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TAXATION *and the* AMERICAN ECONOMY

PRENTICE-HALL ECONOMICS SERIES

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Taxation AND THE AMERICAN ECONOMY

AN ECONOMIC, LEGAL, AND ADMINISTRATIVE ANALYSIS

by William H. Anderson · ASSOCIATE PROFESSOR OF ECONOMICS · UNIVERSITY OF SOUTHERN CALIFORNIA

MEMBER OF THE CALIFORNIA AND WISCONSIN BARS

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To MY STUDENTS in Taxation, Public Finance, and Fiscal Policy without whose interest, stimulus, and assistance this book would not have been possible.

STUDENTS OF PUBLIC FINANCE EVERYWHERE, who must contribute to the building of a better science of government finance and who must aid in molding sounder tax policies in the future.

OUR CITIZENS AND TAXPAYERS, who have been the support of our democracy in peace and war, in prosperity and depression.

OUR TEACHERS IN PUBLIC FINANCE, who bear a special responsibility to our young citizens both in economics and in citizenship.

OUR TAX ATTORNEYS AND ACCOUNTANTS, who each year wrestle with innumerable, difficult tax problems for our taxpayers.

OUR TAX ADMINISTRATORS, who are continually on the tax firing-line dealing with tax problems and policies.

THIS BOOK IS RESPECTFULLY DEDICATED

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Preface

THE SWEEPING CHANGES in taxation, public finance, and fiscal policy during the last thirty years have been most striking—so striking, in fact, that the field of fiscal policy has become the Number One economic policy at the federal level of government.

In the light of these changes, the traditional general public finance books that attempt to cover this now highly complex and extensive field in one volume have become inadequate for the purposes of a full-fledged, semester course in taxation. Though most of these books are excellent for general public finance purposes, no more than about one-third to one-half of their content is devoted to taxation—not enough for a thorough and well-balanced course in taxation alone.

There has arisen, therefore, a vital need for a book on taxation. Since the burdens of taxation have become so heavy and since they now touch almost everyone directly, the initial interest of most students and citizens is strongest in the "taxation aspects" of government finance. This book is intended in part to give the reader a well-grounded understanding of taxation on the American scene.

It will proceed as a three-way analysis: economic, legal, and administrative. An effort will be made to lay careful economic foundations before advancing into the work of the book as a whole and before discussing each major type of taxation. Careful economic analysis of the area to which a tax is to be applied is a highly necessary condition of a sound and equitable tax policy. The legal and institutional setting of taxation provides the very vehicle by which taxes are levied, collected, and enforced, and tax policy is carried out. Taxation is so highly legal and institutional in character that to discuss it in the abstract is unrealistic and fruitless. Finally, tax administration, a special phase of the institutional setting, can no longer be by-passed with a few paragraphs here and there. Good administration is very essential both to the success and the equity of the tax system. The working analysis of the book as a whole, as we proceed along the three divisions mentioned, will place emphasis upon: (1) principles, (2) problems, (3) policies, (4) practices, and (5) procedures.

My experience as a lawyer, teacher, and circuit rider for the University of Wisconsin Extension Division, teaching hundreds of lay citizens taxation, has brought home to me the need for a book on taxation that would be valuable to the average taxpayer. Taxation is something that touches every taxpayer's heart, pocketbook, and temper. There are very few fields in which the average citizen's interest is greater, or in which his need for understanding is more urgent. This book attempts to contribute to the technical understanding of the citizen as a taxpayer, and the social and economic understanding of the taxpayer as a citizen. Therefore, in addition to serving as a textbook, it can also serve both as a correspondence course on taxation and as a reference book for the interested citizen.

It is with genuine appreciation that I acknowledge the value of much kind and able assistance in the research for and writing of this book. The book has its roots deep in the past. The first constructive influence came from Professor Ray Brown, of the Wisconsin Law School, whose course in taxation inspired, disciplined, and enlightened me in good measure. My years of association with the law firm of Woodward and May, Madison, Wisconsin, taught me much about taxpayers, their problems, and the technical aspects of taxation.

To Dr. Walter W. Heller, of the University of Minnesota, must go a special blue ribbon for having received me out of the rough and tumble of a law office and given me an inspired and competent orientation in the economics of taxation and public finance.

Immeasurable credit and appreciation is due Dr. Harold M. Groves, of the University of Wisconsin, in whose classes and seminars I matured in this field. My association with him as research assistant in the preparation of his *Postwar Taxation and Economic Progress* and in revising his *Financing Government* produced a wealth of experience that has been invaluable in the present undertaking. His ideas and those of his five books are registered at many points in this book.

The opportunity of writing a correspondence course in taxation under Dr. J. L. Miller, of the University of Wisconsin Extension Division, yielded experience that was directly useful in the completion of the present task.

Several of my own colleagues have given me competent assistance in areas of their interest: Dr. E. Bryant Phillips, on the "Historical Aspects of American Taxation"; Dr. Roy L. Garis, on the "Taxation of Banks"; and Professor Rex Ragan, on the "Taxation of Business." Their willingness and helpfulness is highly appreciated.

A number of graduate students in taxation and public finance have made constructive contributions. First and foremost, my research assistant

Robert J. Schier, has made substantial contributions to the construction of a number of chapters. His all-around research, writing, and editorial assistance have been extremely valuable. Other graduate students who have made contributions of noteworthy value are Lang Cantrell, Robert T. Collins, Gertrude Hengerer, Chester Ferguson, Nai-Chiung Hsu, Harry A. Marlow, Homer H. Hamner, Thomas Alexander, Mohammed K. Anous, Yen Hui Ho, Robert Hutchison, and Cecil W. Wilson. A number of undergraduate students submitted special papers which were also drawn upon in some measure.

I am indebted to Robert Schilling for the preparation of the charts, diagrams, and cartoons. Genuine appreciation is due Wilbur F. Eastman, Jr., Associate Editor of Prentice-Hall, and Edgar P. Thomas, Southern California representative for Prentice-Hall, for their courteous helpfulness and encouragement in facilitating the preparation and the submission of the manuscript.

My thanks go to Eleanor Olson, Loyal D. Frazier, and Rose Marie Bassi for their assistance in the typing of the manuscript. Finally, immeasurable appreciation is due my wife, "Swance," for her ever-ready secretarial and editorial assistance in the preparation of the manuscript through all its stages.

WILLIAM H. ANDERSON

Los Angeles, California

Part One

THE FOUNDATIONS OF AMERICAN TAXATION

I. TAXATION AND THE MODERN ECONOMY

II. THE CONSTITUTIONAL FOUNDATIONS OF AMERICAN TAXATION

III. THE ECONOMIC FOUNDATIONS OF TAXATION
• *The Selection of Revenue Sources and the Distribution of the Tax Burden*

IV. THE ECONOMIC FOUNDATIONS OF TAXATION
• *Shifting, Incidence, and Effects of Taxation*

V. THE ROLE OF ADMINISTRATION IN THE TAXING PROCESS

I

Taxation and The Modern Economy

TAXES CAN BE USED, *as the occasion warrants, to regulate the speed of the economic machine.... If taxes have these vast potentialities, our choice of taxes—the decisions we make as to what taxes we shall impose and on whom the burden shall fall—has far more to do with the fate of the nation than most people think.*

—RANDOLPH E. PAUL [1]

Overview

BENJAMIN FRANKLIN is reported to have said, "In this world nothing is certain but death and taxes." If this statement was true in Franklin's time, how much more true it is in our day. With local, state, and federal expenditures tending toward $100 billion per year, with a national debt of more than $260 billion, and with our responsibilities as a nation extending far beyond our national borders, we shall for many years to come continue to bear total tax burdens which only a few years ago would have seemed unbelievable.

In an economic system such as ours, functioning essentially as a capitalistic, private enterprise system tempered with certain governmental controls, it has long been recognized that taxation can be of strategic, economic significance in the operation of that system. Since the time Adam Smith discussed tax theory and tax policy in his famous *An Inquiry into the Nature and Causes of the Wealth of Nations*, emphasis has been placed upon levying taxes in such a way as to cast a minimum burden upon the production of wealth. In private business-thinking, this has taken the form of a social injunction: "Don't kill the goose that lays the golden egg."

During much of our history, however, the tax system has been looked upon as the instrument by which to pay the ordinary and regular expenses of government. The social and economic impact of two world wars and a major economic depression have brought us to the realization that taxa-

[1] Randolph E. Paul, *Taxation for Prosperity*. Indianapolis: Bobbs-Merrill, 1947, p. 413.

tion is no longer the "mere meal ticket" of government.[2] The concern of Adam Smith over the relation between taxation and production has evolved into a much broader concern over the relation between taxation and the functioning of our entire economic system—a concern over the effects of taxation upon consumption, investment, production, employment, and income.

The task of seeking out the correct tax principles, working out the soundest tax policies, and properly adjusting the tax load has become more difficult than ever before in our history. It is a job that will require not only a high degree of technical craftsmanship but also a higher quality of social and economic statesmanship. We shall need, therefore, to make a reappraisal of the place and importance of taxation in a modern economy operating under a private enterprise system and democratic institutions.

The purpose of this chapter will be to serve as the general "setting" for the thought and analysis of the remainder of the book. The appreciation of the character of that "setting" involves an understanding of a number of factors: (1) the growth in government responsibility and the reasons for that growth; (2) the "extent" of the growth in public expenditures; (3) the expansion of total tax burdens; (4) the rise of the public debt; (5) the impact of the expenditure-debt-tax burden upon the economy; (6) the character of the private and public economy; (7) the significance of taxation to private business activity; (8) the recognition that taxation is but a part of the broader concept—fiscal policy, which can make a constructive contribution to the better functioning of the private enterprise economy; and finally (9), the trends in American taxation.

The Growth in Government Responsibility

THE RISE of modern national states with their increased conflicts in the international arena plus the rise of complex social and economic systems have made necessary striking increases in the number, extent, and intensity of public functions by all units of government, national, state, and local. The most rapid increase has come since 1900. Two world wars and a major economic depression have accelerated the trend toward heavier responsibilities of government for the protection and welfare of the people. With these increased tasks has come the need for heavier tax burdens and the necessity of allocating a larger proportion of the national income to the work of the public economy.

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[2] Harold M. Groves, *Postwar Taxation and Economic Progress*. New York: McGraw-Hill Book Co., 1946, p. 1.

CAUSES OF GROWTH IN EXPENDITURE, TAXES, AND DEBT

Many years ago a German economist, Adolph Wagner, enunciated what is now looked upon as a "law" of increasing state functions. It possessed a tone of historical causation. He expressed it as follows:

> Comprehensive comparisons of different countries and different times show that, among progressive peoples, with which alone we are concerned, an increase regularly takes place in the activity of both the central and the local governments. This increase is both extensive and intensive: the central and local governments constantly undertake new functions, while they perform both old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a more satisfactory fashion, are satisfied by the central and local governments.[3]

This generalization seems to be well borne out by experience in the United States, especially since 1900. Among the more important factors that have contributed to expanding public expenditures, taxes, and debts are: (1) industrialization and economic concentration; (2) growth in population and urbanization; (3) the expansion of public wants; (4) wars and the needs of national defense; (5) depressions and the need for social planning; (6) the growth of democracy and the new attitude toward government; and (7) the rise in the general level of prices.

EXTENT OF GROWTH IN PUBLIC EXPENDITURES

The over-all increase. The increase in the expenditures of all units of our government is relevant and significant because it measures the total tax burden which the economy as a whole must ultimately bear. This over-all growth has been so substantial that it is almost unbelievable. Total expenditures of all units of government amounted to about $850 million in 1890. By 1925 they stood at $9.42 billion, and by 1940 at $18 billion. They reached an all-time high in 1945, the last year of the war. At that time they tallied close to $110 billion. By 1948 total governmental expenditures were about $54 billion, but are now tending toward $100 billion per year again.

After each major war in our history there has been a tendency, at least at the federal level, for expenditures to proceed into the future at a level four to five times what expenditures had been just prior to the war. That was true after the Civil War and World War I; that again seems to be the general pattern after World War II. This time, however, state and local expenditures also have risen more rapidly than they did after World War I.

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[3] *Grundlegung der politischen Oekonomie,* Bk. VI, Ch. 3 (3rd ed. 1893). Translated and quoted in C. J. Bullock, *Selected Readings in Public Finance,* (3rd ed.). Boston: Ginn and Co., 1924, p. 32.

Expansion of federal expenditures. In the period before the depression of the "thirties," the expenditure of public funds was divided among the three strata of government about as follows: 35 per cent federal, 15 per cent state, and 50 per cent local. At the crest of the war effort in 1945 more than 90 per cent of total expenditures were incurred by the national government. That trend began to appear in the 1930's when on the average more than 50 per cent were by the central unit. Since World War II, in spite of the fact that state and local expenditures have been rising substantially, federal disbursements still constitute about 75 per cent of the total.

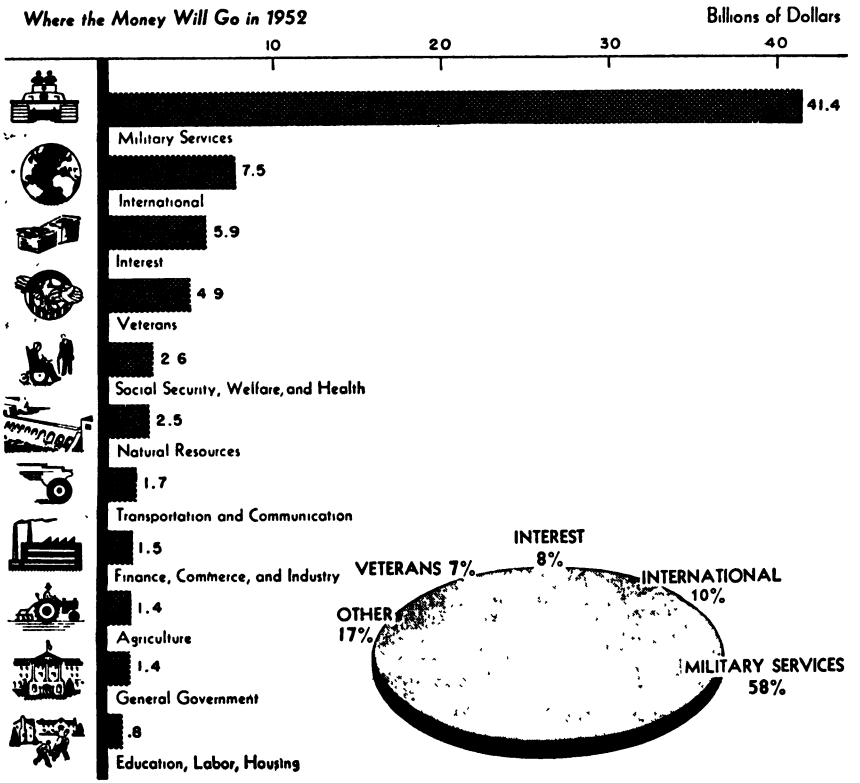


FIGURE 1. *The Distribution of Federal Budget Expenditures, Fiscal Year, 1952.* (Source: *The Federal Budget in Brief, Fiscal Year 1952*, p. 9; Bureau of the Budget, U. S. Government Printing Office, Washington, D. C., 1951.)

Federal expenditures stood at $291 million in 1890. They rose to $3.11 billion in 1923. They again rose to about $7 billion in 1935. By 1940 the federal budget was running close to $9 billion a year. The war peak was about $100 billion a year and since the war it has not gotten below $40 billion. The trend was definitely upward again in 1951. The near future portends even greater federal expenditures—$60 to $70 billion per year.

The Growth in Total Tax Burdens

THROUGH THE PROPER PLANNING and adjustment of the revenue system our government can meet its fiscal obligations and accomplish certain constructive nonfiscal objectives. Just as there have been substantial increases in the volume and types of public expenditures, so have there been big changes in the volume and types of taxes collected at all levels of government.

Marked changes have taken place in our tax system since 1900. First, the volume of tax revenue collected has expanded very noticeably. Second, new types of taxation have been injected into the tax structure. Third, the types of taxes used have changed substantially in their relative importance as sources of revenue. Fourth, the tax system as a whole has tended to become better adjusted to the ability-to-pay concept. This is especially true at the federal level where the income tax has become the principal source of revenue.

THE OVER-ALL INCREASE IN TAX BURDENS

During most of the years since 1900, the trend in the amount of tax revenues collected has followed quite closely the upward swing in public expenditure. In the two World War periods and the Depression era, however, expenditures far outran the revenues collected. The tax revenue for all levels of government rose from $1.4 billion in 1902 to $10.3 billion in 1930, then dropped off somewhat in the early 1930's. By 1940, however, the tax revenues had risen to $12.9 billion. In 1945, the peak year for both war expenditures and war tax collections, total tax receipts for all units of government were in the vicinity of $57 billion.

Since the close of World War II, "total federal tax receipts" have dropped off several billion dollars, but state and local taxes have had the tendency to rise. More recently, however, both federal expenditures and taxes have been clearly on an upward trend. By the early 1950's total tax collections for all units may approach $90 billion per year, a figure that is noticeably higher than the crest of World War II taxation.

THE EXPANSION OF FEDERAL TAX BURDENS

Both the "rate" of increase and the "amount" of increase in tax burdens have been most striking at the national level. Total federal collections rose from $567.2 million in 1900 to $6.7 billion in 1920, from $5.4 billion in 1940 to a peak of $47.7 in 1945.[4] They dropped down several billion in 1946, '47 and '48, but in 1950 and 1951 they headed upward again. Fed-

[4] *Annual Report of the Secretary of the Treasury*, 1947, p. 6 and pp. 274-276.

eral tax collections will probably exceed $60 billion per year during most of the 1950's.

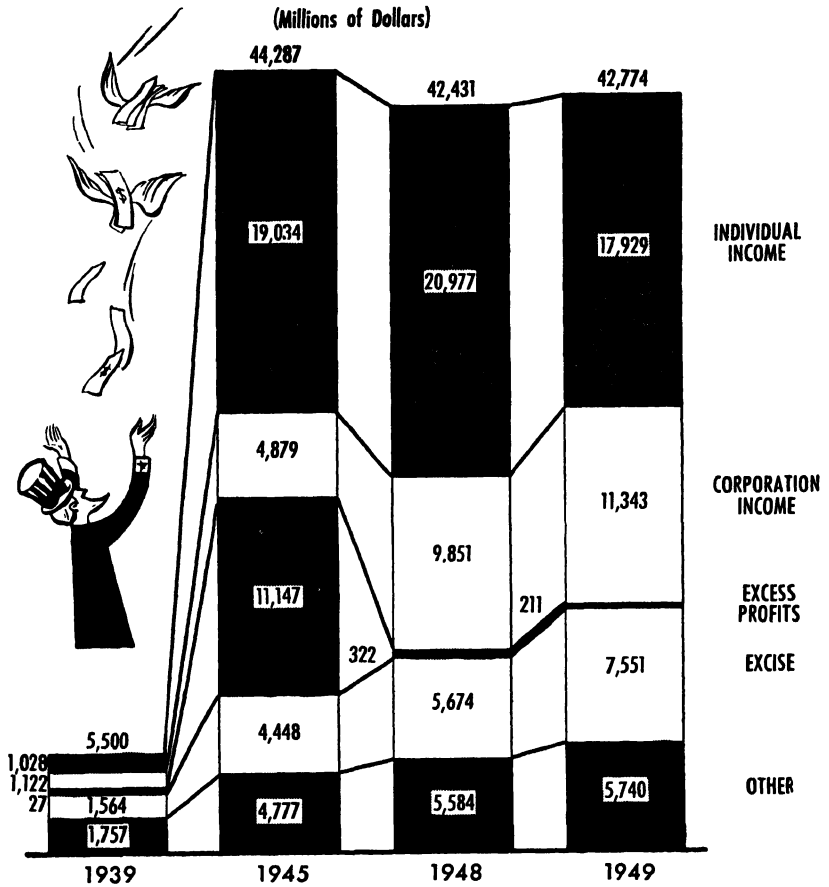


FIGURE 2. *Federal Tax Collections by Source, 1939-1949 (Selected Years).* (Source: Suggestion for the chart and the 1939-1948 data from *Facts and Figures on Government Finance, 1948-49,* 1948, p. 52, courtesy of the Tax Foundation, New York. Data for 1949 from the *Budget of the United States Government* for Fiscal Year ending June 30, 1951, Washington, D. C., 1950.)

The "per capita" tax receipts of the federal government increased from $6 in 1916 to $30 in 1936. They advanced to a high point of $309 in 1945. They dropped to $252 in 1947 but had risen to $264 by June 30, 1948. The per capita tax burden for all levels of government had risen to $378 in 1945. It stood at $357 in 1948.[5] That figure will run over $400 in the early 1950's.

As a proportion of the total taxes collected in the United States, the

[5] Tax Foundation, *Facts and Figures on Government Finance, 1948-49,* New York, 1948, p. 48.

federal government's share amounted to about 30 per cent in 1915. It reached 82 per cent in 1944 and amounted to 74 per cent in 1948.[6]

The central government collected about $67.9 million from the individual income tax in 1916. The figure had risen to $1.4 billion in 1941 and rose to $19.3 billion in 1947. It reached almost $21 billion in 1948. In 1947 the total receipts from federal individual income and corporate profits taxes amounted to $29.3 billion, or more than two-thirds of all federal collections.

The Rise of the Public Debt

OUR EXPERIENCE with the growth of public debt has been somewhat different from that with expenditures and taxes. In the period from 1900 to the outbreak of World War I, the federal debt remained relatively constant. State debt increased, but not strikingly. Local debt, however, nearly doubled from 1900 to 1912. The heavy increase in the federal debt came in World War I, in the depression years, and in World War II.

THE OVER-ALL INCREASE IN PUBLIC DEBT

In 1902 the "total public debt" in the United States amounted to about $3.4 billion. It reached $5.7 billion by 1912 and $39 billion in 1932, in spite of the fact that the federal debt dropped off materially in the 1920's. It reached the high point of $285 billion in 1946 and settled back to about $275 billion in 1947 and $268 billion in 1948. The trend, unfortunately, seems to be upward again at all levels of government in the early '50's.

THE INCREASE IN THE FEDERAL DEBT

The increase in the debt of the federal government has been the most striking of all. Though it remained about $1 billion from 1900 to 1914, it rose to a peak of $26.5 billion in 1919. It was reduced at about the rate of $1 billion per year in the 1920's and reached its lowest point ($16 billion) after World War I in 1930.

Since that time it has been steadily increasing as the national government suffered deficits in its budget for seventeen continuous years. It had expanded to $48.4 billion by 1940 and had reached the highest figure in the history of the country in February 1946. At that time it grossed $279.2 billion. By June 1946, however, it had been reduced to $269.4 billion. This reduction was made possible by the large surplus in the Treasury. It reached the lowest point since the war in April 1949 when it amounted to $251.5 billion. By August 1949 the gross federal debt had climbed to $255.8 billion and in 1951 was approaching $260 billion. This is not a

[6] *Ibid.*, p. 49.

