public finance was in state reports and the speeches and writings of public men. Of the more extensive treatises mention may be made of H. C. Adams' *Science of Finance* (1898) and *Public Debts* (1887), the first of which served somewhat the same function in the United States as did Bastable's *Public Finance* in England. His work on the public debt was the first of its kind in the United States and is still an inexhaustible source of reference on the subject. Henry George's *Progress and Poverty* (1879) was influential both in the United States and abroad. He favored the appropriation of economic rent to the State in lieu of all other taxes. E. R. A. Seligman's contributions, particularly on shifting and incidence, and the theory of equity in taxation, are the outstanding American works in the field. In recent years the interest in public finance has been rapidly increasing and numerous excellent treatises, monographs and reports have appeared.

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