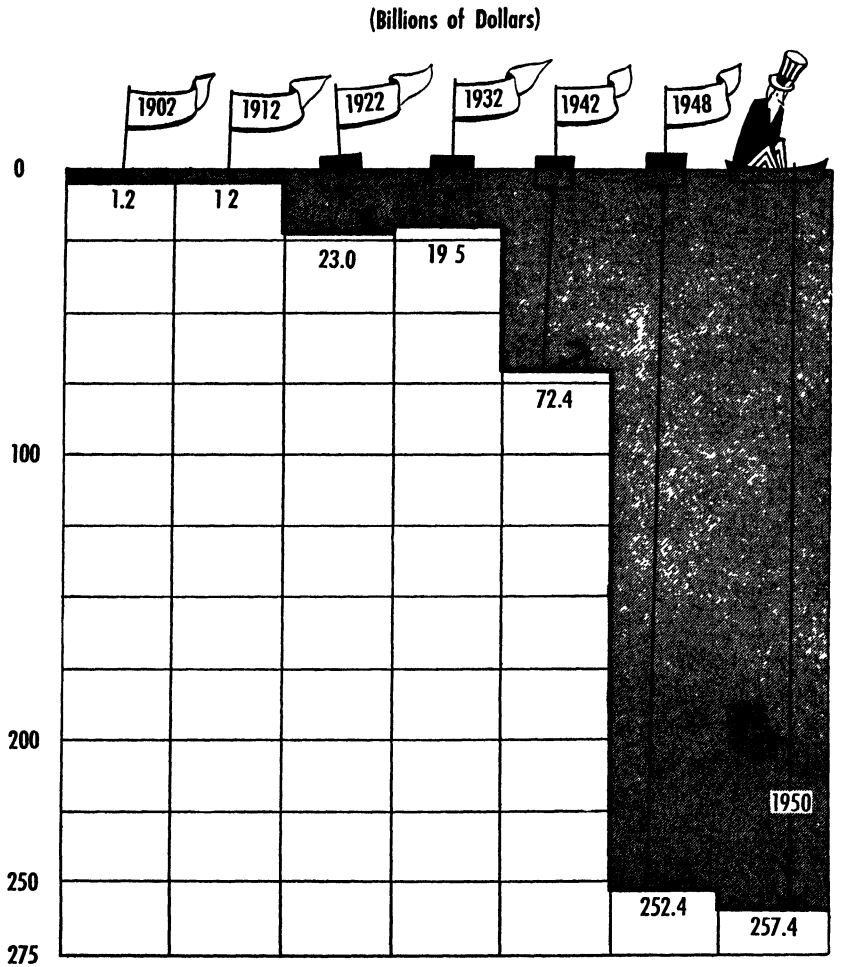


FIGURE 3. *Gross Federal Debt, 1902-1950 (Selected Years).* (Source: Suggestion for the chart and 1902-1942 data from *Facts and Figures on Government Finance, 1948-1949,* 1948, p. 114, courtesy of the Tax Foundation, New York. Data for 1948 and 1950 from *Federal Reserve Bulletin,* July, 1950, p. 867.)

heartening sign, especially in a period when it was hoped that we would be able to make reasonable reductions in the federal debt.

The Impact of Expenditure and Taxation on the Economy

WE HAVE NOTED the striking increase in public expenditure, taxation, and debt during the last fifty years. What do these increased burdens mean in relation to the workings of our economy? What is their total impact

upon our social and economic system? That burden may not be too easy to measure exactly, but when government absorbs 20 to 25 per cent of the gross national product in peacetime, it cannot help but have noticeable effects upon the system, first as a subtraction from the private economy and then as an addition back through the public economy. How can we gauge in some measure those impacts and effects?

Per capita costs. One way of testing whether the expenditure outlays have increased as compared with a previous period is to measure the costs per person. In 1890 the per capita total expenditures in the United States expressed in current dollars were only $13.56. By 1913 they had risen to $30.24 per person; by 1929 to $96.35, and by 1941 to $182.79. In about fifty years the per person costs had multiplied about 12 times.[7] Since 1941 the per capita expenditures have risen even higher. During the war years the total "per capita" outlays expanded enormously and amounted to $759.36 in 1944.[8] By 1948 per capita costs had come down about 50 per cent. However, in 1951 they were headed upward again. With per capita costs somewhere in the vicinity of $375, they have increased about threefold since 1940. There is little doubt that per capita costs are high. Our greatest hope in lowering them lies in our ability to increase our per capita income faster than per capita expenditure.

Expenditures, taxes, and gross national product. Relating expenditures to national income will show what part of that income is taken over by the public economy and will also show the expanding significance of government financial operations in the economy as a whole. Then, too, the relation measures roughly the rate of increase in the level of governmental services as compared with rate of increase in the general standard of living.[9]

In 1890 about 5 per cent of the gross national product expressed in current dollars went for all governmental expenditures. By 1913 it amounted to somewhat more than 6 per cent; 1929, 9.8 per cent; 1933, 19 per cent; and 1941, 22.9 per cent. In 1944 total war and government costs constituted about 48.6 per cent of the gross national product. Since that time the proportion has been declining, and in 1946 and 1947 it ranged slightly above 18 per cent.[10] Again, however, for the 1950's the proportion absorbed by expenditures may well approach 30 to 40 per cent while we are on a semi-war footing. If all-out war itself comes, then total expenditures may reach over 50 per cent of the gross national product.

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[7] Harold M. Groves, *Financing Government.* New York: Henry Holt and Co., 1945, p. 470.

[8] Tax Foundation, *Facts and Figures on Government Finance, 1946-47,* New York, 1946, p. 16.

[9] Philip Taylor, *The Economics of Public Finance.* New York: The Macmillan Co., 1948, p. 47.

[10] The Tax Foundation, *Facts and Figures on Government Finance, 1948-49,* New York, 1948, p. 17.

Two other standards for judging the impact of our tax-expenditure burden upon the private economy which would be interesting to observe are: (1) how our tax-expenditure burdens affect the proportion of our national income available for "private consumption," and (2) how they affect the proportion available for "private investment." We all know that our tax-expenditure load does affect them both positively and negatively. How to measure specifically the degree of these tendencies is not any easy matter. On the consumption side, we would have to calculate the extent to which our income and consumption taxes affect total purchasing power. On the investment side, we would have to measure the degree to which our business, income, and inheritance taxes affect total savings.

More careful analysis must be applied to the effects of the government's fiscal operations upon employment, production, and income, as well as upon the distribution of income and wealth. Public finance can no longer be a static, piecemeal science. It must appraise its true relation to the private economy and to the functioning of the economy as a whole. In fact, it must now be recognized that even under democratic institutions we have two interrelated sectors—one private and one public; the two together make up the economy as a whole.

The Private and Public Economy

IN THE PAST many economists looked upon public finance as a factor external and disturbing to the functioning of the private economy. Taxes were too often viewed only from the burden side. Public expenditures were appraised as nonproductive. The general philosophy was to keep public expenditures at an absolute minimum. During the last fifty years, however, as our economic system has become more complex, both the economists and the people have come to recognize the true significance of the public sector of the total economy.

Today most Americans acknowledge that, even under what is essentially a private enterprise system of economics, it is necessary for us to provide for our various human wants through two spheres of activity, one private and one public.

THE PRIVATE SECTOR

In the private sphere we attempt to provide for the great bulk of our individual economic needs. Here each determines his own needs and commands goods and services according to his purchasing power. What is produced and offered is determined by the composite demand of millions of individual consumers. In this sphere it is often said that the consumer is sovereign. Here we "vote with our dollars." The mechanism through which we vote is the price system—by our willingness to pay given prices for particular goods. In acquiring most of the goods and

services necessary for daily living, we pay for them with money or credit out of our individual pockets.

The private sector, therefore, operates very largely under what has been called the "market principle," the self-regulatory mechanism of supply and demand.[11] This mechanism is often tempered with some measure of institutional control. But as a basic organizing and operating principle for supplying thousands of types of goods to millions of individual consumers, it is superior to any other mechanism yet conceived. As one authority has stated, it is "an organizing principle of such usefulness in a complex society that if we had not inherited it, its inventor today would be honored as one of the great benefactors of mankind." [12]

THE PUBLIC SECTOR

What was once called the area of public finance is now more realistically appraised as the public sector. Helpful as the "market principle" is, there are certain areas of our social and economic wants that are not, or cannot be, supplied effectively by the private economy. Therefore, for centuries certain basic social protections and services have been rendered by government. This has been true under various types of government. During the past fifty years because of the increased complexity of our economic system, world wars, and severe depressions, the functions of public finance have expanded enormously. Because governmental expenditures now make up a larger proportion of the expenditures of the entire economy than ever before, there are those who claim that it is more accurate (for the purposes of national economic analysis) to speak of the public economy.

The public sector also satisfies human wants. Public finance is a branch of the broader field of economics, and it also deals with the satisfaction of human wants. The democratic state is, among other things, nothing more than the agency through which the people seek to fulfill certain social and economic needs. True, government is the rule-making and the protection-giving agency in our social existence, but it does a good deal more than lay down the working rules and provide police protection. Our governmental units now supply an ever-increasing volume of want-satisfying services for our citizens.

Social experience has demonstrated that such services as roadbuilding, education, public health protection, garbage removal, provision for harbors and airports, the care of those who have "borne the battle," the postal service, and conservation of natural resources (as well as many "regulatory services") can best be performed and distributed under the leadership of government.

The conclusion is, of course, that in a complex industrial society it is

[11] Gerhard Colm, "Why Public Finance?," *National Tax Journal*, Vol. I, No. 3, September 1948, pp. 196-197.

[12] *Ibid.*, p. 197.

absolutely necessary to have joint action in many service-producing areas. The public sector of the economy does satisfy many human wants that we would not care to be without and that we would not care to turn over to private agencies.

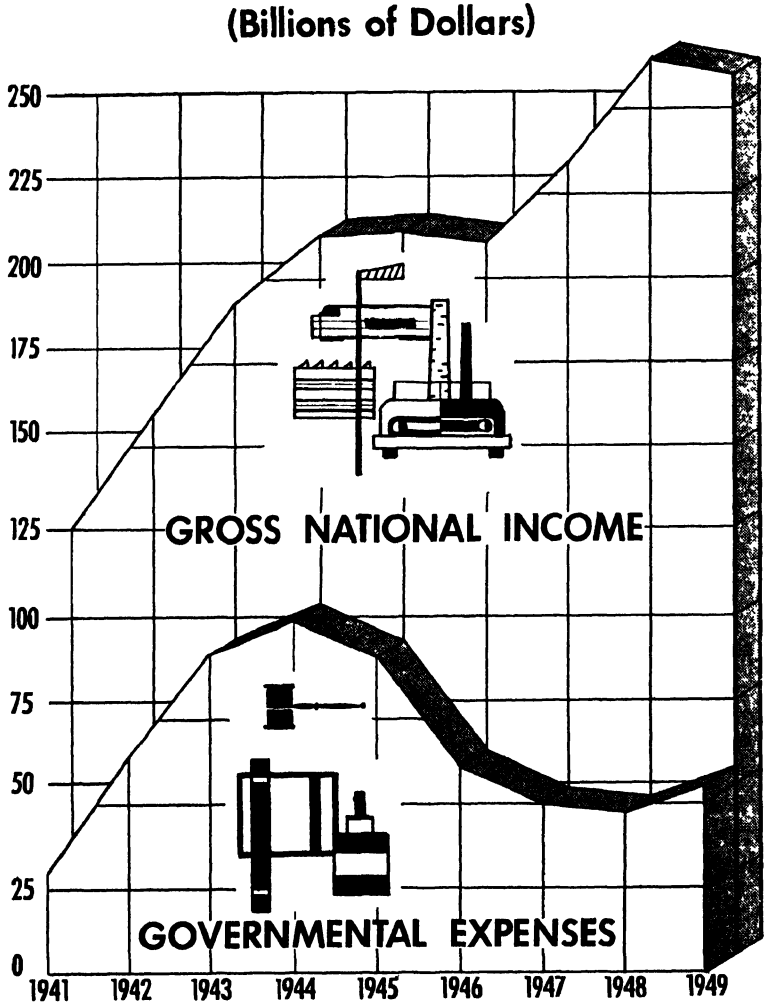


FIGURE 4. *Governmental Expenditures and Gross National Income, 1941-1949.* (Source: Suggestion for the chart and 1941-1945 data from *Facts and Figures on Government Finance, 1948-1949,* 1948, p. 16, courtesy of the Tax Foundation, New York. Data for 1946-1949 from Department of Commerce figures and *Annual Reports of the Secretary of the Treasury.*)

In the public sector we determine what we want by "voting by ballot," either directly or through our representatives in the various legislatures. Having decided what we want and need in a collective way, we must

make provision for payment. We all know now that the services supplied by government must "ultimately" be paid for by taxes. In a very broad sense, taxes are in the nature of exactions which the community as a whole must pay for the goods and services furnished the citizenry by the state. They differ from "prices" in the private market in that they can and often are levied upon particular individuals for the general welfare and without regard to the value received by those individuals.

The public sector as a segment of the total economy. The above is not a complete survey of all government activities, but it does indicate that units of government function as "economic units" in some respects similar to private business. This is especially true on the purchases and expenditures side. In buying goods and services the public units pay out money (just as do private business units) and thereby add to the income stream. Even on the taxing side or in selling such services as water, electricity, and other special services, public agencies take money out of the expenditure stream just as does the department store when it sells clothing. Furthermore, governments may issue and sell bonds in the same way as corporate business to carry on certain types of operations. On the other hand, like business, governments may build up their reserves of cash by collecting currently more in revenues than they pay out. Or they may do just the opposite by collecting currently less than they expend.

When we view the activities of all units of government against the economy as a whole, the significance of government as an "economic unit" becomes even more striking. At the peak of the war effort total "tax collections" absorbed about 29 per cent of our gross national product, and close to 36 per cent of the net national income; total governmental "expenditures" accounted for about 48.6 per cent of a gross national product of about $210 billion. In the fifth year after the war the public economy continued to absorb more than 25 per cent of a substantially increased gross national income. That proportion is likely to increase markedly during the 1950's.

When the totals and proportions of the tax-expenditure figures run so high, they are bound to have profound effects upon the private economy and the economy as a whole. Viewing the effects upon the entire economy, these expenditures will tend to affect the way in which "resources are allocated," the "pattern" in which the total product will be distributed among various economic groups, and quite likely the general levels of production, employment, and income in the system. They will be prone to affect the levels of the "private consumption-demand factor" on one hand and the "private investment-capital formation factor" on the other. These effects must not be overlooked in any study of taxation in a modern economy.

Taxation and Private Business Activity

THE NEED FOR HIGH LEVELS OF CONSUMPTION AND INVESTMENT

The overwhelming majority of Americans believe in the private enterprise system. They want the "private economy" to make the optimum contribution to high levels of production, employment, and income. They want the private economy to make up just as large a part of the total economy as possible. Furthermore, they desire the private enterprise system to function within the framework of a constitutional democracy with all the freedoms and safeguards that that implies. They realize that even in a democracy the power to tax is both broad and deep, but they do not believe that the power to tax should be exercised as the "power to destroy."

The analysis of taxation principles, problems, and policies in this text will be made in relation to a private enterprise economy. It will endeavor to discover how taxation under democratic institutions can aid in the preservation of and contribute to the better functioning of that system. Clearly, it will be the purpose of this text to seek guideposts that indicate how to avoid hampering such a system in its production, consumption, and investment operations.

To function properly a private enterprise system must, on one hand, possess an "effective demand" for the goods and services it produces and, on the other, it must have a constant flow of "venture capital" into the system so as to expand and improve its plant and equipment. It is only by this flow of capital that the levels of productivity can be raised. Both consumption and investment can be affected adversely by taxation.

BALANCING THE INTERESTS OF CONSUMPTION AND INVESTMENT

Neither the interest in consumption nor investment has an absolute priority in the tax system. Both consumption and investment in good and rising volume are necessary to keep the private enterprise system functioning at high levels of employment. It behooves us, therefore, to strike the proper *balance* between the interests of consumption and risk-taking. It is not necessary to collect 80 per cent of the revenue by high, "progressive" income taxes any more than it is wise to do the same by "regressive" sales and excise taxes (which take a larger proportion of the little fellow's income). The two types of taxes should be balanced in such a way as to minimize the impact of progressive taxes on investment and regressive taxes on consumption. This can be done by careful economic analysis and scientific tax planning.

Taxation Part of Broader Concept —Fiscal Policy

TAXATION CAN NO LONGER be viewed as an independent fiscal instrument, charged merely with the responsibility of raising the revenues to pay for the "ordinary" expenses of government. Taxation must be viewed in its relation to the functioning of our private enterprise system. This has become true whether we like it or not, and whether we want it or not.

With the federal postwar budget expanded from four to five times what it was in the 1930's and with the over-all budget representing 20 to 25 per cent of the gross national income, we have no alternative but to recognize the strategic significance of tax-financing. It has now become necessary to place greater emphasis upon the types of taxes, the levels of rates, the variations in those rates, and the burden-character of the tax structure as a means of controlling business fluctuations and stabilizing employment at higher levels.

Taxation can make its contribution to a counter-cycle fiscal policy. This is true even though the power to tax can only be wielded by legislatures. In the incipient stages of our recessions, more than reasonable time is usually available for governmental action. Furthermore, our Congress now meets a good part of each year. Both Congress and the President now have the advice of the President's Council of Economic Advisers. Besides, the action does not necessarily have to be trigger-quick.

A flexible tax policy can be of material aid in curbing the undesirable characteristics of the various phases of the business cycle. This is especially true in inflationary periods when the proper degree and distribution of taxation could have strong anti-inflationary results. On the downswing, with multi-billion-dollar-budgets, covered largely by taxes, it seems economically logical that the right kind of "tax reduction" could be a strong anti-recession instrument.

Trends in American Taxation

TAXATION has been of strategic significance in the growth of human affairs. The filling of the public purse and the control of the purse strings have been centers of conflict and of growth in the social, political, and economic affairs of every modern nation.

There has been no clear pattern in the evolution of public finance institutions. There is little that is strictly new among tax instruments in use today. Practically every modern tax tool has its counterpart in the history of some nation in the past. The progressive income tax stands out as one of the few modern innovations. The general property tax is undoubtedly one of the few characteristically American developments.[13]

[13] Groves, *Financing Government*, p. 20.

The changes that have taken place have not been so much in the basic types of taxes as in their expansion and refinement. Significantly, most of these changes have come about in the environment in which taxes have to operate—that is, in the social and economic institutions. With the advent of the industrial revolution, the rise of the modern corporation, the tendency toward territorial interdependence, the extension of universal suffrage, the stimulation of class conflict, the changed attitude toward the responsibilities of government, and modern economic depressions and modern world wars, there has come a multitude of public finance problems which are broader, deeper, and more complex than ever before. All this has made necessary the refinement and extension of many old tax instruments and the development of some that are new.

Some of the more pronounced trends in American taxation over the years have been: (1) readjustments in the property tax; (2) the expansion of consumption taxation and especially sales taxation; (3) more extensive and multiple business taxation; (4) the use of progressive income taxation; (5) the increased use of death and gift taxes; (6) the development of special-benefit taxes; (7) the growth of multiple taxation between the states; (8) the increase in tax duplication as between the three levels of government; (9) the growth of a patchwork tax system; (10) the beginning of the use of taxation as a counter-cycle instrument; and (11) such miscellaneous developments as heavy tax evasion and avoidance, the increase in the strategic significance of tax administration, and the growth of group-conflict in taxation.

Conclusions

TAXATION in the mid-twentieth century in a modern industrial society is a matter totally different from taxation in the typical national state of the late nineteenth and early twentieth century. Taxation can no longer be looked upon as the bare "annual pay check" to cover the "regular" expenditures of government.

The tasks of formulating scientific tax principles, working out the soundest tax policies, equitably adjusting the tax load, and effectively gathering in the needed total revenues are now extremely delicate and expert responsibilities.

The technical craftsmen, the social, economic, and business statesmen will have to be cognizant of the new relation of taxation to the economic system. They will have to recognize how the characteristics of a highly industrialized society place new demands upon government, upon the tax system, and upon the economic system itself. They will also have to take full account of how an unsettled world, threatened with a possible World War III, accentuates the demands upon government. Therefore all of our citizens will have to weigh well a number of factors:

1. The expansion of the responsibilities of government has been so great that it cannot be ignored in tax planning. Much of the growth in expenditures has come in response to real needs that could not be avoided. That does not mean, however, that we should not appraise the social utility of all prospective new expenditures. Likewise, it does not imply that old expenditures should not be carefully scrutinized to meet the tests of comparative need and social advantage.

2. The total tax burdens have now become so large that further additions to the load must be carefully weighed and justified. If there is no alternative but to add to the load, then the additional taxes must be placed upon those tax bases where they will do the least social and economic harm.

3. The total public debt has now reached such proportions that further *substantial additions* to it cannot be viewed with equanimity. In fact, every effort should be made to minimize further rises. Concrete policies should be pursued to reduce public debt every year in which we enjoy high levels of income and employment and in which we are not faced with the responsibilities of war.

4. The impact of our expenditure-tax-debt burdens expressed as a proportion of our gross national product and as a per capita load is so great at present that every expenditure act of government can have serious effects upon the functioning of the economy. Taxes, expenditures, and debts must be continuously and skillfully managed. Because the tax loads do run high, the proper lightening, at the right time, can have real anti-depression effects.

5. It must be recognized that even in the United States we have both a private and public economy—that the two together make up the economy as a whole. The two sectors must co-operate to supplement and strengthen each other.

6. Taxation must have regard for the functioning of the private economy. Taxation must give due weight to maintaining and encouraging private business activity. It can do these things best by *balancing* the interests of consumption and demand on one hand, and risk-taking and investment on the other.

7. Taxation is one of the major instruments in that broader concept known as *fiscal policy*. When taxation is properly "co-ordinated" and "timed" with the other instruments, it can make a constructive contribution to the better functioning of the private enterprise economy. Furthermore, it can do this without injuring the private enterprise system or destroying basic democratic freedoms.

2

The Constitutional Foundations of American Taxation

> 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 the nation as the air he breathes is to the natural man. It is not only the power to destroy but also the power to keep alive.*
>
> —U. S. SUPREME COURT.[1]

Overview

THE POWER TO TAX is an inherent part of the sovereign powers of every independent state. Without this power, modern national states could not long exist. This was well demonstrated by the weak and short life of our early national government provided by the Articles of Confederation. Therefore, the Constitutional Convention of 1787 (recognizing certain inherent powers of sovereignty) created the Federal Constitution with broad powers of taxation in the federal government. However, the power to tax is by no means absolute and unlimited. Here the people have placed limitations upon it in the federal and state constitutions.

Tax systems in the United States are based upon laws enacted by legislative bodies. The federal taxing power is prescribed and limited by the Federal Constitution. The states are limited in their exercise of the taxing power by the Federal Constitution and the constitutions of the several states. Finally, the powers of the local units to tax are "granted" by state constitutions and statutes and are "limited" by the Federal Constitution, state constitutions, and state statutes.

Since "the power to tax involves the power to destroy," [2] the limitations on the taxing power in the state and federal constitutions become very important for democratic peoples. The courts ultimately determine whether a tax statute is valid under federal and state constitutional standards. In

[1] *Nicol v. Ames*, 173 U. S. 509, 515 (1899).
[2] *McCulloch v. Maryland*, 4 Wheaton 316 (1819).

order to understand many types of tax problems, it is necessary to master the constitutional principles governing the levy of local, state, and federal taxes.

This chapter will supply that understanding by exploring a number of topics relevant to the constitutional aspects of taxation: (1) some general legal principles of taxation; (2) constitutional principles and limitations on federal taxation; (3) federal constitutional checks on state and local taxation; and (4) state constitutional checks on state and local taxation.

SECTION 1

General Principles and Limitations on Taxation

WHAT IS A TAX?

A tax is a compulsory contribution levied by the state (in the broad sense) upon persons, property, income, and privileges for the purpose of defraying the expenses of government. It is a "compulsory contribution" —obligatory upon all who come within the purview of the taxing statute. A tax can only be levied by the duly constituted "public authority." In a democracy that is almost invariably the legislative body in which the people are represented. Taxes must be levied according to established principles. Clearly, a tax should not be a "penalty" for doing or omitting to do some act. A tax may be levied without regard to "particular benefits" to particular individuals. Finally, the tax must be levied for the common good; as the courts say, it must be for a "public purpose."

THE POWER TO TAX

The power to tax is legal in character. The power to tax is essentially a constitutional and legal power. The taxing power is inherently implied in sovereign existence. However, in constitutional democracies the power to tax is specifically granted in the "basic law of the land" to the legislative body. The Federal Constitution specifically provides that "The Congress shall have power: To lay and collect Taxes, Duties, Imposts, and Excises to pay the Debts and provide for the common Defence and general Welfare of the United States. . . ." [3]

Our state governments have reserved and inherent taxing powers which arise out of their sovereign character, but even so the people in their state constitutions usually "grant" the taxing power to the state legislatures. These constitutions and the state legislatures in turn generally prescribe the character and extent of the power to tax of all the nonsovereign, sub-

[3] Art. I, Sec. 8. Cl. 1.

ordinate, local units. These units, therefore, can tax only such subjects and by such means as they are permitted by the sovereign power.

The power to tax cannot be delegated. The taxing power is a sacred power which is "vested" in the legislative branch of government; it is so strongly vested in the chosen representatives of the people that it cannot be delegated to other governmental agencies. This concept of non-delegation is rooted in the democratic theory of "no taxation without representation" and the "separation of powers" as between the legislative, executive, and judicial branches of government. The taxing power is essentially a legislative function and should be exercised by the legislature only.

It is sometimes argued that law-making bodies give away certain taxing powers to tax administrative agencies (such as the tax commissions, departments of taxation, and boards of assessment), but this is not true. They usually do not delegate any "basic taxing power." They determine what shall be the tax base, the tax rates, and other standards, and then they authorize the special agencies to administer and carry out the intent of the legislature within the standards set by the legislature. The basic principle is that the legislature is not permitted to delegate its power to tax.

THE EXTENT OF THE POWER TO TAX

The power to fix degree of taxation is quite extensive. In the absence of constitutional restrictions, the legislature's legal authority to fix "tax rates" is quite unlimited. That is why income tax rates in the top brackets can be carried to the very point of confiscation, if the legislature sees fit. During World War II the federal personal income tax rate on the "marginal" part above $200,000 was 94 per cent.

This power to set rates, however, assumes an absolute character only if the tax law in all other respects meets constitutional standards (such as due process, reasonable classification, and equal protection). Consequently, "excessive rates" will not invalidate a tax law which is otherwise valid. This principle was recognized and enunciated by the Supreme Court as early as 1819 when Chief Justice Marshall said the taxing 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." [4]

TAXATION MUST BE FOR A PUBLIC PURPOSE

Origins of public purpose. Of the general limitations on the taxing power, the requirement that a tax must be levied for a public purpose is one of the strongest. It has grown more out of custom and common law than out of constitutional prescription, although this inherent limitation has been formally declared in many state constitutions. Theories of this

[4] *McCulloch v. Maryland,* 4 Wheaton 316, 428 (1819).

limitation have been advanced through the study of the nature of taxation and of free government itself.

Since the adoption of the Fourteenth Amendment to the Constitution (which is a limitation upon the states), the "due process" clause has been construed to be a specific statement of this limitation as applied to "state taxation." The states may not "deprive any person of life, liberty, or property without due process of law." In such cases the courts have claimed that taxes levied for nonpublic purposes were not in accordance with due process of law. The corresponding "due process" clause of the Fifth Amendment (which is a limitation upon the federal government) has not yet been construed as a limitation upon the "federal powers" as related to public or nonpublic purpose in taxation.

The problem of defining public purpose. The most difficult feature of the public purpose limitation is the problem of distinguishing between public and nonpublic purpose. Such an interpretation depends upon the social and economic conditions prevailing at the time the courts are called upon to define public purpose in the given case. During the first half of the last century, the doctrine of public purpose was used in the "state" courts to curb governmental expenditures. The courts, both state and federal, have since taken it upon themselves to declare that a given expenditure is or is not for a public purpose. A number of states, however, have "codified" the doctrine of public purpose by placing specific restrictive clauses in their constitutions.

In general, the issue of public purpose is raised in two classes of cases: (1) those involving government grants to private persons and corporations, and (2) those involving the assumption by government of new functions, usually of a business or proprietary character.

Grants to private entities. One of the first cases of this kind to arise in the state courts was *Sharpless v. The Mayor of Philadelphia.*[5] It took the form of a taxpayer's suit to restrain the Mayor and City Council of Philadelphia from subscribing to the stock of two private railroad corporations entering the city. In this case the court was able to find "public purpose." The court maintained that the railroads (which served the city) rendered a public service and operated in the public interest. Here the *public utility character* of the railroads seemed strong enough to supply the public purpose element. Wherever that has been the case, the courts have had little difficulty in upholding state and local statutes.

In the situation where the private business receiving the grant has been of a *non-utility character,* the courts have been more reluctant to interpret the use of the public funds as one for a "public purpose." The leading case expressing this point of view is a Kansas case that reached the U. S. Supreme Court.[6] A Kansas statute permitted municipalities to loan money

[5] 21 Pa. 147 (1853).

[6] *Citizen's Savings & Loan Assn. v. Topeka,* 20 Wall. 655 (1874).

or credit to aid private corporations to locate in the cities. Topeka issued municipal bonds to a bridge company as a donation for such a purpose. The Court had no difficulty in holding "no public purpose." It looked upon the grant as one to a private corporation and refused to look beyond to any possible economic benefits that might flow to the community from having the bridge company located there. A recent Wisconsin decision adhered very strictly to this view in spite of certain elements of contract involved in the case.[7]

Under conditions of *economic emergency*, the courts in recent years have been more liberal in their interpretation of what is public purpose. A Mississippi statute permitted the expenditure of public money to buy or build industrial plants for leasing to private corporations on conditions approved by the state industrial commission. The purpose of the statute was to provide income-creating work for unemployed citizens and to induce a balance between agriculture and industry. This law was sustained by the State Supreme Court in spite of the fact that the state constitution contained a specific provision against pledging the public credit to aid a private agency.[8] The court took cognizance of the lack of industrial capacity and employment in Mississippi and the emergency character of the legislation to sustain "public purpose."

At the federal level there has never been any serious judicial challenge of expenditure on the ground of the lack of public purpose. Ship subsidies to private shipping companies have been common in our history. Aids and subsidies to private agriculture are now a common practice. The extension of public credit to private individuals and corporations (under such federal agencies as the Reconstruction Finance Corporation, Home Owners' Loan Corporation, and the Federal Housing Administration) is now quite firmly established and goes unchallenged.

State and municipal enterprises. Taxes collected or money borrowed to finance publicly-owned industries of the *public utility* type have been consistently held to be a legitimate public purpose. Expenditures for municipal waterworks, electric light plants, street railways, wharves, and ferries have been sustained by the courts as valid public purposes. However, the use of public funds to finance *proprietary enterprises* of a non-utility character has not always met with quite the same recognition.

Portland, Maine, pursuant to a state statute, established a fuel yard financed by municipal funds. Winters had been severe and shortages of fuel had developed. The case was contested on the ground that it deprived taxpayers of property without due process of law. The U. S. Supreme Court could not agree that there was any violation of due process. The emergency conditions strengthened the public purpose in that an ade-

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[7] *Wendlandt v. Hartford Accident & Indemnity Co.*, 222 Wis. 204 (1936).
[8] *Albritton v. City of Winona*, 181 Miss. 75 (1938).

quate fuel supply was necessary to the health and welfare of the people of the state.[9]

In the 1920's South Dakota passed an act which permitted certain state officers, if they found that gasoline prices were too high, to purchase gasoline and sell it at retail. The law permitted part of the "gasoline tax" money to be used as "capital" in the state gasoline business. In this case the state's own supreme court held the statute invalid on the ground that the state constitution and laws had been adopted with the idea of "encouraging private enterprise." To enter the state as a competitor in a nonutility business would require an amendment to the state constitution.[10]

Nevertheless, under the right circumstances, several state and federal decisions have recognized the right to use public funds for business enterprises usually reserved for private activity. Shortly after the close of World War I, the North Dakota farm economy was faced with a serious postwar depression. The state legislature (under authority of the State Constitution) passed what in effect was an economic reconstruction act. It created a state Industrial Commission which was authorized to conduct and manage certain enterprises for manufacturing and marketing "agricultural products," for establishing and operating a warehouse, elevator, and flour mill system. The act also provided for a state-owned-and-operated bank. The act was challenged in the Federal Supreme Court, but that Court could find no violation of due process.[11] The Court recognized the emergency conditions and also was inclined to accept the judgment of the people of the state.

For the purpose of promoting and advertising the state apple crop, the State of Michigan recently enacted a statute which placed a tax upon all apples (with certain exceptions) produced within the state. The Michigan Supreme Court held that the promotion of such a large and important industry in the state economy would create advantages for the public well-being, and thus the statute satisfied the requirement of public purpose.[12]

Conclusion. No court has ever developed a logically correct and completely adequate definition of public purpose, largely because the concept is relative in character. The courts have tended to decide what is public or nonpublic purpose upon the recognized historical functions of democratic governments. As social and economic conditions have changed so as to create new public interests and necessities, the courts have been prone to give weight to those changes. In the face of emergency, even our more conservative courts have not been reluctant to expand the notion of public purpose. The public purpose concept still stands, but it means something different from what it did fifty years ago.

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[9] *Jones v. City of Portland*, 245 U. S. 217 (1917).
[10] *White Eagle Oil & Refining Co. v. Gunderson*, 48 S. D. 608 (1925).
[11] *Green v. Frazier*, 253 U. S. 233 (1920).
[12] *Miller v. Michigan State Apple Commission*, 296 Mich. 248, 296 N. W. 245 (1941).

REASONABLE CLASSIFICATION

The theory of reasonable classification. The second general limitation upon the taxing power arises from the democratic concept that government must be guided by considerations of justice and equity—that taxes must not be arbitrary and capricious. In an effort to reach "justice" in taxation, the courts have worked out the doctrine that in the distribution of the tax burden there must be "reasonable classification" of the subjects of taxation and of the categories within any given subject. This policy of treating those in different circumstances differently and those in similar circumstances similarly, it is believed, assures an optimum of justice for all.

Classification itself is not prohibited by the Federal Constitution, although in their local constitutions some states have "uniformity" clauses which prevent classification and differentiated treatment under the property tax. Where classification is permissible and is invoked, however, it must be reasonable; otherwise the tax statute may be found invalid under the Fifth or Fourteenth Amendments to the Constitution.

Judicial expansion of the doctrine. For some twenty years after the adoption of the Fourteenth Amendment, the Supreme Court maintained that the "equal protection" clause of the above amendment had no application to state tax legislation. By 1890, however, the Court in the *Bell's Gap Railroad Company* case [13] began the development of the equal protection clause as a limitation upon the taxing power of the states. The Court pointed out that the clause was not intended to prevent a state from adjusting its tax system in all proper and reasonable ways. But it warned that "clear and hostile discriminations" against particular persons and classes, especially those of an unusual character—those unknown to the practice of our government—might be obnoxious to the constitutional limitation. At the same time the Court admonished that the "equal protection" clause as a limitation upon the taxing power of the states "should be applied with great caution."

Judicial standards of reasonable classification. It took some time, however, before the Court enunciated any standards of what was meant by "reasonable classification." The problems of reasonable classification became more extensive with the expansion of progressive income and inheritance taxation. As the problems came before it, the Court began to define and distinguish. Since 1920 that process has gone on more or less continuously. In one of its best early pronouncements the Court began to define reasonable classification thus:

> The classification must be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similiarly circumstanced shall be treated alike.[14]

[13] *Bell's Gap Railroad Co. v. Pennsylvania*, 134 U. S. 232 (1890).
[14] *F. S. Royster Guano Co. v. Virginia*, 253 U. S. 412 (1920).

But it pointed out that this difference "need not be great or conspicuous in order to warrant classification." [15] The process of definition has gone on. In another case the Court said:

> Any classification is permissible which has a reasonable relationship to some permitted end of governmental action.... It is enough for instance if the classification is reasonably founded in the purposes and policy of taxation.[16]

From the latter interpretation it can be seen that a classification is reasonable if it is necessary to administer and carry out tax policy. It has been so held in a Kentucky case. The state imposed a tax of fifty cents per hundred dollars on the "out-of-state" bank deposits of its citizens, but only ten cents on those within the state. The Court upheld this classification and the differentiated tax treatment as reasonable. It was founded in "the purposes and policy of taxation." It would be more difficult to enforce and collect the tax on "out-of-state" deposits than on domestic ones.

Reasonable classification remains a basic requirement of every tax law where grouping and classifying is relevant. It means that the classification must not be arbitrary; that it must bear a logical relation to the permitted purposes of government; or that it be founded in the purposes and policies of taxation. It means that those in different circumstances (usually economic) may be treated differently, taxwise. Those in similar circumstances must be dealt with similarly. Once the classifications are made, those within each classification must be treated alike.

JURISDICTION TO TAX

Jurisdiction necessary to exercise power to tax. Even though the given unit of government possesses the "power to tax," the question still remains, does it have the "jurisdiction to tax" in the given instance? By jurisdiction is meant the right to tax the particular person or thing. Again it is the "due process" clause of the Constitution which has been construed to limit a state's jurisdiction to tax. The general principle based on that clause is that a state may tax only those subjects which are within its territorial boundaries. A governmental unit may acquire the right to tax by having (1) jurisdiction over the person, or (2) jurisdiction over the thing (property, income, inheritance or privilege), or (3) jurisdiction over both the person and the thing. In order to determine whether or not a given state has the right to tax, the "situs or legal location" of the person or the thing must be known. The state in which lies the situs or location of the person or thing has the jurisdiction to tax.

Taxable situs and jurisdiction. What determines the "taxable situs" of a given person or thing? In the case of a *person* the "taxable situs" is at

[15] *Keeney v. New York*, 222 U. S. 525 (1912).
[16] *Watson v. State Comptroller*, 254 U. S. 122 (1920).

his *domicile.* The domicile is his regular and permanent place of abode—where he ordinarily makes his home. If a man lives in Los Angeles, California, then the City of Los Angeles and the State of California have the right to tax him under certain types of taxes.

In the case of *tangible subject matter,* the "taxable situs" is at the place where it is usually kept and used. Only the state in which it is located (permanently used or kept) has the right to tax. In the case of *real estate* no problem arises; that can only be taxed in and by the state in which it is located, because it is by its very nature immovable. In the case of *tangible personal property* no serious problems of taxable situs arise because the great bulk of it remains clearly within particular units of government. Some questions of fact do arise when certain types of tangible personal property (such as automobiles) are moved and used in several states during a given taxable year.

Jurisdiction to tax intangibles. By far the more serious problems in tax-situs determination arise in connection with intangible personal property—very often movable and only "representative" of other property. The best examples of this type of property are stocks, bonds, bank deposits, notes and mortgages, contract rights, and certain privilege rights. The prohibition against a taxing-government levying a tax beyond its territorial jurisdiction assumes that the subject matter of the tax has a determinable geographical location. But that is not always the case. Taxes are imposed upon any number of intangible elements such as acts, legal rights, privileges, and representative property.

At common law the courts worked out the principle of *mobilia sequuntur personam* (movables follow the person). In more recent times the principle amounts to "intangibles follow the person." Wherever the owner of the intangibles makes his domicile, that state has the right to tax said intangibles. At one time it was held that *only* the state of the domicile could tax. In recent years the courts have had the tendency to say that any state that gives protection or benefit to the intangibles also has the right to tax. The result is that two or more states may tax the same thing.

The important thing to remember at this point is that "jurisdiction to tax" is a condition precedent to the *exercise* of the "power to tax" in the given instance. Each governmental unit must establish its "right to tax" in each case, and it will do so under principles which the courts recognize as sufficient to create "taxable situs." [17]

TAXATION FOR NONFISCAL PURPOSES

The concept of nonfiscal purposes. In the traditional sense, the basic purpose of taxation is to raise revenues to defray the expenses of govern-

[17] This question of jurisdiction to tax will be dealt with in greater technical detail under property, income, and inheritance taxation.

ment. However, taxation may be used for purposes other than raising revenue. These purposes, often termed "nonfiscal," are usually *regulatory* in character. The use of taxation for regulatory purposes may or may not be permissible, depending upon what is regulated and how it is done. The courts have not drawn the line of demarcation very accurately.

Nonfiscal purposes upheld. A review of some of the more important decisions will reveal the pattern of judicial reasoning in this field. In 1865 Congress imposed a 10 per cent tax on state bank notes, the effect of which was to drive them out of circulation and to open the way for the note issues of the federally chartered "national banks." The tax was challenged on the ground that it was being used to destroy state note-issues and not to raise revenue. The Court upheld the tax on the theory that Congress *had* the power to "coin money and regulate the value thereof." Since it had the power to regulate, the "use of a tax" to achieve that purpose was not illegal because Congress was doing indirectly (by taxation) what it could do directly if it chose to do so.[18]

On a later occasion Congress placed a tax of ten cents per pound on colored oleomargarine sold in interstate commerce. *Prima facie*, it would seem that legislation regulating the manufacture and sale of oleomargarine fell within the police powers of the states (not the federal government). When the tax was challenged as a federal regulatory tax, the Supreme Court upheld it.[19] The Court maintained that the statute on its face was a revenue statute, and although it might operate to prevent deception in the sale of oleomargarine for butter, its "primary object must be assumed to be for raising revenue." The Court stated that it had no right to look into "incidental" motives. Some time later the Court on the same theory upheld a tax upon the manufacture and sale of opium.[20]

As we shall see later, in the 1920's and 1930's in a number of instances the Court was reluctant to uphold certain regulatory taxes on the grounds stated in the *McCray* and *Doremus* cases. However, in 1937, it did sustain the Federal Social Security Act. This Act provides for a payroll excise tax, the proceeds of which are to be paid into the U. S. Treasury. It also authorizes Congress to make appropriations to the states to aid them in the administration of their unemployment compensation acts. In *Steward Machine Co. v. Davis* [21] the company paid the tax and asked for a refund on the ground that the tax was not an excise; that its purpose was not taxation but an illegal infringement of the powers reserved to the states; and that it coerced the states in contravention of the Tenth Amendment.

But the Court refused to hold the tax section of the Act invalid because

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[18] *Veazie Bank v. Fenno*, 8 Wall. 533 (1869).
[19] *McCray v. U. S.*, 195 U. S. 27 (1904).
[20] *U. S. v. Doremus*, 249 U. S. 86 (1919).
[21] 301 U. S. 548 (1937).

it did not believe that the Act coerced the states; that it did not unduly usurp the residual powers of the states; and that the states were free to change their social security systems at any time without serious legal consequences.

The same problem of how far the taxing power may be used for regulatory purposes also comes up under "state" enactments. At times the states find it desirable and convenient to utilize the power to tax as a supplement to their police powers. The states in most instances are in a stronger position to do so than the federal government because they possess extensive police powers to regulate many domestic matters relating to public health, safety, morals, and general welfare. But it is still not clear whether the states can regulate under the guise of taxation when they can not do so directly.

A case presenting an issue of that character arose in the State of Washington in 1934. The Supreme Court sustained a tax of fifteen cents per pound levied on all butter substitutes sold within the state.[22] The recognized purpose of that tax was to prevent the sale of oleomargarine within the state and to preserve the butter market for the domestic dairy farmers. The Court reasoned that the due process clause could not be invoked to declare the state law invalid unless the law was so "arbitrary" as to compel the conclusion that it was not an exercise of the taxing power—that it was in fact the exercise of some "forbidden power."

A comparable problem arises when the states attempt to regulate "particular lines of business" by special taxation. The most notable example is in the field of chain store taxation. But here the Court has not been very much concerned about the nonfiscal aspects of the tax as such. It usually raises this issue: Has there been reasonable classification in applying the tax? If there has, the state may tax even though regulatory purposes are patent in the act. The whole issue of chain store taxation is discussed in Chapter 20.

Nonfiscal purposes held invalid. At the federal level the Supreme Court has on a number of occasions declared "invalid" attempts on the part of Congress to regulate by taxation. It has done this in spite of the relatively strong language in the *McCray* and *Doremus* cases on the strength and scope of the taxing power. Twice in our history Congress has attempted to regulate child labor: once by means of the taxing power and once by the use of the commerce power; but in each instance the Court found adequate grounds upon which to declare those attempts unconstitutional.

In 1919 Congress levied a tax of 10 per cent on the net profits of firms which knowingly employed children under sixteen years of age in mines and quarries and under fourteen years of age in mills and factories. The

[22] *Magnano Co. v. Hamilton*, 292 U. S. 40 (1934).

enforcement of the law was to be by both the Treasury Department and the Department of Labor. The law was *challenged* on the ground that it was a "regulation of the employment of child labor" and therefore an invasion of a function exclusively reserved for the states. It was *defended* on the theory that it was a "mere excise tax" levied by Congress under its recognized taxing powers.

But the Supreme Court in the famous "Child Labor Case" held the act unconstitutional.[23] It raised two questions: (1) Does the law impose a tax with only incidental restraint and regulation? or (2) Does it regulate using the so-called tax as a penalty? The Court concluded that the Act was a regulatory act beyond the powers of Congress, with the tax present merely as a penalty for the violation of the child labor regulations; the Court declared that the Act provided a heavy exaction for departure from a detailed course of conduct in business. It described in detail the various regulatory provisions, how each employer's factory was to be "inspected" not only by the Treasury, but by the Department of Labor as well. Then the Court added:

> 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. Its prohibitory and regulatory effect and purposes are palpable. All others can see and understand this. How can we properly shut our minds to it? [24]

The same types of issues arose again under certain "New Deal" legislation whereby Congress attempted to control and regulate various phases of our economic life either under the taxing power or under the commerce clause. The leading case involving the use of the "taxing power" is *U. S. v. Butler.*[25] In 1933 Congress passed the *Agricultural Adjustment Act* which provided for a processing tax to be levied upon the processing of certain basic agricultural products. The proceeds of the tax were to be paid as benefits to all farmers who lived up to the terms of the act and who voluntarily held out of cultivation a certain allotted number of acres of land.

In the *Butler* case, Butler—acting as receiver for Hoosac Mills Corporation—attempted to enjoin the collection of the federal processing tax on the ground that the AAA was unconstitutional. The Court concluded that the act was invalid on two grounds: (1) that it invaded the "reserved powers" of the states to regulate agriculture within their own borders, and (2) that the act was an illegal exercise of the taxing power and spending powers under the general welfare clause. The Court went on to say:

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[23] *Bailey v. Drexel Furniture Co.*, 259 U. S. 20 (1922).
[24] *Ibid.*, 36-37.
[25] *U. S. v. Butler*, 297 U. S. 1 (1936).

> Congress has no power to enforce its commands on the farmer to the ends sought by the Agricultural Adjustment Act. It must follow that it may not indirectly accomplish those ends by taxing and spending to purchase compliance. The Constitution and the entire plan of our government negative any such use of the power to tax and to spend as the act undertakes to authorize. It does not help to declare that local conditions throughout the nation have created a situation of national concern.[26]

In the same year the Court had to rule on another of the "New Deal" acts, *The Bituminous Coal Conservation Act of 1935*. The purpose of the act was to impose a code of fair competition upon the industry. It therefore placed an excise tax of 15 per cent upon the sale of all bituminous coal. However, if the given coal firm complied with the conditions of fair competition, it would be given a credit of 90 per cent of the tax liability. The Court held the act invalid on the ground that the levy was "not an excise tax," but a "penalty" imposed, not for revenue, but to "coerce compliance" with the Coal Conservation Act.[27]

The effect of these decisions denying the use of federal taxes for regulatory purposes is not as significant today as it was at the time the decisions were handed down. Today many federal regulations of our economic life are being upheld under the federal government's broad power to regulate interstate commerce. Furthermore, it can "purchase" compliance to federal regulations under the "general welfare" clause so long as the funds come from the *general revenues* of the government and so long as a tax is *not* used as a *penalty* for noncompliance. In the social security field the Court has permitted the use of an excise to carry out the social purposes of the act.

SECTION II

Special Limitations on Federal, State, and Local Taxation

Special Limitations on Federal Taxation

BROAD as the federal taxing power is, it is not without its limitations. Several specific constitutional limitations which hedge about the otherwise extensive federal power to tax are: (1) taxes may be collected only to "pay the debts and provide for the common defense and general welfare of the United States"; (2) no tax or duty may be laid on articles

[26] *Ibid.*, 74.
[27] *Carter v. Carter Coal Co.*, 298 U. S. 238 (1936).

exported from any state; (3) direct taxes must be *apportioned* among the several states according to population; (4) indirect taxes must be *uniform* throughout the United States; and (5) that portion of the Fifth Amendment which provides that no person "shall be deprived of life, liberty, or property without due process of law" is sometimes interpreted to place qualitative limitation upon the federal power to tax.[1]

In addition, there exist some implied limitations that arise from the basic character of a "federal system." There has developed, therefore, the general constitutional principle that the federal government may not tax the property, agencies, or instrumentalities of the state governments.

THE GENERAL WELFARE LIMITATION

One of the purposes for which the federal government may exercise the taxing power is to provide for the "general Welfare of the United States." This clause is at once a "limitation upon" and an "expansion of" the taxing power, and it has been so used on various occasions in our history. As a limitation it is in effect an inherent restriction upon sovereign power. It has been applied in a restrictive manner to two issues in federal taxation—to "earmarked" and regulatory taxes.[2]

When taxes are levied in the true exercise of the taxing power and the revenue goes into the "general fund," the Supreme Court will not seriously inquire into the character of federal expenditures. However, if the revenue from a given tax is allocated to a particular function or regulation, then the Court will appraise whether or not that function is in fact for the general welfare. If the Court finds that Congress does not have the given power or that the function is not for the general welfare, it declares the act invalid.

This was the position the Court took in the AAA case. The processing tax was allocated to the purposes of crop control: the regulation was, therefore, declared invalid because the objectives of the Act were beyond the power of Congress.[3] Yet in the social security cases, in spite of the fact that the payroll excise tax was specifically earmarked for the purposes of the Social Security Act, the Court was able to find sufficient "general welfare" to uphold these taxes.[4]

At the federal level, a tax to discourage or control some private activity will usually be found as not levied for the "general welfare." This does not, however, prevent highly protective tariffs or specific subsidies to certain social and economic groups within the economy.

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[1] The footnotes in Section II are numbered in a separate series from those in Section I in order to avoid high numbers.

[2] William J. Schultz and C. Lowell Harriss, *American Public Finance* (5th ed.). New York: Prentice-Hall, Inc., 1949, pp. 172-173.

[3] *U. S. v. Butler*, 297 U. S. 1 (1936).

[4] *Steward Machine Co. v. Davis*, 301 U. S. 548 (1937).

TAXES ON EXPORTS PROHIBITED

The Constitution expressly provides that "No Tax or Duty shall be laid on Articles exported from any State." [5] This prohibition is specifically directed at the federal government. At the time of the drafting of the Constitution, it was the Southern states which insisted upon this clause. They were heavy exporters of cotton, tobacco, rice, indigo, and other products; and they feared injury to their economic life if the national government should have the power to tax exports.

What is an export duty? The provision is stated directly and clearly enough, but the difficulty arises as to the definition of an "export duty." The Court has stated as a general principle that an export duty is a duty "directly and closely" associated with the process of exporting goods.[6] A federal tax levied on the export business as such,[7] or on "goods exported" or held "for export" would lie within the prohibition and would not be permitted.[8] The immediate purpose of the Constitutional clause is to grant immunity from taxation to goods in the actual course of exportation, but the realization of that objective has been held to justify extending the scope of the prohibition to include taxes and duties other than those levied directly upon the exports themselves.

DIRECT TAXES MUST BE APPORTIONED

The rule of apportionment. At two different points in the Constitution there exist express requirements that "direct taxes" when levied by the *federal government* must be *apportioned* according to population.[9] Ordinarily, taxes are apportioned over the "tax base" to which they are applied. But it is not with that type of apportionment that the above constitutional provisions are concerned. The apportionment, in the case of direct taxes, must be among the *several states according to population.*

Real estate taxes are direct and must be apportioned. A tax on real estate has always been recognized as a "direct tax" in a constitutional sense. Such a tax is usually levied on a proportional basis upon the assessed valuation of the property. It is very difficult to levy a property tax according to population. The federal government has never been able to do it directly. On the occasions when Congress has attempted to levy a property tax according to the requirements of the Constitution, it has usually had to requisition a given amount of money from each state

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[5] Art. I., Sec. 9, Cl. 5.

[6] *Thames and Mersey Marine Ins. Co. v. U. S.*, 237 U. S. 19 (1915).

[7] *Brown v. Maryland*, 12 Wheaton 419 (1827).

[8] *Turpin v. Burgess*, 117 U. S. 504 (1886).

[9] Art. I., Sec. 2, Cl. 3: "... direct Taxes shall be apportioned among the several States ... according to their respective numbers." Art. I, Sec. 9, Cl. 4: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration...."

(with the apportionment based upon each state's population). And then it has had to require the individual state to levy a "mill rate" on the property large enough to meet the state's quota. Congress has attempted to do this several times in our history (the last time was during the Civil War), but the results have been so poor that this procedure has not been attempted since.

What other taxes are direct? But the problem of federal "direct taxation" does not stop with property taxes because there are other "direct taxes" which it might want to levy. And here again the problem of defining terms arises: What is a direct tax? From the very adoption of the Constitution, capitation and property taxes have been generally recognized as direct taxes. They have, therefore, not created any issue of definition. This has not been true with respect to a number of other taxes.

The first examination of this issue was the Hylton Case.[10] In 1794 Congress had placed a tax on carriages according to their value. The Court sustained the tax. It "doubted" whether an assessment of personal property was a "direct tax." It sustained the carriage tax on the theory that it was a levy on "expense"— i. e., on the "use" of the carriage. Such a tax was an "excise" tax and therefore indirect. It will be recalled that during World War II the federal government levied a "use tax" on automobiles.[11]

CERTAIN FEDERAL SALARIES MAY NOT BE DIMINISHED

There are a number of constitutional provisions not directly related to taxation which have been construed as limitations upon the taxing power. One such clause provides that the salaries of the President and federal judges shall not be diminished during their continuance in office.[12] When income tax acts attempt to tax the salaries of the above officials, the acts come into conflict with these sections.[13] The main reason for the existence of the nondiminution provision has been to insure "judicial independence" by protecting judges against both direct and indirect salary reductions.

However, since the recent depression the federal government has been attempting to broaden its income tax base, and consequently efforts have been made to avoid the effect of these provisions and to tax these officials on their federally-earned incomes. These attempts as finally stated appear in the Revenue Act of 1934 and provide:

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[10] *Hylton v. U. S.*, 3 Dall 171 (1796).

[11] The big controversy on the direct taxation powers of the federal government, however, arose in relation to the income tax. The legal and historical aspects of this issue will be treated in the chapter on the "Economics of Income Taxation."

[12] Art. II, Sec. 1, Cl. 7, and Art. III, Sec. 1.

[13] *Evans v. Gore*, 253 U. S. 245 (1920).

> In the case of Presidents of the United States and judges of the 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.[14]

The original intention of these provisions (to protect the President and federal judges from legislative retaliation on salaries) no doubt was a good one. But in our day, when the income tax is so significant a fiscal instrument, this tax immunity as interpreted by our courts results in a special privilege. However, the amendment of the Revenue Code has been well received, with the result that these officials are now paying income taxes along with all other citizens.

INDIRECT TAXES MUST BE UNIFORM

When the Constitution was drafted, the states and people in effect granted the federal government broad taxing powers, but they also wanted to be sure that they would not be discriminated against in the levy of certain types of taxes. Therefore, there exists a clause in the Constitution which says: "But all Duties, Imposts, and Excises shall be uniform throughout the United States." [15]

This provision gave rise to no serious issues for a long time, because Congress in levying customs duties, and tobacco, beer, and liquor excise taxes made them uniform throughout the country. However, when the federal government began to levy "graduated" income and death taxes, the uniformity clause was invoked by taxpayers in an effort to invalidate progressive tax rates.

The courts have held that the uniformity required under this clause is "geographic" not "intrinsic." Consequently, a graduated tax on legacies and incomes does not violate this provision of the Federal Constitution.[16] Furthermore, the geographic uniformity requires only that the law shall be generally applicable, not that it shall be uniform in its effects upon every state. A federal tax may be levied on a subject such as tobacco manufacturing, which exists in some states and not in others; but wherever tobacco is manufactured the rates must be uniform.[17]

DUE PROCESS OF LAW LIMITATION

The Fifth Amendment contains the "due process clause" which serves as a limitation upon the federal government. It provides that no person shall be "deprived of life, liberty, or property, without due process of law." The courts have not made extensive use of this clause as a limita-

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[14] Sec. 22 (a), *Revenue Act of 1934.*
[15] Art. I, Sec. 8, Cl. 1.
[16] *Bromley v. McCaughn,* 280 U. S. 124 (1929).
[17] *Head Money Cases,* 112 U. S. 580 (1884).

tion on "federal taxing power," although taxpayers have attempted to utilize it on many occasions. As applied to taxation, it requires that the taxes must not be discriminatory; classification is permissible, but it must be reasonable.

The "retroactive application" of a tax will be forbidden under this clause if, at the time of the transaction which occasioned the tax, the taxpayer could not have understood or foreseen the nature of the burden imposed by the tax.[18] This is especially true under gift and inheritance taxes where the donor has changed his position and rights have become "vested" before the retroactive tax law was passed. In situations of the latter kind, the courts hold that the tax is arbitrary and invalid. The courts do not hold the same view on retroactive income taxes, however. Here they usually allow retroactivity within the taxable year, and some courts have even held it valid to the previous year.[19] A federal statute which compelled the inclusion in the estate of the deceased a gift made within two years of death without any opportunity to show that the gift was not in contemplation of death was held invalid as being arbitrary and a taking of property without due process of law.[20]

STATE INSTRUMENTALITIES IMMUNITY FROM FEDERAL TAXATION

The theory of the instrumentalities doctrine. Another limitation upon the federal taxing power which is not expressly stated in the Constitution (but one which grows out of the very nature of our "federal system") provides that the federal government may not tax the agencies and instrumentalities of the several states. The whole theory back of this prohibition is that the federal government and the states are "sovereign" within their respective spheres and that one should not have the right to interfere with the legitimate functioning of the other.

Origins of the immunity doctrine. The first judicial appearance of this so-called intergovernmental tax immunity doctrine was in the case of *McCulloch v. Maryland* in 1819.[21] In 1818 the State of Maryland passed an act taxing the note-issues of "all banks or branches thereof" not chartered by Maryland. This tax legislation was aimed at the Bank of the United States. The United States Supreme Court declared the Maryland tax on the Bank unconstitutional on the ground that no state had the right to tax an agency created by the federal government to aid it in carrying into execution its legitimate powers.

The extension of the immunity doctrine to the states. In the years

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[18] *Nichols v. Coolidge,* 274 U. S. 531 (1927); *Blodgett v. Holden,* 275 U. S. 142 (1927).

[19] *Welch v. Henry,* 305 U. S. 134 (1938).

[20] *Heiner v. Donnan,* 285 U. S. 312 (1932).

[21] *McCulloch v. Maryland,* 4 Wheaton 316 (1819).

that followed, the courts had the tendency to extend the immunity doctrine to protect the agencies and instrumentalities of the states as well, and thus the courts placed a limitation upon the taxing power of the federal government. In the case of *Collector v. Day* [22] the Court held that a state judicial officer was immune from a federally imposed general income tax. The circle was now complete and each sovereign level of government was to be protected in its own sphere.

The Supreme Court held in *Pollock v. Farmers' Loan & Trust Co.* that the federal government could not tax the bonds or the interest on the bonds of state and local governments.[23] In the 1920's the federal courts went so far as to hold that the wages and salaries of the employees of a municipally-owned street railway were immune from federal income taxes.[24] A few years later a federal attempt to levy a manufacturer's excise tax on motorcycles sold to a Massachusetts city was held invalid.[25]

Limitation of the doctrine. However, the Court has placed some "limits" on the immunity of the states from federal taxation. In the situation where a state or local government engages in a business ordinarily looked upon as private, then the salaries and income from such "proprietary interest" are subject to federal taxation.[26] In the late 1930's the Supreme Court reversed itself on the constitutionality of a federal income tax as applied to state and local salaries generally. It upheld the federal taxation of salaries paid by the Port of New York Authority, not on the theory that it was a proprietary agency, but on the premise that the federal tax was "nondiscriminatory." The Court held that Port Authority employees were merely being taxed on the same basis along with all other citizens and that the taxation of the employee could not burden the functioning of the unit of government.[27]

The dissenting opinion in the *Gerhardt* case appraised the decision as overruling a "century of precedents." The next year the Court faced the whole question of the taxation of public employees and officials more squarely. It directly overruled *Collector v. Day* and in effect opened the way for the taxation of federal employees by the states, and state employees by the federal government.[28] The income from state and local bonds is still sheltered from the federal income tax by the old intergovernmental immunity doctrine. It is now believed, however, that *Graves v. O'Keefe* makes it possible to remove the "state instrumentalities

[22] *Collector v. Day*, 11 Wall. 113 (1870).
[23] *Pollock v. Farmers' Loan & Trust Co.*, 157 U. S. 429; on rehearing 158 U. S. 601 (1895).
[24] *Frey v. Woodworth*, 2 Fed. (2nd) 725 (1924).
[25] *Indian Motorcycle Co. v. U. S.*, 283 U. S. 570 (1931).
[26] *South Carolina v. U. S.*, 199 U. S. 437 (1905).
[27] *Helvering v. Gerhardt*, 304 U. S. 405 (1938).
[28] *Graves v. O'Keefe*, 306 U. S. 466 (1939).

immunity" doctrine except as a protection against discriminatory taxes aimed at the performance of recognized state governmental functions.

Conclusions. It is probably true that John Marshall never dreamed that his words in *McCulloch v. Maryland* would become the basis for very extensive immunity from taxation. When the opinion is carefully read, it seems quite clear that Marshall spoke against "discriminatory taxes" that could be a burden upon some essential function of government. The court continued to expand the doctrine right down into the 1920's. Since then it has been withdrawing tax immunity and limiting the exemption.

Federal Constitutional Checks on State and Local Taxation

SOURCES OF LIMITATIONS

The states are sovereign bodies within their respective spheres and therefore possess full and inherent taxing powers. These inherent powers have been limited by their own volition, however. First, they and the people have delegated some of these taxing powers to the federal government; and second, by ratifying the Constitution they have placed themselves under a few basic restrictions. Again, some of these limitations are "expressly stated" in the Constitution, whereas others have been "construed" as limitations by the courts out of the very nature of our federal and constitutional system.

FEDERAL LIMITATIONS ON THE STATES OUTLINED

A number of constitutional and judicial limitations upon the taxing powers of the states and local governments stand out as the most significant. The first two limitations are specifically expressed in the Constitution: (1) no state may levy import or export duties, and (2) no state may levy tonnage duties. Either of these may be done with the consent of Congress, however. Several general restrictions apply to taxation only in an incidental manner: (3) federal treaties are supreme over state taxing powers; (4) no state may pass a law impairing the obligation of contracts; (5) one state may not discriminate against citizens of another state; (6) no state may deprive any person of life, liberty, or property without due process of law; (7) no state may deny the equal protection of its laws to any person within its jurisdiction. Several other restrictions have developed as the result of judicial interpretation of the Constitution and our federal system of government: (8) no state may tax the agencies or instrumentalities of the federal government; (9) no state may tax so as to interfere with interstate commerce; and (10) no state

may tax in such a way as to interfere with certain basic liberties guaranteed by the Constitution.[29]

A careful legal analysis of these limitations and how the courts have construed them should throw substantial light on how "extensive" and "effective" are federal constitutional limitations upon the taxing powers of the states.

PROHIBITION OF STATE CUSTOMS

A state may not, without the consent of Congress, lay duties on imports or exports except what may be absolutely necessary for executing its inspection laws.[30] The power to tax imports is specifically delegated to the federal government. The states may not tax either the business of exporting or the export commodities by any means, direct or indirect. A tax on the "gross receipts" from "the business of exporting" has been held to violate the provision.[31] A general net income tax is no violation, however.

NO TONNAGE TAXES

Another provision of the Constitution enjoins any state from laying any duty on tonnage without the consent of Congress.[32] A tonnage tax is a levy upon ships according to their size and capacity for the right of entering and leaving the ports of a state. The purpose of the prohibition is to strengthen the state restriction on import and export duties. A state, however, is not prohibited from charging for facilities and services furnished to and enjoyed by vessels.[33]

TREATIES SUPREME OVER STATE TAXING POWERS

The treaty-making power of the federal government is very broad. Furthermore, any treaty entered into by the United States is part of the Supreme Law of the land. These principles are necessary in order to give the national government a free and unhampered hand in the conduct of foreign affairs. Therefore, a federal treaty is superior in legal effect to given state tax law. If the federal government enters into a treaty with a foreign country providing for reciprocal nondiscrimination as to taxation of a particular type, then a state tax of that type would be invalid.[34]

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[29] The general pattern of the above paragraph is adapted from Shultz and Harriss, *op. cit.*, p. 178.

[30] Art. I, Sec. 10, Cl. 2.

[31] *Crew Levick Co. v. Pennsylvania*, 245 U. S. 292 (1917).

[32] Art. I, Sec. 10, Cl. 3.

[33] *Keokuk Northern Line Packet Co. v. Keokuk*, 95 U. S. 80 (1877).

[34] *Mager v. Grima*, 8 Howard 490 (1850).

STATES MAY NOT IMPAIR CONTRACTS

That no state shall pass any law impairing the obligation of contract is a specific prohibition in the Federal Constitution.[35] Its impact upon state taxation is only incidental, but the prohibition is relevant in connection with public borrowing and taxation to pay state debts. If a state issues bonds for public purposes and specifically exempts the bonds or the income from taxation, the state cannot abrogate its exemption agreement with respect to the bonds already issued and outstanding. To do so would be a violation of the "impairment clause," because the exemption agreement is a "contract" within the terms of said clause.[36] Likewise, if a state or local government sells bonds to the public under a statute which requires the unit of government to tax sufficiently to meet the obligations on the bonds, it may *not* afterwards fail to tax for that purpose.[37]

NO DISCRIMINATION AGAINST OTHER CITIZENS

The Constitution specifically provides that "the citizens of each State shall be entitled to all the privileges and immunities of citizens of the several states." [38] This clause has been construed as a limitation of the power of any state to discriminate in taxation against the citizens of other states—resident or nonresident. Under it, assessors may not assess the property of nonresidents on a basis different from that applied to the property of state residents.[39]

Peddlers from other states may not be taxed more severely than local merchants merely because of their out-of-state origin,[40] nor may heavier death tax rates be applied to the estates of nonresident decedents than upon those domiciled within the state.[41]

Corporations do not receive tax protection under the "privileges and immunities clause" because they are not recognized as "citizens" within the meaning of that clause. States are, therefore, free to levy heavier and even different taxes upon corporations chartered in other states as compared with those chartered by the home state.

DUE PROCESS LIMITATION UPON THE STATES

Just as the federal government is limited by a due process clause, so are the states. The Fourteenth Amendment provides that *no State* shall

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[35] Art. I, Sec. 10, Cl. 1.
[36] *McCallen v. Massachusetts*, 279 U. S. 629 (1929).
[37] *Van Hoffman v. City of Quincy*, 4 Wall. 535 (1866).
[38] Art. IV, Sec. 2, Cl. 1.
[39] *Beeson v. Johns*, 124 U. S. 56 (1888).
[40] *Ward v. Maryland*, 12 Wallace 418 (1870).
[41] *Smith v. Loughman*, 245 N. Y. 486 (1927). The U. S. Supreme Court in effect upheld this state decision by refusing *certiorari*.

"deprive any person of life, liberty, or property without due process of law." This clause has been used quite extensively in limiting certain types of state tax legislation. It has three definite applications to state tax laws: (1) it serves as a legal buffer against the levy of a tax beyond the territorial jurisdiction of the state or local government; (2) it acts as a limitation upon excessive and confiscatory taxes; and (3) it prevents a state from using arbitrary and unjust methods of assessment, review, and administration that would deny the taxpayer an opportunity to be heard.[42]

Due process and jurisdiction to tax. Due process as a limitation upon the taxing power of the states is valuable in preventing a state from taxing beyond its jurisdiction. In the case where the subject matter has a determinable geographical location, the application of the limitation is direct and effective. But with the development of a whole host of intangible property which is movable, the determination of the "location" is not simple; the courts have had to work out a doctrine of legal situs, and then due process is enforced in relation to legal situs. Even so, the courts have permitted some types of intangible property to have more than one legal situs (and therefore subject to taxation in more than one jurisdiction without a violation of due process).

Another issue involving jurisdiction and due process as a limitation arises in connection with the taxation of a foreign corporation. When is a foreign corporation "doing business" sufficiently within a state to give that state the jurisdiction to tax the corporation as such? Isolated acts performed by the corporate entity within a state have usually been held insufficient to bestow jurisdiction. Incidental acts unconnected with the main purpose of the company fail to establish jurisdiction. Mere ownership of property by a foreign corporation in a state will not produce jurisdiction to tax the "corporation as such."

Due process and confiscatory taxation. Due process of law is seldom called upon as a defense against confiscatory state and local taxes. This is so because from their inception our federal courts have held that when the power to tax exists, the "degree" of the burden is a matter for the legislature, provided the classification is reasonable. On a few occasions the courts have held that certain taxes were "too heavy" under the circumstances so as to amount to "taking of property without due process of law."

A strong case of a violation of "due process" arose when a state attempted to tax the income of the husband in such a way as to include the income of his wife. The court maintained that one person's tax could not be measured by reference to another person's income. Any

[42] Shultz and Harriss, *op. cit.*, p. 181.

attempt to collect the entire tax from the husband would clearly be a violation of due process.[43]

Due process and tax procedure. The due process clause is valuable as a limitation in connection with tax administration and procedure. It requires that there be a formal act of assessment, that the assessment be made a matter of record so that the taxpayer can inform himself of the fact and the amount of the assessment.[44] Finally the taxpayer must have an opportunity to appear before some board of review and present his case against the assessment.[45] Any failure to allow this would be a violation of "procedural due process of law." A similar violation occurs when a state inheritance tax law conclusively presumes that all gifts made within six years of death are in contemplation of death and therefore taxable under death taxes.[46]

STATES MAY NOT DENY EQUAL PROTECTION

Another clause of the Fourteenth Amendment provides that no state shall "deny to any person within its jurisdiction the equal protection of the laws." It is usually invoked by taxpayers and applied by the courts against arbitrary or hostile discrimination based upon no reasonable differences. The courts, however, are reluctant to invalidate a state or local tax law as arbitrary. If any logical basis for the tax classification can be found, the courts will tend to uphold the state tax.[47] Furthermore, the difference serving as the basis for classification need not be substantial so long as it bears a logical relation to the permitted purposes of government.

FEDERAL INSTRUMENTALITIES IMMUNITY FROM STATE TAXATION

Theory of the doctrine. Just as the federal government may not tax the agencies and instrumentalities of the states, so the states may not tax those of the federal government. This legal theory had its origin in the famous case of *McCulloch v. Maryland* discussed briefly in the earlier section on the state instrumentalities limitation.

In 1816 Congress had chartered the Second United States Bank. Part of the stock in the bank was owned by the United States government. The bank set up branches in a number of cities including Baltimore, Maryland. It had been authorized to issue bank notes. Maryland passed an act taxing the note issues of all banks not chartered by itself. This act directly affected the note issue power of the federally-chartered bank.

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[43] *Hoeper v. Tax Commission of Wisconsin*, 284 U. S. 206 (1931).
[44] *Illinois Central Railroad Co. v. Kentucky*, 218 U. S. 551 (1910).
[45] *Turner v. Wade*, 254 U. S. 64 (1920).
[46] *Schlesinger v. Wisconsin*, 270 U. S. 230 (1926).
[47] *Butler Brothers v. McColgan*, 315 U. S. 501 (1942).

The Court held the tax on the Second United States Bank unconstitutional on the theory that the tax interfered with a legitimate function of the federal government. Such power in the hands of the states would make them capable of "arresting all measures of the government and of prostrating it at the foot of the states." Speaking for the Court, John Marshall reasoned that the Constitution and the laws made in pursuance thereof were "supreme," that they controlled the constitutions and laws of the states, and that they could not be controlled by the latter. "The power to tax involves the power to destroy." [48]

The Court recognized, however, that the limitations imposed upon the states did not prevent them from taxing the "real property" of the bank in common with all other real property within the state. Carefully analyzed, the decision appeared to be opposed to "discriminatory taxes" directed at agencies of the federal government, but not to apply to general, "nondiscriminatory taxes."

Extension of the doctrine. In 1842 it was held that federal employees were exempt from state taxation on their federal salaries.[49] For years the Court kept expanding the doctrine. After the Civil War, national banks chartered by the federal government were immune from state taxation except as permitted by Congress. Federal bonds and the interest from those bonds are immune from state taxation.[50] Federal property is clearly exempt.

The reduction of the doctrine. In recent years, the courts have begun to narrow the exemption of federal instrumentalities. Independent contractors can no longer claim exemption on their compensation for work done for the federal government.[51] Working for the government on an independent contract does not make a contractor an "agency" of the federal government. As a result of several decisions, since 1939 the immunity of federal officials and employees from state income taxes has been removed. The Court held that these income taxes were general and nondiscriminatory and could not possibly burden the functioning of the federal government.[52]

The most serious blow to this immunity doctrine came during World War II when Alabama placed a sales tax upon the sale of goods generally in the state and then compelled a contractor for the government to pay sales taxes on materials and supplies used on a government contract. Here, definitely, the sales tax increased the cost of the federal government. But the Court said the tax was general and nondiscriminatory and

[48] *McCulloch v. Maryland*, 4 Wheaton 316 (1819).

[49] *Dobbins v. Commissioners of Erie County*, 16 Peters 435 (1842).

[50] *Weston v. Charleston*, 2 Peters 449 (1829); *Missouri ex rel Missouri Insurance Co. v. Gehner*, 281 U. S. 313 (1930).

[51] *James v. Dravo Contracting Co.*, 320 U. S. 134 (1937).

[52] *Graves v. O'Keefe*, 306 U. S. 466 (1939); *State Tax Commission v. Van Cott*, 306 U. S. 511 (1939).

that the indirect increased cost was the natural result of our federal system of government.[53]

STATES MAY NOT INTERFERE WITH INTERSTATE COMMERCE

The theory of the doctrine. There exist no express prohibitions against state taxation of interstate commerce. However, as the result of judicial construction there are a number of implied limitations upon state powers to tax interstate and foreign trade. These limitations upon the states are inferred from the fact that the Constitution specifically grants to Congress the power, "to regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes." [54]

The judicial growth of the doctrine. Again, it has been the courts which have attempted to define the interstate limitations upon state taxing power. To the disadvantage of state and local revenue sources, for a number of years the courts seemed to protect, almost jealously, the federal right to control interstate trade. In recent years, the courts have been more liberal in allowing the states to exercise their taxing powers in relation to property, income, sales, and business that is associated with activity across state lines. This has been especially true where the tax has been "nondiscriminatory" and where there has existed a logical basis for a state to claim the right to some revenue because of benefits bestowed, privileges granted, or costs incurred. However, the general rule still remains that any state or local tax which directly or indirectly discriminates against such commerce as a business or against goods moving in interstate commerce is unconstitutional.[55]

Property used in interstate commerce. What is and is not interstate commerce is one of the basic issues that usually has to be decided on the facts of the particular case. The states have the right to tax "property used" in carrying on interstate commerce—that is, the part of it which comes within their jurisdiction (such as railroad property, trucks, and buses). Such property may be taxed under a general tax which is "nondiscriminatory." A state may tax the gross receipts of a railroad *in lieu* of a property tax, but it probably may not tax both.[56] However, a state may tax only that part of the property or gross income of the railroad company as can reasonably be "apportioned" to the jurisdiction of that state.[57]

[53] *Alabama v. King & Boozer*, 314 U. S. 1 (1941); Contra, *U. S. v. County of Allegheny*, 322 U. S. 174 (1944). In the latter case, however, federal property leased to a private corporation was held immune from a local property tax.

[54] Art. I, Sec. 8, Cl. 3.

[55] *Brown v. Maryland*, 12 Wheaton 419 (1827); *Hale v. Bimco*, 306 U. S. 375 (1939).

[56] *Oklahoma v. Wells Fargo*, 223 U. S. 298 (1912); *Nashville Chattanooga & St. Louis Ry. v. Browning*, 310 U. S. 362 (1940).

[57] *Fargo v. Hart*, 193 U. S. 400 (1904); *Johnson Oil Refining Co.*, 290 U. S. 158 (1933).

Business in interstate commerce. A state may tax the business net income of a corporation engaged in interstate commerce, in the case where it does both interstate and intrastate business; but the tax must be fairly apportioned to the intrastate activity. However, if the corporation does no intrastate business, the interstate business alone cannot be burdened with a corporate net income tax.[58]

Even a gross income tax on corporations engaged in interstate commerce is permissible if the tax is specifically allocated to the business within the jurisdiction of the state. Recently the Indiana gross income tax as applied to the International Harvester Co. was upheld.[59] In 1947, however, the Court held that if a gross receipts tax did in fact *burden or interfere* with interstate commerce, it would be invalid "even though" it was "nondiscriminatory" in its purpose.[60]

Recently the Court has upheld a franchise tax on a pipeline company engaged exclusively in interstate oil-pumping. The Court reasoned that the tax could be justified on the theory of protection and benefits received from the state through which the pipeline passed.[61]

Goods in interstate commerce. The general rule is that goods moving in the channels of interstate commerce may not be taxed by the several states, even though the tax is a general and nondiscriminatory one. Goods on their way and which have not arrived at their destination [62] and commodities in foreign commerce still in their "original packages" [63] may not be taxed by the states. However, once such goods come to "rest" (or anytime after sale within the state has been completed), they may be taxed.[64]

Sales, uses, and interstate commerce. A state may not place a "sales tax" on exports and imports over its borders even though the sales tax is a general one which covers with equal impact all sales within the state. A recent Tennessee case so held. The Court said that a sales tax is a tax on the freedom of purchase and an interference with the flow of interstate commerce.[65] However, when goods are bought at retail outside the state and brought into the state, then the state has the right to tax the "use" of those goods. This is a tax upon the privilege of enjoying them within the state.[66]

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[58] *Alpha Portland Cement Co. v. Massachusetts*, 246 U. S. 203 (1925).

[59] *International Harvester Co. v. Indiana*, 322 U. S. 340 (1944); See also *Freeman v. Hewitt*, 329 U. S. 249 (1947).

[60] *Joseph v. Carter & Weeks Stevedoring Co.*, 330 U. S. 422 (1947).

[61] *Memphis Natural Gas Co. v. Stone*, 68 S. Ct. 475 (1948).

[62] *Sonneborn Bros. v. Cureton*, 262 U. S. 506 (1923).

[63] *Burke v. Wells*, 208 U. S. 14 (1908).

[64] *Sonneborn Bros. v. Keeling*, 262 U. S. 506 (1923); *Minnesota v. Blasius*, 289 U. S. 717 (1933); *Southern Pacific Co. v. Gallagher*, 306 U. S. 167 (1939).

[65] *McLeod v. J. E. Dilworth Co.*, 64 S. Ct. 1023 (1944).

[66] *Henneford v. Silas Mason Co.*, 300 U. S. 577 (1937).

State Constitutional Checks Upon State and Local Taxation

THE SOURCES OF THE LIMITATIONS

In their tax legislation, state and local governments must consider "state constitutional limitations" as well as those in the National Constitution. The states have broad "residual powers" to tax all persons and property within their respective jurisdictions, subject to the above types of limitations. The states in turn have the power to create subordinate units of government (cities, counties, villages, etc.), but these units have only such taxing powers as are expressly granted to them by the state constitutions and legislatures.

Several states place no constitutional limitations upon the state and local taxing power; it is left to the legislature to exercise discretion in this matter. One state, Louisiana, has gone so far as to place the entire state and local tax system into its constitution. Some state constitutions specifically prohibit particular types of taxes. The poll tax is so prohibited in a few states.

TYPES OF STATE CONSTITUTIONAL LIMITATIONS

Some of the more common restrictions existing in state constitutions today are: (1) requirement of equality and uniformity in taxation; (2) taxation according to value; (3) limitations on tax rates; (4) injunctions against double taxation; (5) taxation for public purpose only; and (6) limitations on the delegation of the taxing power.

EQUALITY AND UNIFORMITY REQUIREMENTS

Nature of uniformity clauses. Probably the most common and the strongest of the requirements in state constitutions is that of "equality and uniformity." Some states require both; some only one—"uniformity"; others require both "proportionality" and "uniformity."

In many states, the "uniformity" restrictions apply *only* to general property taxes. In a number of states, including Texas, the state constitutions provide that the rule of taxation shall be uniform as applied to "other taxes" as well. In some states (Georgia, for example), the same result is reached by "judicial decision" in interpreting the state constitution. The courts in two other states, Washington [67] and Illinois,[68] have extended the uniformity limitation to other taxes by construing taxes on the income from property as taxes on the property itself.

Meaning and effect of uniformity clauses. What is the meaning and effect of these "uniformity" clauses in state constitutions? They bas-

[67] *Culliton v. Chase*, 174 Wash. 363 (1933).
[68] *Bachrach v. Nelson*, 349 Ill. 579 (1932).

ically relate to the "rate" of taxation; where they refer to property taxation, they require that the rate on property must be uniform within each taxing district. The limitation definitely *rules out* "graduated rates" in property taxation. In those states where the limitation applies to other taxes, it may make graduated income taxes legally impossible.

Next, these clauses relate to the "tax base"—that is, to the kind of property and to the ratio of the "assessed value" to the "true value." Here uniformity requires that all property be treated alike, regardless of type, and that the ratio of "assessed value" to "true value" must be the same for all property within each taxing district. This very often precludes the classification of property according to kind and prevents a differentiated tax treatment based upon economic characteristics.

MISCELLANEOUS STATE CONSTITUTIONAL RESTRICTIONS

Mention should be made of some of the other state constitutional restrictions. It is quite common to find that property can only be taxed "according to the value," and in no other way. Some states require that property assessment shall be based upon "fair market value." Since the depression years, a number of states have placed *limitations* upon property "tax rates" that can be levied. Many states attempt to avoid the inequities of double taxation of the same tax base by positive prohibitions against such taxation. Many states have specific "public purpose" clauses in their constitutions. Finally, a number of states want to be sure that the taxing power remains in the hands of the chosen representatives of the people in the legislative bodies. Their state constitutions, therefore, contain specific limitations on the "delegation" of the taxing power to executive and administrative agencies.

Conclusions

IT IS HIGHLY ESSENTIAL that the tax student and layman have a "working knowledge" of the legal and constitutional aspects of taxation. Constitutions, statutes, and court decisions are the very vehicle and framework within which taxes are cradled and administered. The study of taxation in the United States is complicated by the fact that we have a *federal system* of government with two layers of "sovereign governments" and two layers of "written constitutions." That means that each must respect the sovereign powers of the other.

Because there are two layers of written constitutions, there are also several layers of constitutional limitations. There are: (1) federal constitutional limitations upon the federal government; (2) federal limitations upon state and local governments; and (3) state constitutional limitations upon state and local governments.

It must also be remembered that it is the function of the courts to interpret and apply the constitutional limitations to the tax statutes as the issues arise. The decisions of the courts on many issues have been neither clear nor consistent—a matter which further complicates the understanding of American taxation.

This chapter has endeavored to present and analyze only the more fundamental constitutional principles and limitations of taxation. These and other principles will be discussed in effective detail in later chapters that deal with particular taxes.

3

The Economic Foundations of Taxation · THE SELECTION OF REVENUE SOURCES AND DISTRIBUTION OF THE TAX BURDEN

NOR IS IT *sufficient that a tax system shall be substantially just; it ought to be generally recognized as such.... The establishment of general principles on this point for the guidance of financial policy and their recognition by the people in general are so eminently desirable, that the investigation of the grounds on which taxation should be distributed is a work of utility in the narrowest practical sense.*

—C. F. BASTABLE.[1]

Overview

THE STATE is predominant in satisfying "common wants," that is, those wants which must be satisfied through group organization and activities. But in satisfying these wants and apportioning the costs, the state operates differently from private enterprise. In the first place, membership is more compulsory and thus contributions are compulsory if the state so chooses. In the second place, the benefits of the services it performs are usually indivisible and immeasurable. In the private enterprise system there is a price for each commodity or service that is bought. Each person pays that price if he wants the service. But on what basis may government distribute the costs of such services as police protection and education which benefit the whole community?

Because public expenditure is absorbing an increasingly large proportion of our national income, it is extremely important to the general welfare of society "what" revenue sources are used for financing public expenditures and "how" their burden is distributed among the economic groups and individuals in our economy. Without the development of some principles or guides, taxation would be completely at the whim of

[1] C. F. Bastable, *Public Finance* (3rd ed.). London: Macmillan & Co., Ltd., 1922, p. 296.

administrators or legislators and the compulsion of special-interest groups. Such principles of taxation have been developed through the years, and they have greatly increased in both complexity and number the famous four canons of Adam Smith.[2]

It shall be the function of this chapter to analyze and discuss: (1) basic factors to be considered in selecting sources of revenue; (2) the principles of apportioning governmental tax burdens; and (3) ways of setting up tax "rate" *structures* or *scales* so as to achieve particular patterns of distribution of the tax burden.

Principles for the Selection of Tax Sources[3]

JUSTICE IN TAXATION

At least as far back as Adam Smith and English constitutional law of the eighteenth century, there has prevailed the notion in Anglo-Saxon nations that taxes ought to be fair, equitable, and just. But justice as an "ethical" concept is largely subjective. Most concepts of justice, however, have something in common. They usually imply ideas of relative equality and lack of discrimination. Out of these notions the courts have developed the "working rules" of justice in American taxation.

Legal justice: reasonable classification. The Supreme Court of the United States has forbidden certain types of discrimination in taxation by means of its doctrine of "reasonable classification." In a famous decision, Supreme Court Justice Bradley declared: "... clear and hostile discriminations against particular persons and classes... might be obnoxious to the constitutional prohibition."[4] The constitutional prohibition referred to was the equal protection clause of the Fourteenth Amendment of the Federal Constitution. Later decisions have sanctioned any classification which has a "reasonable relation to some permitted end of governmental action. It is enough, for instance, if the classification is reasonably founded in the purposes and policy of taxation."[5] These decisions mean that people may be classified only where public policy can constitutionally and legally recognize certain differences. People regarded alike must be treated alike. Redheads cannot be taxed more than blonds merely because they are redheads. It is reasonable classification, however, to

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[2] Adam Smith's four canons, similar to those of German Cameralist Johann Von Justi and reflecting the sentiments of the day, are found in his *Wealth of Nations*, 1776, Book V. They are abridged: (1) proportional to one's ability, (2) certain and not arbitrary, (3) convenient to pay, and (4) economical to collect.

[3] The "principles" have been variously called canons, guides, goals, standards, ideals, criteria, and maxims.

[4] *Bell's Gap Railroad Co. v. Pennsylvania*, 134 U. S. 232 (1890).

[5] *Heisler v. Thomas Colliery Co.*, 260 U. S. 245 (1922).

graduate a personal income tax according to net income and to exempt those in the lower income groups, or to make a distinction in taxation between different industries, such as the anthracite and bituminous coal industries, or the butter and oleomargarine industries. All such classifications have a "reasonable relation" to the permitted purposes of government.

ADEQUACY OF YIELD

Probably the most important administrative principle is that the tax system should be devised so as to yield adequate revenue to carry on the authorized activities of the government. Without such yield, the government will be either forced to suspend its activities below the level of maximum social benefit, or it will be forced to borrow or print money to finance these activities—both of which actions are undesirable as a consistent policy. The great difficulty today, in times of greatly expanded governmental services at all levels, is in preventing "adequacy" from becoming the "whole criterion."

The taxes giving the largest yields today on the federal level are the personal net income tax and the corporate net income tax. During the war, excess profits taxes also yielded a large amount of revenue. On the state level the general sales tax, motor fuel sales tax, and individual and corporation income taxes are the most bountiful revenue raisers. On the local level, the property tax is the old standby, but this has recently been supplemented by such other revenue raisers as retail sales taxes and low flat-rate income taxes in some municipalities. High yields depend upon income conditions in the economy, the quality of administration, and public co-operation.

FLEXIBILITY OF YIELD

Related to the problem of adequacy of yield is that of flexibility of yield. This refers to the ability of a tax to yield more in prosperous times and in times of unusual need. Although flexibility has been made a criterion of a good tax or tax system, no agreement has been reached as to the degree of flexibility desirable at any particular level of government. This is because the degree of flexibility depends upon a number of things. It depends upon the *costs* of services in prosperity and depressions, the *volume* of services including expanded welfare services during depressions, and the *methods* chosen to finance these services, whether by taxation, borrowing, or accumulated reserves. It depends in addition upon the part which each governmental unit is to play in over-all fiscal policy and the extent to which state and local expenditures will be paid for by grants-in-aid.

Flexibility may be achieved in two major ways. The first is by "cy-

clical sensitivity" of a tax or tax system, sometimes called built-in flexibility, which means the power of increasing yield on the upswing of a business cycle without a change in rates. The other method is by "elasticity" or the ability to change the amount of revenue appreciably with a change in rates. As applied to the tax system as a whole, elasticity refers to the ability to expand the tax system quickly through changes in methods of taxation, rates, and bases in times of need. Net income taxes appear to satisfy best the needs of cyclical sensitivity, whereas net income taxes, sales taxes, and property taxes all have a large elasticity of yield with a change in rates.

STABILITY OF YIELD

Stability of yield is the opposite of flexibility of yield. In times of depression, sufficient stability of yield to pay for governmental expenditures was once considered desirable. However, with the concept of a managed fiscal policy, not accepted by all economists and public finance experts, the stability ideal has lost ground to that of flexibility of yield, especially on the federal level. On the local level stability of yield still is a prime requisite, and it probably will remain so until such a day as local fiscal policy is co-ordinated with that of the federal government or until state aid in times of depression suffices to offset the need for stability. During the depression of the 1930's, even the general property tax lacked stability of yield because of the large volume of delinquencies. It thus seems that stability of yield needs to be considered in relation to the tax system as a whole; it needs to be achieved, when desired, by an elastic tax system which can be expanded or contracted as conditions warrant.

ADAPTABILITY

Adaptability refers to the ability to adjust the tax system to changes in economic conditions, fiscal policy, politics, ethics, and social expediency. It is related to (but is not the same as) elasticity. One of the greatest criticisms of taxation on the state and local levels is that the tax systems are rigidly bound by constitutional provisions which prevent alterations suitable to changed conditions. Of particular vulnerability to attack are the uniformity and equality provisions in state constitutions which prevent progression in rates and which greatly restrict classification of property for purposes of taxation. Then, too, there are the rigid state restrictions on local tax sources, only recently being loosened, which prevent the local units from complying with their new needs for revenue. This lack of adaptability in many instances is further complicated by extensive constitutional tax exemptions, especially in relation to property taxation, which reduce the "tax base."

TAX NEUTRALITY

One of the most recently developed principles of taxation proclaims that taxes should be as "neutral" *in their effects* as possible. It is admitted that all taxes have effects, and this leads to the question: In what respects should a tax be "neutral"? There have appeared at least three different concepts of neutrality.

1. The "leave them as you find them" principle argues that a tax should not change the rank in which a person stands in the hierarchy of wealth and income. The principle is justified on the basis that human satisfactions and economic incentives will be less affected if people are permitted to retain the same "relative" economic and social rank after taxation as they had before.

2. A second definition of neutrality is "taxation that does not alter the allocation of resources." [6] This concept of neutrality is justified because it results in *beneficial effects* upon the morale of taxpayers, in the *optimum allocation* of resources, and in the *maximum satisfaction* of consumers.[7]

3. Neutral taxation has recently been defined also as that taxation which makes the tax burden "independent of choices made or actions taken" by the taxpayer. It would seek to minimize the decisions made merely because of the "tax consequence" involved. For example, under the income tax, neutrality would require that the tax burden be made independent of the time of realization of income, of changes in investment channels, of methods of earning a livelihood, and the like. The justification of such a concept of neutrality is the prevention of widespread avoidance and undesirable economic repercussions which would otherwise limit the degree of progression in the tax system.[8]

Tax neutrality of the second and third varieties is a desirable objective in tax policy. Clearly we should not encourage unwise allocation of resources by tax policy, nor should tax policy become so all-controlling that individual and business units would gauge all their business and economic decisions by "tax consequences." Every effort should be made to achieve as large a measure of tax neutrality as is reasonably possible.

A number of other very important factors in selecting revenue sources are usually considered at this point. These are the principles, however, that are related to tax administration and tax compliance. In this book, they will be dealt with in the chapter on tax administration.

[6] Discussed in *Carrier Taxation*, a report of the Board of Investigation and Research, House Document 160, 79th Congress, 1st Session, 1944, pp. 46-47 and 350-351. Definition reaffirmed by a committee of the National Tax Association under Carl Shoup as chairman, *Proceedings of the National Tax Association*, 1946, pp. 71-103.

[7] Harold M. Groves, "Neutrality in Taxation," *National Tax Journal*, 1:18, March 1948.

[8] The development of this type of a relatively "neutral" tax system is attempted with originality in William Vickrey, *Agenda for Progressive Taxation*. New York: The Ronald Press, 1947, pp. 214-215.

les for the Distribution of Tax Burdens

ANOTHER SET OF PRINCIPLES which must be considered in selecting revenue sources is the group which has to do with apportioning the tax burdens among the citizens. This set of principles deserves separate and special consideration because "how the tax burdens should be distributed" is a basic problem in tax policy and is a very controversial one in the political and social arena. The principles which have evolved should be accurately stated, carefully analyzed, and objectively appraised. The two basic principles that now seem to predominate in democratic countries are *benefits received* and *ability-to-pay*. Several other supplementary principles will also be reviewed.

THE BENEFITS RECEIVED PRINCIPLE

The benefits received principle stated. This doctrine declares that tax burdens should be apportioned according to the benefits persons, property, and economic institutions receive from government. In the private markets all goods and services bear a price tag which expresses the economic value in terms of money. There is a presumption in the market that "one pays for what he gets" and that "he gets what he pays for."

Since the general theory of public services is that the citizens as a group pay for the services of government, then it would seem only fair and logical that each person should pay for the benefits that he receives at the hands of government. This should be especially true in relation to "those services" that can be *distinguished* from those which are clearly for the "common good"—those in which the individual benefit is reasonably discernible and measurable.

Benefits received appraised. The big difficulty, however, in the application of this principle to most of the services rendered by government is that there is no exact calculus by which the values received by any one individual can be measured. Who, for example, benefits most from fire protection? Those whose homes begin burning and are saved by the firemen? Or all those whose homes receive "standby protection" from the fire department? The same can be asked of the police department, of national defense, of traffic regulation, of general public education—in fact, of most of the thousand and one services performed by government. Again, who receives the greater benefit from government, the rich or the poor? How will such benefit be measured?

Another difficulty in the application of the doctrine is that many of those who receive benefits from government are not able to pay for them. For example, under our humanitarian policy we provide homes and various types of charitable institutions for the aged and for orphans, and we provide other benefits which cannot be completely paid for by the

recipients. Furthermore, state benefits are usually compulsory, so that citizens cannot refrain from buying them.

Benefit principle valid in some areas. The application of the benefits received principle is thus restricted to permitting taxation only by governmental units which perform services for the subject of the tax and to the use of fees and licenses for "special services" performed which are predominantly of an individual rather than a social benefit (such as garbage collection fees, hunting licenses, marriage licenses, and the like). Such charges thus closely resemble the free market determination of prices. One prominent source of special benefit charges is found in the "special assessments" made by local governments on property, usually according to some measure of front-footage, often varied according to the distance from the improvement, for such services as sewer installations and street and sidewalk paving. The point is that there are areas in our tax system where the benefits principle can and should be applied. The weaknesses of the principle do not invalidate it completely. As the over-all principle, however, it should not be controlling in our day.

COSTS INCURRED

A close relative but distinct from the benefits received principle is the "costs incurred" principle of taxation. According to this principle, individuals or business units should be taxed according to the costs incurred by government in dealing with them, even though the costs incurred do not particularly measure the benefits which the individual or business unit receives. Thus, corporations would be taxed according to the governmental costs of regulating them. Frequently the costs incurred coincide with the benefits received, as in many special assessments and service charges.

THE ABILITY-TO-PAY PRINCIPLE

The ability-to-pay principle stated. One of the most influential and yet most-widely-debated tax doctrines today is the ability-to-pay principle. The theory asserts that each person should contribute to government according to his ability to do so. In other phases of our private lives, by custom and habit we have the tendency to require persons to contribute according to their means. This is generally true within the family, the church, and charitable and social groups. Why not apply the same principle in apportioning governmental burdens?

As in the case of benefits received, ability-to-pay is not amenable to any easy calculus by which to measure the purported ability. There is no consensus of what the standards ought to be. Several criteria present themselves. Some would accept property and wealth as the test of ability. Others advocate the "volume of expenditure," and still others emphasize

income as the truest measure of ability. The more pragmatic tax philosophers present an eclectic standard of a combination of all three.

Even after a given basis is agreed upon, definitions of "wealth," "income," and "expenditure," as the case may be, raise problems of clarification. Then, too, there is always the problem of the rapidity with which the tax rates ought to advance as the property, income, or expenditure base increases. Some would seek even further criteria: they would want to measure the "quality" as well as the "quantity" of the ability based upon the "ease" with which the particular ability is acquired. Is it acquired through the rendition of "personal services" with its human vulnerability and depreciation of human resources? Or is it acquired through the holding of property, business assets, or natural resources? All these issues must be wrestled with by our legislators as they attempt to frame our tax laws and policies.

Ability-to-pay justified. For many years, the tax theorists have endeavored to define ability-to-pay and to justify it by the elements that go into it or the purposes to be accomplished by it. The ability principle stated by Adam Smith did not clearly indicate by what measure the ability was to be determined. It was not until later that John Stuart Mill brought forth the "sacrifice" or subjective element of taxation and declared it to be one of the elements entering into ability. Later still, an objective element of taxation called "faculty" was formulated by Professor Seligman and other writers. Although Bastable makes a distinction between "ability" and "sacrifice," the prevailing concept of ability-to-pay today includes both subjective sacrifice and objective faculty as its component elements.[9] Therefore, ability-to-pay is usually justified under the following theories:

1. *Sacrifice theories.* Sacrifice theories of ability to pay include such measuring sticks of justice as "proportional sacrifice," "equal or equal relative sacrifice," and "minimum or equi-marginal sacrifice." Such theories of sacrifice in recent years have been explained in terms of the diminishing marginal utility of income. Income is asserted to have a diminishing marginal utility to the possessor as the amount of it increases. The marginal dollar of a higher income is believed to have less utility to the owner than the marginal dollar of a lower income. Taxing higher incomes thus results in less personal sacrifice per dollar taken than taxing the lower incomes.

Two of the sacrifice principles compare *individual* sacrifices. According to the principle of proportional sacrifice, the direct real burden on every taxpayer should be *proportionate* to the benefits he receives from the income. According to the principle of equal or equal relative sacri-

[9] C. F. Bastable, *op. cit.*, p. 301.

fice, the direct money burden of taxation should be distributed in such a way that the direct *real* burden on all taxpayers is *equal.*

The third sacrifice principle examines the *total* of individual sacrifices. According to the principle of "minimum sacrifice," the burdens of taxation should be so adjusted that the *total sacrifice upon society* is at a minimum. This carried to its logical conclusion results in equi-marginal sacrifice, so that a tax system in accord with such principles would have relatively high exemptions and an almost complete confiscation of income above the exemption level.

The sacrifice theories have frequently been used to justify progressive taxation. Whether this is valid depends upon the rapidity of decrease in the marginal utility of income. To justify progressive taxation, the principle of equal sacrifice requires a more rapid decline in marginal utility than does the principle of proportional sacrifice. The principle of minimum sacrifice will result in steeply progressive taxation if it is assumed that the marginal utility of income decreases at all.

The group theory of minimum sacrifice, however, has been severely criticized because of alleged theoretical fallacies. It is argued that the concept of diminishing marginal utility arose in economic theory as an explanation of demand for consumption goods. When the marginal utility approach is applied to taxation, it must be related to money and income—not to specific goods and services. Ability-to-pay taxes are not levied upon goods and services.

The higher incomes are used for both "consumption" and "investment." On the consumption side, the marginal utility of income for furs, diamonds, beautiful automobiles, and so on may actually increase as income rises. Furthermore, there are strong individual differences as to the marginal utility of income; these range from the relative indifference of the hobo to the high desires of conspicuous consumers and the greed of misers.

On the investment side, for those in the higher brackets the marginal income possesses a high marginal efficiency for investment purposes. Their desire to invest in stocks, bonds, and other active investments is highly significant because the people in these income brackets do not ordinarily consume all that they receive. There is a serious question as to whether income of this type declines in importance as large amounts of it are acquired.[10]

2. *Faculty or earning power.* The objective side of ability is generally considered to be the principle of "faculty." It comprehends both

[10] M. Slade Kendrick, "The Ability-To-Pay Theory of Taxation," *American Economic Review,* Vol. 29, March 1939, pp. 90-101; see also Henry C. Simons, *Personal Income Taxation.* Chicago: University of Chicago Press, 1938, pp. 6-15. *Cf.* David McCord Wright, "Income Distribution Reconsidered" in *Income, Employment and Public Policy,* Essays in honor of Alvin H. Hansen. New York: W. W. Norton & Co., 1948, pp. 159-176.

the power of earning an income and the power of supporting government. It is generally recognized that "money makes money," that the more income a person has, the greater will be his power of making still more. Money works for him. On the other hand, the more income a person has, the greater his ability to support his government. This comes close to the doctrine of saying "where the money is, there tax it"; such is frequently the sole interpretation of ability to pay by those who claim, for example, that corporations have a great amount of ability to pay. Actually, this latter interpretation of faculty is a narrow social expediency doctrine rather than an ethical one.

3. *Privilege or advantages enjoyed.* The principle of "privilege" is sometimes used in support of the doctrine of ability to pay in that the "privileges" enjoyed contribute to ability to produce. The principle asserts that a person's taxes should be related to the amount of "privilege" he receives from his government and from his social environment, the stability of which is largely maintained by government. In its narrow sense, the principle of privilege cannot be distinguished from the principle of benefits received, and the same arguments apply to it as apply to the benefits received principle. In its broader sense it overlaps the principle of "unearned income" in that a large proportion of the fruits a man receives are not solely a result of his own efforts but are in part the results of the environment in which he works and in part the result of his social inheritance. It overlaps, too, the state-partnership doctrine, in that a state is a partner in all that is produced under its jurisdiction.

4. *Conservation of purchasing power.* It is often argued that the application of the ability-to-pay principle makes it possible to leave a larger volume of purchasing power in the hands of the lower-income groups and thus sustains the market and demand for goods and services. There are those who contend that strong consumption and demand are a condition precedent to high levels of investment, production, and income. Without high levels of consumption and demand, they argue, unemployment of men, plants, and equipment will follow. Those with the greatest propensity to "consume" are those in the lower brackets of income, and they make up a large percentage of the total population. Therefore, anything that the tax system can do to leave a larger proportion of income in the hands of millions of consumers would tend to have a stabilizing effect upon the economy.

5. *Equitable distribution of wealth and income.* Another ground upon which the ability-to-pay advocates attempt to support their theory is that it tends toward a more equitable distribution of wealth and income. Such distribution is usually sought as an aid in the equalization of economic opportunity, in preventing "oversaving" and in avoiding "underconsumption." Practically all Americans will agree that the tax system should at least "not widen" existing inequalities in wealth and income.

There are still some who say that the tax system should "leave them as it finds them." Most Americans accept the idea that taxation should contribute to greater equality of opportunity and more equitable distribution of income. The real controversy lies in the degree to which those objectives should be carried out.

THE TAXATION OF UNDESERVED INCOME

The theory stated. Another basic theory of the distribution of the tax burden asserts that tax rate structures should not only consider the "quantity" of the income, but the "quality" as well. They should consider the ease with which the income is acquired—the undeservedness of the income. Professor Alfred Marshall developed the theory that rent-like income may exist for the different factors of production because of temporary shortness of supply; such income he called "quasi-rent." Henry George in his *Progress and Poverty* advocated the concept of a "single tax" on the theory that land produced a "net product" or "surplus" that was not due to the activity of the land owner but was specifically attributable to the land and its social surroundings.

More recently, John A. Hobson has propounded the theory that "unearned surpluses" exist throughout society because of monopolies, unequal bargaining power, and superior cunning in the market. Community sentiment today frequently classifies many other types of income as unearned (such as excessive inheritances, excessive profits, windfall incomes of various kinds due to chance or luck, the sudden discovery of oil or valuable minerals on a farm, increases in bare land rent because of community development, and the like). Some taxes have been suggested for tapping such unearned income. These include Henry George's famous *single tax* on bare land rent, land value increment taxes, steep inheritance taxes, steeply graduated income taxes, and excess profits taxes.

It may be that in certain areas a few big unearned prizes must be kept available in order to draw forth capital and enterprise for extremely risky undertakings. On the other hand there are many types of unearned income which are of the "windfall" character, the taxation of which can in no way affect risk-taking and investment.

THE SOCIAL EXPEDIENCY THEORY OF TAXATION

The theory stated. A fourth theory of the distribution of the tax burden is the social expediency theory. It is an eclectic theory—a theory that combines several or all of the other theories for use in the tax system as a whole according as the given theory is applicable and workable under the circumstances. It is the kind of theory which recognizes that the subjects of taxation in our society are so numerous and complex that *no one theory* is adequate to create a fair and well-balanced distribution of the total tax burden. This composite theory takes the pragmatic view

and asserts that that tax source is best which works best, all tax factors and distribution theories considered.

The theory applied. As a practical matter this is the general theory that we in our American experience have used and are still using. As the circumstances required, we have woven together a tax fabric that utilizes the several distribution theories as well as other tax factors, such as "adequacy of revenue," ease of administration, and nonfiscal purposes. The principle of benefits received has been applied whenever the benefits are reasonably measurable and where special benefits are clearly discernible. In some areas and under some taxes, the concept of ability-to-pay is given full play. In wartime we attempt to get at undeserved income by excess profits taxes. Under some circumstances adequacy of revenue and ease of collection seem to dominate the scene.

The Use of Taxation for Nonfiscal Purposes

IN RECENT YEARS both our fiscal theorists and our legislative bodies have advocated and used taxation for purposes other than that of raising revenue. All taxes are bound to have some effects on the economy besides bringing in the revenue. That was true in the past when in most instances taxes were levied largely to pay the regular expenses of government. In more recent years, however, there has more frequently been injected into our tax laws the "specific intent" that taxes should accomplish certain social and economic objectives in addition to raising revenue. Some of the more common examples of nonfiscal objectives in taxation are protective tariffs, taxes on oleomargarine to protect dairy farmers, taxation to discourage the use of certain goods (such as liquor and tobacco), taxation to encourage the wider distribution of wealth, taxation to avoid injuring consumption and investment, and so on.

TWO APPROACHES TO NONFISCAL PURPOSES IN TAXATION

It is possible to distinguish between two types of attitudes toward the effects of taxes. The first may be called the *traditional attitude;* it was well-developed before the 1930's. Under this approach, the effects of taxation were considered only in relation to such activities as institutional control, sumptuary taxation, and providing the least hindrance to the operation of the economic system. On the whole, the effects of taxes were usually considered of secondary importance to "revenue" considerations.

Another attitude, however, views taxation in conjunction with other elements of fiscal policy and public expenditure as a weapon of over-all economic control. This may be spoken of as the *economic strategy*

attitude. It goes so far as to say that revenue considerations should be subordinated to questions of economic policy concerning production, employment, and income. This school of thought has increased in influence since the depression of the 1930's.

APPRAISAL OF TAXATION FOR NONFISCAL PURPOSES

The use of taxation for nonfiscal purposes is one of those controversial issues which is continuously aired in business and economic journals as well as in American legislatures. Opinion is sharply divided on the matter, even in regard to social-control taxation in the traditional manner.

Although it is generally agreed that all taxes have effects other than purely fiscal effects, and that these effects should be taken into consideration in distributing the tax burden and selecting revenue sources, it is far from agreed that these effects should be given such importance as to lead to almost total disregard of the other canons of sound taxation.

Taxation for traditional nonfiscal purposes is objected to by some because the tax system is already complicated enough without the added burden of regulatory functions. It is said further that if such regulation is needed, it can be carried out more effectively through direct regulatory statutes.

Taxation for purposes of economic strategy is attacked on the ground that not enough is known about the operation of the economic system to insure that fiscal policy will produce the effects desired; that it is extremely complicated and unwieldy; that it presents an uncertain tax environment for business; that it discourages planning and initiative; that it will tend to irritate conditions rather than alleviate them; and that it will lead gradually to the socialist state. Proponents counter, however, that enough is known to act, and that even if some of the disadvantages are true, failing to alleviate unstable economic conditions may lead to the destruction of our society. The conclusion is, however, that there are circumstances under which nonfiscal taxation of the "traditional" type is both desirable and feasible. In like manner, non-fiscal taxation of the economic strategy type (when properly integrated with other fiscal and economic policies and when judiciously used) can have constructive effects. We must be warned, however, that the tax system should not be the main lever of control for the economic system.

Tax Rate Structures

TYPES OF TAX RATE STRUCTURES

Basic tools. The application of the various principles of taxation to particular taxes requires the development of *rate structures* or *rate pat-*

terms for these taxes. We have already spoken of progressive and proportional forms of taxation. Before we can analyze and describe the various types of tax structures and test their equity and effects, it is necessary to understand certain basic tools used in tax analysis and tax calculation.

Among these basic tools are:

1. *The tax base* is the very object upon which the tax is levied and to which the tax rate is applied. Under the property tax that tax "base" is the assessed valuation of the property; under the income tax, it is the net income; and under the sales tax, it is the value of goods purchased.

2. *The tax rate* is the percentage of the tax base that is to be taken by the given tax law. It is in relation to the tax rate that various types of patterns, scales or schedules of rates are developed. In the tax field these are known as "rate structures."

3. *The tax* is the amount of money that has to be paid under the tax law. The amount of the tax is ascertained by multiplying the "base" by the "rate." This is expressed by the formula, B x R = T. When the "base" and "amount of tax" are known, the "rate" can be calculated by use of the formula, T ÷ B = R.

Basic rate structures. A tax "rate structure" or pattern expresses a relationship between the rate and the base. It has to do with "how" the rate "behaves" as the base increases or decreases. There are several basic types of rate structures:

1. *A progressive rate structure* is one in which the rate increases as the base increases. It will be shown later that it is possible to have different "degrees" of progressivity in rate structures.

2. *A proportional rate structure* is one in which the rate remains constant regardless of whether the base increases or decreases, or whether the base is large or small.

3. *A regressive rate structure* is one in which the rate decreases as the

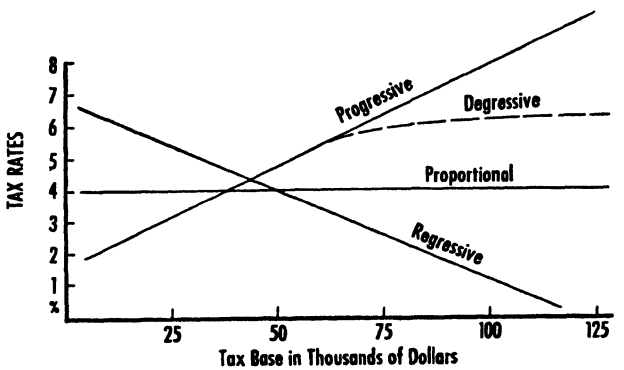


FIGURE 5. *Types of Tax Rate Structures.*

base increases. Again it is possible to have different degrees of regressivity.

4. *A degressive rate structure* is one in which the rate increases at a decreasing rate of increase as the base becomes larger. This is a special form of progressive rate structure.

Figure 5 presents graphically the pattern of each type of rate structure.

It is possible to work out many degrees of proportionality, progressivity, and regressivity in the basic types of rate structures. A proportional tax may be proportional at a 3-per-cent rate, 10-per-cent rate or at any particular higher rate. A progressive rate pattern may be mildly progressive or steeply progressive and may vary as to the degree of progressivity in various segments of the rate schedule. About the same can be said for regressive patterns.

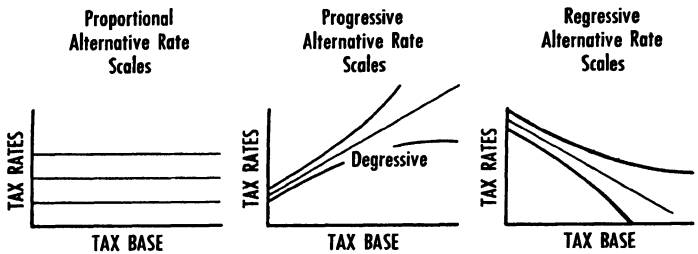


FIGURE 6. *Alternative Tax Rate Structures.**

* The idea for setting up these alternative tax rate structures was derived from Philip E Taylor, *The Economics of Public Finance.* New York: The Macmillan Co, 1948, p 288

EXAMPLES OF THE VARIOUS TYPES OF RATE STRUCTURES

Progressive taxes. In the United States progressive tax rates are found in taxes on individual net incomes, corporation net incomes, estates and inheritances, and on certain specific businesses (as in chain store taxation). Though the tax is usually progressive as measured against income or wealth, the base utilized in chain store taxation, for example, is the number of stores. In progressive taxation the rates are usually levied according to what is known as the "bracket" system. Instead of levying a different tax rate to be applied to the total base for each increase in the size of the base, the law is set up so that separate levies apply only to the various "brackets" of income. For example, let us suppose that under an income tax law the brackets are 0-$1000, for which there is complete exemption from taxation; $1000-$2000, for which the rate is 1 per cent; $2000-$3000, for which the rate is 2 per cent; $3000-$5000, for which the rate is 4 per cent; and so on. This means that any income in excess of $1000, but less than $2000, is taxed at 1 per cent; any income in excess of $2000 but less than $3000 is taxed at 2 per cent; and so forth. The bracket system is superior because the progression is smooth. The other system

is to make the top-bracket rate apply to the entire tax base. Great Britain uses this system under its estate tax. Under such a system, the tax one would have to pay on an income of $3001 might be so much greater than one would have to pay on an income of $2999 that the taxpayer would be clearly better off with the lesser income. In fact, it would be to one's advantage to do everything possible to keep the income below the $3000 margin. The rates stated in the tax statute are known as "nominal" or legal rates.

Because most progressive taxes are levied according to the bracket system, it is often necessary to calculate the true or *effective* rate. This effective rate is the "average" rate applied to the whole base, including the amount of the exemption, found by dividing the total amount of the tax by the total base. The accompanying table illustrates the bracket method of levying a progressive tax and the determination of the "effective" rate for a hypothetical income of $4000.

Income Bracket (Base)	*Nominal or Legal Rate*	*Tax*
0–$1000	0 (exemption)	0
$1000–$2000	1%	$10
$2000–$3000	2%	$20
$3000–$4000	4%	$40

Total Income: $4000. Effective Rate: 1.75% ($70 : $4000). Total Tax: $70.

Although the upper-bracket rate applying to that income is 4 per cent, the effective rate is only 1.75 per cent.

Under the bracket system, in addition to "nominal" and "effective" rates, a third type of rate is relevant for tax analysis—the "marginal" rate. Such a rate is one which applies to the final increments of the taxpayer's income. In the above rate structure, if the taxpayer had a $3800 income, then $800 would be the marginal portion of his income and 4 per cent would be the marginal rate. This rate may be of strategic significance, especially in relation to economic incentives.

Degressive taxes. Degressive rate structures may be actually found in the state income and inheritance taxes. A degressive rate is really a variation of the progressive pattern. It usually contains some progressivity in the lower brackets and then tapers off in the upper brackets.

Proportional taxes. In the United States proportional rate schedules are commonly applied to such taxes as general property taxes, sales taxes, excises, customs duties, payroll taxes, and most local business taxes (usually low flat-rates regardless of the size of the base). The bulk of the revenue from such nominally proportional taxes accrues to state and local governments.

Regressive taxes. It is often claimed that local and state taxation is becoming increasingly regressive in character as a result of the search for new revenue sources. Yet there is in the United States probably *no* tax

that is "nominally" regressive in rate structure. Wherein lies this paradox?

The general property taxes, excises, and sales taxes in particular, previously mentioned as proportional taxes, are generally assumed to be regressive "in effect." This means several things. In the taxation of property, it means, first of all, that even though the "nominal" rate on property is proportional, the tax rate when applied to the actual value of the property is regressive (a) because of the tendency of assessors to under-assess higher-valued real property, and (b) because of the extreme evasion of assessment of intangible property which is concentrated in the hands of the wealthy. Second, for property, sales, and excise taxes, the tax rate becomes regressive "in effect" *when the base is hypothetically shifted to income.* This is because the amount of assessed property a person holds or the amount of purchases a person makes of sales-tax or excise-tax items does not increase as rapidly as his income or wealth. Thus we can say, speaking loosely (though in a very useful sense), that property and sales taxes tend to be regressive in character. They tend to hit the little fellow harder; they take a larger proportion of his income.

In all this discussion, *rate* structures must be distinguished from what is sometimes called the *tax* structure. Whereas the rate structure refers to the "change in rates" with an increase in the tax base for a given tax, the tax structure refers to the "types and arrangement" of the taxes which go to make up a "tax system."

An Evaluation of Progressive Taxation

MORE HEAT and argument have been generated about the subject of ability-to-pay taxation and progressive tax rates than about any other tax subject. Although the use of progression in tax systems has had increasing popularity since the middle of the nineteenth century, this increase has been only at the expense of much vituperation and many reasonable arguments on the part of the opposition. We have already presented the more important arguments that are usually offered in support of progressive taxation. Therefore, it is only logical and fair to present and appraise the arguments offered in opposition to progressive taxation.

ARGUMENTS AGAINST PROGRESSIVE TAXATION

Sacrifice theories may not justify. Many claim that the sacrifice theories (as supported by the diminishing marginal utility of income) do not justify progressive taxation.

First, it is maintained that the utility of money, as contrasted with the utility of goods, does not decrease with an increase in supply, for money

to many means power, prestige and satisfaction of keenly developed tastes.

Second, even if there is a diminishing marginal utility of income, there is no assurance that it diminishes rapidy enough to justify progressive taxation according to any except the minimum sacrifice principle.

Third, because of varying human characteristics, responsibilities, and capabilities of enjoyment, it is not possible to adjust the scheme of taxation to the sacrifices of each individual; it is possible only to achieve a "rough justice."

Fourth, as John R. McCulloch said in 1865, "The moment you abandon, in the framing of such taxes, the cardinal principle of exacting from all individuals the same proportion of their income or of their property, you are at sea without rudder or compass, and there is no amount of injustice and folly you may not commit." [11] It is argued that there is no standard by which to distinguish a good progressive rate scale from a bad one and hence no brake upon the excesses of progressive taxation.

Against progression as an instrument of social policy. Many arguments are made against progressive taxation as an instrument of social policy. It is claimed that even though the marginal dollars in the larger incomes have a very low utility to individuals, they may have a very high utility *to society* in the form of possible investment capital. And furthermore, removing such dollars through progressive taxation would tend to penalize industry and thrift. "... those who uphold the system as a revenue device are playing into the hands of the group that would use progressive taxation as the means of destroying private capitalism and ushering in the collectivist state." [12]

Principles of Tax Reduction

SO FAR, the canons of taxation in this chapter have been related to the distribution of the tax burden and the selection of revenue sources. The question arises as to the relevance of such principles to "reductions" in the rates after a major war during which rates were boosted substantially to achieve certain war finance objectives. One very practical issue arises: How should the "reductions" be distributed? A given percentage "across the board"? A larger percentage to the low-income groups? A larger percentage to those in the higher brackets? Since World War II

[11] John R. McCulloch, *A Treatise on the Principles and Practical Influence of Taxation and the Funding System* (2nd ed.), 1865, p. 141. See also Elmer D. Fagan, "Recent and Contemporary Theories of Progressive Taxation," *Journal of Political Economy*, Vol. 46, August 1938, pp. 458-485.

[12] Harley L. Lutz, *Guideposts to a Free Economy*. New York: McGraw-Hill Book Co., 1945, Chap. 9; see also Henry C. Simons, *Personal Income Taxation*. Chicago: University of Chicago Press, 1938, pp. 1-40.

we have already had to face issues of this kind, especially in relation to reductions under the federal personal income tax.

As a general proposition the principles of the distribution of tax reductions ought to be about the same as the principles of the distribution of the tax burden in the first instance. Under a personal income tax, the concept of ability-to-pay should be controlling. However, the standard for reductions can be stated in terms of the "greatest comparative need" for the reduction. This is especially true when the lower bracket rates have been increased several times over what they were before the War. This is further true when we consider that millions of veterans have returned home after having given up their income-earning possibilities for several years. These citizens, both men and women, have gone back to work in the hope of getting the necessities and few of the luxuries in life for themselves and their families. It seems quite inequitable that they be required to bear high first- and second-bracket rates.

The application of the "greatest comparative need" to tax reductions will probably necessitate granting higher "percentage decreases" in the lower brackets. The fairness of this can be appreciated when we realize that even the upper-income people would get the advantage of higher percentage decreases as to their lower-bracket income. It is true they would get lower percentage decreases in the upper brackets, but these decreases in the upper brackets mean substantial "dollar" benefits.

Putting the Principles to Use

OF WHAT USE are the principles of distribution, a skeptical reader may ask, if they aren't put into practice? The skeptic can then point to such conditions as the protective tariff, excessive tax exemptions, oleomargarine taxes, and excessive use of sales taxes. Perhaps the skeptic is right when he proclaims that the general distribution of the tax burden is all too often according to vote-catching potentialities and expediency rather than according to recognized principles.

Undoubtedly, the large expenditure requirements at all levels of government are a part of the reason for the disregard of sound tax principles. These expenditures have been increasing each year. Some solutions in this respect would be greater economy and efficiency in government, reduction of war expenditures as soon as feasible, co-ordination and expansion of revenue sources, and the like.

But at least as influential as the need for revenue in causing neglect of sound taxation is the intense class rivalry involved. Pressure groups in legislatures become more numerous, better financed, and better represented each year. Thomas S. Adams, in his presidential address at the

fortieth annual meeting of the American Economic Association, recognized this full well when he began by saying:

> 'In taxation,' says the cynic, 'let me make the deals and I care not who makes the ideals.'... While taxation may not have started as a class struggle, and while the class element is modified in the United States by the operation of constitutional inhibitions, modern taxation or tax-making in its most characteristic aspect is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned. Class politics is of the essence of taxation.[13]

Here the solution appears to rest in the recognition of the "harmonies" of taxation, not just the "conflicts." [14] These harmonies include a common interest in justice, in the general productivity of the economic system, and in administrative conditions such as certainty, and low cost of administration and compliance. They include further our interest in the general welfare in the long run, our interest in meeting powerful challenges to our institutions from without, and our interest in the public interest. These harmonies should motivate us to use sound and equitable principles in allocating tax burdens.

Conclusions

IT IS FREQUENTLY SAID that there is such a conflicting variety of principles of taxation that almost any type of tax or tax system can be justified by the selection of the appropriate ones. Many crimes have been committed under the banner of fiscal expediency. The answer is that all of the principles have their place of importance, depending upon the particular social and economic circumstances to which they are applied. Judging according to a yardstick of "public welfare" is essential if the principles are not to be prostituted to the selfish ends of special interest groups.

There are admittedly difficulties in their application. These include the changing conditions in society, the breadth of interpretation possible, the lack of knowledge of many of the social and economic effects of the taxes, the dispute between the use of many taxes or few, between obtaining justice by "each tax" or by the "tax system as a whole," the urgent need for revenue at all levels of government, and the conflict between shortsighted "special interests" and the "public interest." But these difficulties should not blind us to the value of the principles. Neither

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[13] T. S. Adams, "Ideals and Idealism in Taxation," *American Economic Review*, XVIII, 1925, p. 1.

[14] See Roy Blough, "Conflict and Harmony in Taxation," from an address before the American Philosophical Society, Philadelphia, February 18, 1944; reprinted in Harold M. Groves, *Viewpoints in Public Finance*. New York: Henry Holt & Co., 1947, pp. 712-720.

should we be lulled into accepting them as they are; rather we should strive to penetrate much of what still remains unknown. The public and its legislative representatives must be educated to the importance of such principles in promoting the general welfare. We should not give up an attempt at justice because it cannot be obtained exactly. A "rough justice" is better than none.

4

The Economic Foundations of Taxation · SHIFTING, INCIDENCE, AND EFFECTS OF TAXATION

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.[1]

Overview

STUDENTS OF PUBLIC FINANCE have long realized that many taxes do not "stay put" upon the person or business unit which initially pays the tax. If every tax were in fact ultimately borne by the person who paid it in the first instance, there would be no problem of *tax shifting*. The problem of *incidence*, however, would still be present. The location of the incidence would be simple; the real problems would be those of weighing the burden and measuring the effects of the tax.

It is now well-observed that some taxes do not remain where they are originally levied. Some of them are pushed on to someone other than the first payer. In cases like that of the gasoline tax, it is quite clear what happens. With respect to many other taxes, however, just "what" takes place and "how" it occurs is by no means as clear. In some instances, the tax law is phrased in such a way as to aid (or even require) that the tax be shifted. A very relevant question should, therefore, arise in the mind of every tax student: Who ultimately bears the economic burden of a given tax imposed by government? In this era of heavy taxation and public expenditure, the answer to that question becomes even more relevant than ever before.

Shifting and incidence is one of the more difficult aspects of both

[1] David Hume, *Political Discourses*. Edinburgh, 1752, Chapter VII.

economics and public finance. A good deal of our understanding of it is based upon theoretical analysis. In order to facilitate the mastery of the theory, processes, and effects, the work of the chapter will be divided into two major sections: (1) shifting and incidence fundamentals and (2) shifting and incidence theories. It shall be the primary purpose of the chapter to present a non-technical understanding of shifting and incidence principles.

SECTION I

Shifting and Incidence Fundamentals

WHY UNDERSTAND SHIFTING AND INCIDENCE

Why is it necessary for the student of taxation to understand the principles of shifting and incidence? The truth of the matter is that our knowledge of certain aspects of taxation would not be very accurate or sound if we were ignorant of shifting and incidence, and its effects. No matter how thorough one's knowledge of the theories of the distribution of the tax burden, all will go for naught, if the tax burden is shifted to someone other than the one contemplated by the original tax. Until we know something of this shifting, we can never be certain whether a given tax is progressive, regressive, or otherwise.

A study of shifting and incidence should aid us materially in several respects. It should aid us: (1) in determining the *location* of the economic burden of the tax: Who really pays the taxes? (2) in determining the *weight* of the burden; (3) in judging whether a given tax is progressive, regressive, or otherwise; (4) in judging whether the tax system as a whole is progressive, regressive, or otherwise; (5) in determining the general fairness and equity of the given tax; and (6) in discovering the social and economic *effects* of the tax, for it is only by knowing the situs of the burden that we can identify and weigh the effects.

BASIC DEFINITIONS

Impact. The *impact* of a tax is the point of the initial or immediate money burden of a tax. The person who makes the actual payment of the tax to the government is the one who bears the impact of a tax. When an observant person purchases gasoline he notices that the actual price he pays per gallon is divided into several parts: the price of the gasoline, and federal, state, and possibly local taxes. According to the sign, which is usually posted on the side of the gasoline pump, the buyer of gasoline is paying a certain number of cents per gallon in taxes. But

the gasoline buyer never makes out a check to the government. Who bears the impact of the tax? Depending on how the tax is levied, either the processor or distributor of the gas must pay the government. The impact of the tax is upon them.

Shifting. From the illustration of the tax on gasoline it is seen that the people who bear the impact of the tax are reimbursed for the taxes they paid. The process by which a tax is passed from certain persons to others is known as tax *shifting.* It is commonly said that tax shifting can only be accomplished through changes in price. There must be a transaction between the person who pays the tax and the person to whom he shifts the actual burden of the tax. "Changes in price" must be interpreted in a broad sense if this is to be accurate, however. Instead of changing the price, the seller may change the *quality* of the product which he sells.

Incidence. The incidence of a tax has reference to the ultimate money burden of the tax. The incidence is said to fall upon the person who in effect pays the tax in the higher prices that he is charged for the taxed goods and services he purchases. The point of incidence is looked upon as the "final resting place" of the tax.

Effects. Another term which is frequently used is the effect of a tax. The effects of a tax are all those consequences which flow from the impact, the incidence, or the shifting process. The effects usually have to do with the changes that take place in the economic behavior of human beings as a consequence of bearing the tax burden—especially in relation to the performance of certain basic economic functions such as working, producing, saving, risk-taking, and consuming. This economic behavior may in turn affect supply and demand, and levels of consumption, investment, production, employment, and income.

THE SHIFTING AND INCIDENCE PROCESS

In Figure 7, a graphic picture of the interrelations between shifting, impact, incidence, and effects is shown.

From the diagram it will be noticed that incidence may be at the same point as the impact. This would be the case if the seller could not shift the tax to anybody else and had to bear the real burden himself. It should not be inferred that shifting is an "all or nothing proposition." Any portion of the incidence of the tax may have to be borne at the point of impact, and the balance may be shifted to other persons. Also, shifting is not limited to one stage removed from the impact of the tax. The tax may be shifted to persons many stages removed from the impact. The seller may shift the tax by increasing his price, and the person who buys from him may in turn increase his selling price. Ultimately, a point must be reached where a loss (or greater loss) would result from a price increase, so that further shifting would not occur.

From the diagram it is seen that effects can occur as a result of the impact of a tax. An example of this would be the "disappearance" of State Bank Notes as a result of the 10 per cent federal tax imposed on the issue of them after the Civil War. A truly protective tariff would also be an example of where the effect would accompany the impact of a tax (without any incidence or shifting). There would be no incidence, for incidence applies to a money burden. When the transaction ceases completely, there can be no money burden and no incidence. However, as a *result* of the protective tariff, the American people would pay higher prices for American goods.

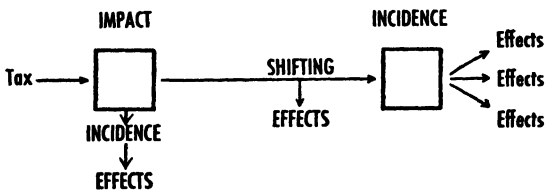


FIGURE 7. *Shifting and Incidence Relationships.*

Effects can also accompany the shifting process. When one discusses tax shifting, the usual assumption that is made is that each person is trying to maximize his profits at all times. Of course, this assumption does not always go unchallenged. If a firm were not maximizing its profits before a tax was imposed but changed its attitude after a tax had been levied on it, then this change in attitude would be an effect of the shifting of the tax.

Certain effects have become such common occurrences that special names have been coined for them. A few of the more common epithets are tax transformation, tax farms, tax migration, evasion, and avoidance.

Tax transformation can be an effect either of shifting or incidence. This name has been applied to those circumstances where a firm (or person) has, as a result of the tax, become more efficient or productive, so that more goods can be produced at the same total cost or the same amount of goods produced at a lower cost. The biggest difficulty lies in proving that the increased efficency is due to the tax. It may be mere coincidence that both occurred at the same time. It can at least be said, however, that a tax could give an added incentive to efficiency and thus absorb the tax.

INCIDENCE AND EFFECTS DISTINGUISHED

It is usually difficult to distinguish between incidence and effects. Consider the case of two goods which can be substituted for each other, such as coal and gas for heating. If many homes and factories have been using coal for heating purposes, a tax on coal might cause many of them to convert to gas heat. In the process of changing to gas there would

tend to be an increased demand for gas stoves, water heaters, and other types of gas appliances, as well as for the regular heating equipment. With the increased demand for these appliances, there would be a tendency for the price to rise. Do the purchasers of the gas appliances bear part of the incidence of the tax on coal?

Under these circumstances, the increased price of the gas appliances probably should be considered as a part of the *effects* of the tax on coal. Then, too, if the government must have a certain sum of tax money, it may have to levy new taxes to make up for the smaller-than-anticipated revenue from the tax on coal. Can those persons who shifted to using gas be said to have shifted the tax that has to be levied upon new sources?

Because of the interdependence of the people in a modern economy, it is possible to raise many vexing problems such as these. To a large extent the definition that is given to certain processes is arbitrary. The important thing is that other persons know what the writer intends to include in his definition, and that the writer is consistent in his use of terms.

If the relative prices of most goods are in a fairly stable relationship and a tax is imposed, theoretically there will have to be a realignment of all of the prices of goods whose demand and supply are affected by the tax. This could traverse the path of increased price for the goods, decreased demand for some goods and increased demand for others, and so on. As a result of lower real wages, workers might demand higher money wages.

In Figure 8 is given one method of distinguishing between incidence and effects. The incidence is limited to the ultimate money burden of

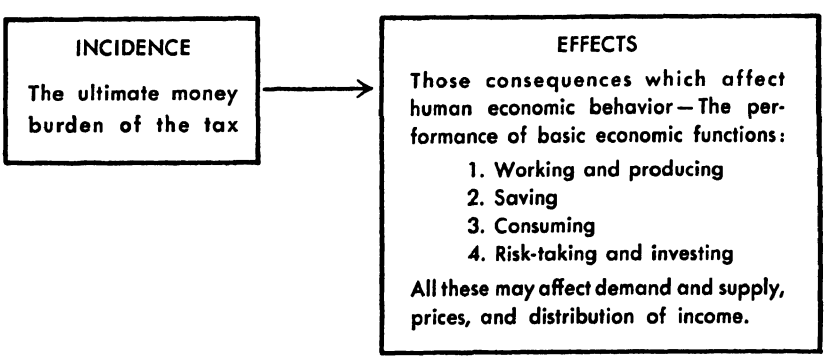


FIGURE 8. *Incidence and Effects Distinguished.*

the tax. Consequently, the incidence will be borne by someone who uses the taxed article. Under effects are considered the changes in the demand pattern for other goods and the economic behavior of people. The more important the tax structure becomes as an instrument of

control, the more importance and weight must be given to the effects of a tax.

FORMS OF SHIFTING

Forward shifting. As has been noted previously, tax shifting takes place through transactions and changes in price (in the broad sense of the term). In the event that the taxpayer increases the selling price of the goods or service he purveys, he is said to shift the tax forward. He shifts the tax in the direction of the ultimate consumer.

A tax on the processor of gasoline is shifted to the owner of the service station, and by the service station operator to the purchaser-users of gasoline. After the tax is levied, each transaction is conducted at a price that is higher than before the tax was imposed. In the case of forward shifting, the prices of "goods and services sold" are increased, and this is probably the most common type of shifting.

Backward shifting. Especially in the case of manufacturers, there is another direction in which the tax may be shifted. The manufacturer buys raw material, hires labor, etc., and if he can pay less for the goods and services he buys, he can shift the tax backward to his suppliers. In this case, each factor transaction is conducted at a price that is lower than before the tax is shifted. The consumer's price may remain the same, however.

There are any number of combinations of shifting which may occur. A part of the tax may be shifted forward, a part of it shifted backward, and part may not be shifted at all, viz., a part of the incidence will coincide with the impact.

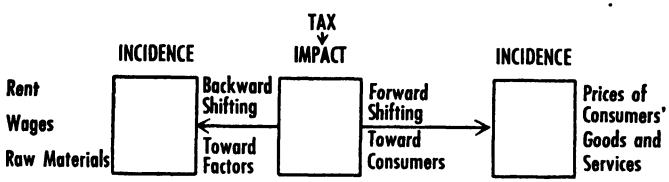


FIGURE 9. *Forward and Backward Shifting.*

Again, the price change which is the result of backward shifting must be considered in the broad sense. Outside of the case of labor payments, the change probably more often results in the absorption of transportation costs (or in additional services by the seller) than in actual price reductions.

The employer may try to shift the taxes backward to labor by attempting to get increased efficiency per man hour of work. Occasionally, the demand for labor may be reduced, as a result of taxes. The rise of unemployment tends to reduce wages, and the tax may be shifted backward to labor in this roundabout way.

An example of backward shifting might be the social security tax. The consensus of opinion seems to be that this tax, which is levied on the employer, tends to be shifted backward to labor, especially in periods of depression and unemployment.

Tax capitalization. Under both forward and backward shifting, the taxes are considered to be placed on flows of goods (that is, on a process that is going on continuously, from raw materials to the ultimate consumers.) A third type of shifting, known as tax capitalization, occurs when there is a transaction involving a long-term, durable good, already existing as a part of a stock of goods. Capitalization results when the present owner is forced to "absorb" the taxes which the buyer of the durable good must pay in the future.

Capitalization is also known as buying free of a tax. The buyer estimates, as best he can, the future anticipated taxes he must pay on the durable good, and he then subtracts the discounted present value of these future taxes from the sum he would otherwise be willing to pay. It is said that the buyer "discounts" the future anticipated taxes. Tax capitalization is calculated by taking the economic rent (net income before the tax) and an assumed or going rate of interest.[2] If there is a plot of land which yields $1,000 a year income, and the prospective purchaser wishes to earn 5 per cent interest on his money, he will be willing to pay up to $20,000 for the land. If a $100 a year tax is levied on the land, which reduces the net income from the land, and he still wishes to earn 5 per cent interest, he will now only pay up to $18,000 for the same piece of land ($900 \div .05 = \$18{,}000$).

It is usually considered, under tax capitalization, that the value of the taxed durable good will decrease. This is not always the case, for under certain circumstances the value of the durable good may increase. This will be true when a tax is levied "unequally" on various durable (investment) goods. The good which the tax strikes least heavily (or not at all) may yield a proportionately greater return and may have an increased (rather than a decreased) value. This can be observed when taxes are removed from particular investment assets.[3]

FACTORS TO CONSIDER IN ANALYZING TAX SHIFTING

There are many factors which will enter into the picture in analyzing the processes and forces in shifting and incidence. From an economic standpoint, the four most important factors deal with the type of the

[2] There are two methods of calculating capitalization. One, the economic rent is divided by the assumed rate of interest ($\$1{,}000 \div .05 = \$20{,}000$). Two, divide 100 by the rate of interest, and multiply the economic rent by the result ($100 \div .05 = 20 \times \$1{,}000 = \$20{,}000$).

[3] Tax shifting is to be distinguished from other means of escape from taxation such as tax evasion, tax avoidance, and tax lobbying. The latter types of escape will be discussed in conjunction with income and death taxes.

tax, economic conditions surrounding the production, exchange, and consumption of the goods or services.

The type of tax imposed. If the firm considers the tax as a cost of doing business, there is a greater likelihood that the tax will be shifted. A tax per unit of sales or on gross sales is more likely to be shifted than is a tax on net sales, net income or surpluses. Also, a tax which does not differentiate between taxpaying units—that is, a general tax—is more likely to be shifted. Thus, it is very difficult for merchants to shift a sales tax when there is another shopping center nearby which has no sales tax. To meet the price of an untaxed competitor, a taxed competitor will have to become more efficient or do business on a lower markup.

Cost conditions in the industry. If the taxed industry is one in which an increased output will result in decreased costs per unit of output, it is called a decreasing cost industry. If a tax is levied on this type of industry, it is commonly said that the price of the product will rise more than the amount of the tax. If the producers are selling all that can be sold at a given price, a tax will tend to reduce the output of the industry. The only way that price can be increased is to reduce the supply. But in reducing the supply the producers will drop back to a higher per unit cost position than they had at the larger output.[4] The price then will rise more than the tax for it is necessary to pay the tax and the increased per unit costs.

If the industry is an increasing cost industry, it is one in which an increased output can only be secured through increasing the per unit costs. Here the imposition of a tax tends to result in a price rise of less than the amount of the imposed tax.[5] Thus, as demand drops because of the rise in price, the tendency is for costs to drop also because production costs are dropping back to a lower cost position.

In constant cost industries, there will be no changes in cost with changes in output. The tendency will, therefore, be for the price change to be the same as the amount of the tax.

The degree of competition in the industry. If there are many buyers and sellers within an industry, it is much more likely that prices will be cut to entice buyers from some of the other firms. If such conditions exist, it is more likely that profits will be nearer the minimum where the various sellers can stay in business. Such conditions increase the possibilities of shifting unit taxes.

If the industry is monopolized, the monopolist will tend to charge a price that will maximize his profits and tend to shift unit taxes. It is here that there will be surplus profits ("surplus" in the sense that the

[4] This assumes that the cost curve for the industry is reversible and that costs will rise as output is restricted. See Robert B. Pettengill, *Price Economics*. New York: The Ronald Press, 1948, p. 199.

[5] *Ibid.* This assumes that costs will fall as output is restricted.

monopolist would not be driven from business if his profits were reduced to a limited extent). The monopolist thus may absorb the tax rather than reduce output and raise price.

Nature of the demand for the product. If the taxed good has an *elastic demand*, it is more difficult to shift the tax than if it has an *inelastic demand*. When a good has an elastic demand, a price rise will decrease the total revenue. With an inelastic demand, an increase in price will increase the total revenue. Thus, over at least a certain price range, the human consumption of a food product such as salt, will be little diminished if the price rises a few cents as the result of a tax. If other conditions are the same, the seller will find less resistance to price increases when there is an inelastic demand for his product.

SECTION II

Theories of Shifting and Incidence [6]

> ANY ANALYSIS *that is offered of the incidence of rates must be taken to refer to general tendencies, rather than actual facts. The causes which prevent these tendencies from being applied in prediction resemble those which prevent mathematical reasoning from being applied to the course of a ball on the deck of a ship that is rolling and pitching in cross seas. If the ship would but stay at one inclination, the movement of the ball could be calculated. But before any one tendency has had time to produce much result, it will have ceased to exist, and its successor cannot be predicted.*
>
> —ALFRED MARSHALL.[7]

Introduction

IT WAS OBSERVED at the beginning of the chapter that there exists a close alliance between the "theory" of *shifting and incidence* and the "theory" of *value and price*. This must necessarily be so because the shifting of tax burdens takes place through the price mechanism. Just *how* does the shifting of the tax burden take place? To that question there is no easily observable answer.

However, a number of theories have developed. The volume of direct scientific investigation on the subject has not been extensive or productive thus far. Any systematic knowledge that we do have on the subject has come about as a result of the analysis by economic and fiscal theorists. The theories have been marked by much disagreement and controversy.

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[6] For a detailed history of the theories of tax shifting see E. R. A. Seligman, *Shifting and Incidence in Taxation* (4th ed.). New York: Columbia University Press, 1926.

[7] Alfred Marshall, *Principles of Economics* (8th ed.). New York: The Macmillan Co., 1948, pp. 795-96.

The Physiocratic Theory

ABOUT THE MIDDLE of the eighteenth century there developed in France a school of economic thinkers known as the Physiocrats. In their writings they created a body of doctrines that laid some foundations for the science of economics.[8] They asserted that there was a natural order for the economic affairs of men and that if this natural order were observed and abided by, the well-being of the greatest number would be achieved. They maintained that God had endowed the human race with *land* which possessed the characteristic of being able to *produce more* than all the costs expended in its cultivation. This "excess" or "surplus" they called a *produit net*. No other factor in production yielded such a surplus.

Furthermore, they held that all other classes (except landlords and cultivators) were sterile. All other classes created no net increase in the volume of product. Workers and manufacturers merely changed the form of raw materials from the land. Transportation agencies merely carried the goods from one place to another. Businessmen merely transferred the goods to the consumer. The change in price that took place during these various transactions was exactly offset by what was consumed during them. They felt that the wages of labor were a necessary cost and that wages were at a subsistence level. The profits that the capitalist manufacturers and businessmen received were also necessary costs—just sufficient to draw from them their particular services. Even when labor and capital worked together they were sterile.

The Physiocrats maintained, therefore, that revenues for the support of government had to come from the net product of land. There was no other source from which they could come. If the taxes were placed upon the working class (since their wages were a necessary cost and already at the subsistence level), they would have to seek higher wages. If the taxes were put upon the manufacturing and merchant classes (since their profits were just sufficient to draw forth their services), they would have to raise their prices. The Physiocrats, therefore, reasoned that under those circumstances the various taxes would in the long run be shifted back to the *net product from land* and with a certain amount of friction and hardship in both the tax and shifting process.

Since the taxes for the support of government must *ultimately* be borne by the net product from land anyway, why not place the tax upon that *surplus* in the first instance? This would avoid the necessity of shifting with its attendant frictions and hardships. As a result of their analysis the Physiocrats advocated an *impot unique* (a single tax) upon the *produit net* of land. Under the Physiocratic theory, all taxes upon the sterile

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[8] William A. Scott, *The Development of Economics*. New York: The Century Co., 1933, p. 49.

and the necessary cost elements in the economy must necessarily be shifted and will ultimately come to rest upon landlords and the surplus gains from their land. They sought to avoid the need for shifting by the use of a single tax.

The Hobsonian Theory

JOHN A. HOBSON, a British economist of the first third of the twentieth century, developed an extension of the Physiocratic theory. He recognized that all taxes must ultimately come out of *surplus* and cannot be economically borne by the *necessary* costs of production. But he recognized that in a modern economic system, *land* is not the only factor that yields an economic surplus. Other factors under certain circumstances receive *more* than is in fact necessary to draw forth the performance of the given economic function. Therefore, he maintained that surplus elements can be found in profits, interest, and salaries.[9] He could have included wages and building rents on occasion.

Hobson opposed indirect taxes and the tendency to shift them. He was concerned about taxing the low-income groups because they possessed very little ability to pay taxes. To tax them was to cut into necessary costs of living. His tax policy was that of taxing surplus elements *wherever* they could be located. Taxes upon *surpluses* are not so likely to be shifted, are more likely to stay-put, and are less likely to cause friction and hardship in the economic system. The desire to shift will not be so great, because where surpluses exist there is no need to shift them. The tax can take a substantial part of the surplus without cutting into basic needs and costs.

The general objective of taxing surpluses is a sound one, but the real difficulty lies in defining, locating, and separating the surpluses in a complex economic system. Furthermore, there is nothing constant and continuous about economic surpluses. They come and go with the phases of the business cycle. They arise in innumerable ways. In a modern industrial society they are not easily reached by any "single tax."

Nevertheless, the theory of taxing surpluses and avoiding the taxation of necessary costs makes sound long-run tax policy. Carried to its logical conclusion, it would put emphasis upon progressive income taxes, inheritance taxes, and excess profits taxes—all of which are taxes recognized as not easily shifted. This theory also leads to a policy of *avoiding* taxes which are easily shifted.

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[9] John A. Hobson, *Taxation in the New State.* New York: Harcourt Brace & Howe, 1920.

The Neo-Classical Theory of Shifting

INTRODUCTION

The theory of shifting and incidence which is most widely accepted at the present time is the one given by the group of economists known as the Neo-classicists. The originator and outstanding writer of this group was Alfred Marshall. His *Principles of Economics* appeared in 1890 and was a synthesis of the outstanding economic thought at that time. In the Neo-classical explanation of value, the principal tool is the marginal analysis of supply and demand.

The suppliers of goods are conceived as having a minimum price at which they will bring to market different quantities of goods—that is, a supply price. Demanders are conceived as having a maximum price at which they will purchase different quantities of goods. A tendency toward an equilibrium or balance within the firm and industry is felt to be operating at all times. This tendency toward equilibrium in the firm is evidenced by the expansion of output during periods when the firm is making good profits and by a contraction of output when sales drop off and profits fall.

When changing conditions result in the expansion or contraction of output, some time must usually elapse before plans can be completed and carried into operation. To aid in the solution of these problems of time, the concepts of the *short run* (or market period) and the *long run* were developed. In the *short run*, the supply of a commodity is considered to be that which is already produced and ready for sale. In the *long run*, on the other hand, the supply of a commodity is conceived as being able to adjust itself to demand by the expansion of plant, equipment, and labor force. In the case of the long run, this would allow time for new plants to be built, and new skilled labor trained. In the event that supply is decreased, the time would be long enough for productive facilities to be decreased through the wearing out of plants without replacements being made.

Most of the analysis as related to shifting and incidence under Neo-classical theory runs in terms of the long-run period. It is felt that effects during the short run are temporary and that the longer or more permanent effects are the most significant ones. It is also in the long run that the actions of the entrepreneurs in response to the imposition of a tax are most observable.

SHIFTING UNDER PURE COMPETITION

Introduction. The theoretical concept of pure competition is probably the most used concept in the study of value and price under the Neo-

classical analysis. Pure competition is used to describe the conditions when there are many buyers and sellers of an "identical good" in a given market. It is impossible for any one buyer or seller or group of buyers or sellers to be able to influence materially either the demand or the supply—and thus the price—of the good.

With many buyers and sellers for the good, the theory of pure competition concludes that no surpluses above cost will remain in the long run. The price of the good being beyond the control of any competitor, each producer will continue to increase his output as long as he can gain by doing so. This action of the competitors in increasing output will, however, increase the total supply of the good. As the total supply increases there is a tendency for price to fall, with the subsequent reduction of profits. In this manner price tends to that point where the competitors are induced to bring only a given supply to the market. The amount which is *necessary* to secure a certain supply is conceived as a *cost;* there is no surplus amount above that which is necessary to secure the given supply.

Pure competition and constant cost. It is commonly accepted that only constant and increasing costs are compatible with conditions of pure competition in the long run.[10] As there are only *necessary* costs (and no surplus) in the long run, the incidence and burden of any *unit tax* placed upon a constant cost industry "must" be shifted. In the short run some of the burden may fall on the competitive "higher cost" firms in the form of losses. Sooner or later some of the firms must drop out, supply will decrease, price will rise, and the tax will be shifted.

Pure competition and increasing costs. The conclusions in an increasing cost industry differ from those in the constant cost industry in that the tax is usually said to be only "partially" shifted. The analysis is similar in all respects to constant cost industries until the conditions surrounding the decrease in output are investigated. When a *unit tax* is placed on goods in an increasing cost industry the tendency will be to cut back output. When production is cut back, the firms revert to a lower cost position in their scale of production. With the decrease in costs it will not be necessary to shift the entire amount of the tax. Part of the added costs of the tax will be absorbed by decreased costs at the new level of production. Therefore, it is generally reasoned that less than the amount of the unit tax is shifted in an increasing cost industry.

Figure 10 is the commonly accepted method of showing what will occur if a tax is imposed. The conditions accompanying the supply and demand analysis in this diagram are of "increasing costs" and "elastic demand," and a "per unit tax" is imposed. The use of this type of

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[10] Albert L. Meyers, *Modern Economic Problems* (2nd ed.). New York: Prentice-Hall, Inc., 1948, p. 50.

diagramatic analysis assumes that a condition of equilibrium has been reached in the industry. The imposition of the tax will then force adjustments to be made as the spread between "costs" and "selling prices" will no longer be satisfactory to some of the firms.

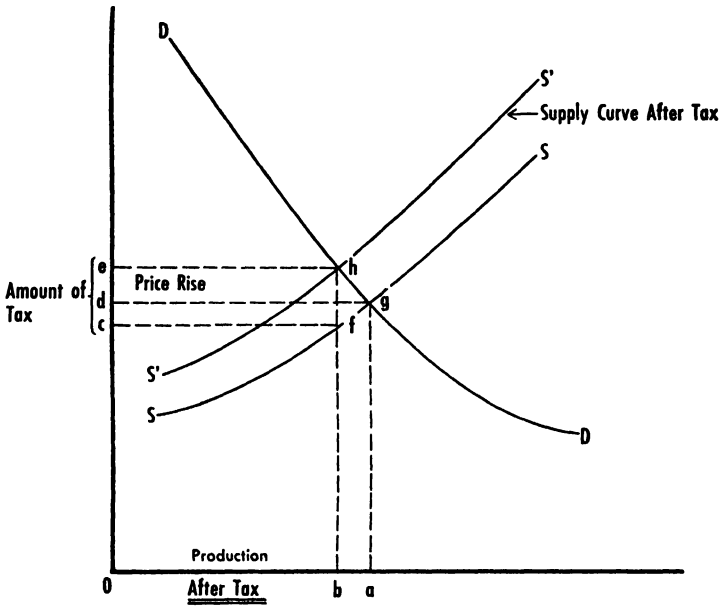


FIGURE 10. *Shifting of Unit Tax Under Pure Competition and Increasing Costs.*

The possibilities of changes in demand accompanying the changes in costs due to tax changes are usually ruled out. One of the arguments is that the government would have spent the money anyway; only if the governmental expenditures are linked to the receipts of a particular tax are changes in demand considered with changes in cost in the analysis of tax shifting.[11] Perhaps the best example of a situation of this sort is where highway expenditures are financed exclusively from receipts of gasoline taxes.

Reverting to Figure 10: DD is the demand curve for the product; SS is the supply curve before the tax, and S'S' is the supply curve after the tax. "Oa" units of the product were sold at the price "Od" before the tax. A tax in the amount of "ce" (or "fh" which is identical) is imposed. Output now drops from "Oa" to "Ob," and the price rises from "Od" to "Oe." Since "ed" is less than "ec," it is seen that the price rise is less than

[11] Otto von Mering, *The Shifting and Incidence of Taxation.* Philadelphia: The Blakiston Company, 1942, p. 134.

the amount of the tax, as "ec" ("fh") is the amount of the tax. This is possible since costs of production, exclusive of the tax, have decreased from "ag" to "bf."

Actually, very few economists would argue that the conditions that would exist under a state of equilibrium are more than a tendency. It is very unlikely that all of the firms in the industry will have the same unit costs of production. In an economy such as ours, the changes come so rapidly that even in a competitive industry the costs are not the same even though the selling price may be the same. In Figure 11 allowance is made so that the different firms can be seen operating at different costs.

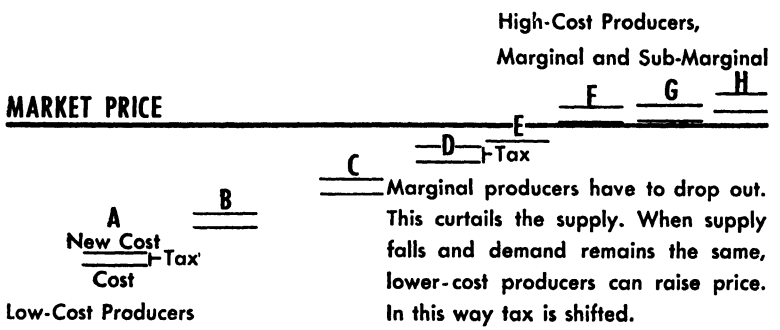


FIGURE 11. *Shifting Unit Tax Under Pure Competition.*

Firms A, B, C, D, and E, are shown operating at a profit. This is a surplus profit over and above the profit necessary to secure the output that they are producing. The profit which is necessary for them is included in their costs. Firms F, G, and H are just about breaking even or operating at a loss (this is not necessarily a loss in the bookkeeping sense of the term "loss" but in the sense that they are not earning enough to keep them in the business indefinitely).

Even under normal conditions without the tax, the marginal firms (F, G, and H) are in danger of being forced out of business because of the normal action of competition. With the imposition of the tax, it is now observed that Firm E has become a marginal firm also. With the already existing pressure on the marginal firms (because of the tendency of the low cost firms to increase output), the extra pressure brought by the imposition of the tax is very likely to result in a decrease in the number of firms. With the decrease in the number of firms will come a decrease in the supply; the lower cost firms will then be in a position to raise the price and the tax will be shifted.

In Figure 12 the same conditions are depicted as in Figure 11 with the exception that a *net income tax* is imposed and that there is an exemption. It is assumed that the low cost firms are the high profit firms.

It is now seen that Firms F, G, and H are not affected by the tax because they have no profits which are subject to the tax. These firms are still "marginal and sub-marginal firms" and will continue to remain so unless (1) there is an increase in demand (and thus of selling price), (2) they are able to lower their costs, or (3) the government grants them a subsidy.

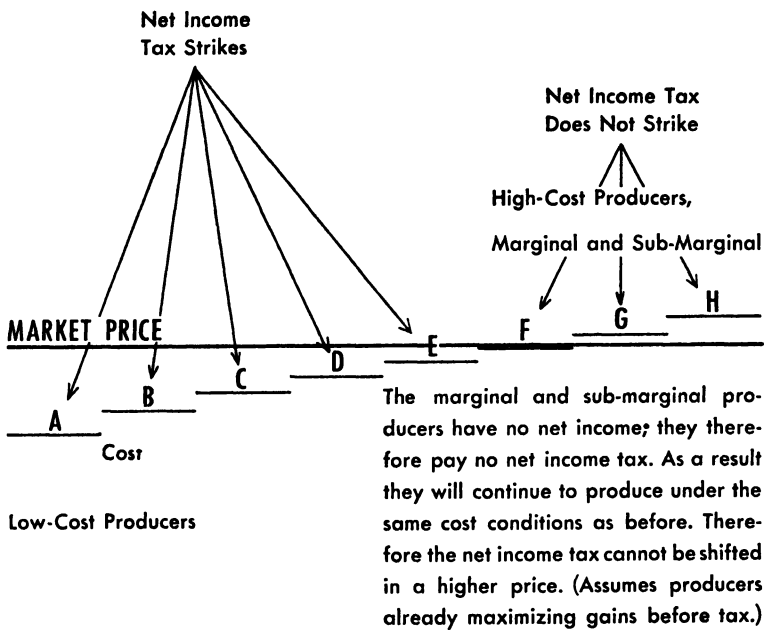


FIGURE 12. *Inability to Shift Net Income Tax Under Pure Competition.*

The important thing to notice is that Firm E does not become a marginal firm as a result of the tax. Firms A, B, C, D, and E have portions of their net income absorbed by the tax, however. Under conditions of increasing costs these firms would be especially discouraged from expanding their output. Although the conditions are not exactly analogous, a progressive chain-store tax works on this same principle.

SHIFTING AND MONOPOLY

Introduction. Pure and perfect competition deals with the circumstances where there are many buyers and sellers. It also assumes that there is perfect knowledge as well as perfect mobility of the factors of

production. In actual practice, however, very rarely do conditions entirely approach the conditions assumed under the concept of pure competition. Professor Chamberlain has stated that there is an element of monopoly in practically all market transactions.[12] The location of the firm, the personality of the seller, the trademark of the product, and other factors all help create monopoly characteristics.

The other condition, then, which is ordinarily considered when analyzing shifting and incidence is that of monopoly. Here there is only one seller of a specific product. The only competition that a monopolist has is from some possible substitute product. One writer has described monopoly as "a marked gap in the chain of substitutes." [13]

The monopolist is usually assumed to take full advantage of all of his monopoly powers. This would usually mean that he is able to gather to himself a surplus over and above the costs which are absolutely necessary to call forth his efforts.

The maximum profit position of the monopolist is at the price and output condition where marginal cost is equal to marginal revenue. The definition of marginal cost is "the addition to total cost which is due to an additional unit of output." The definition of marginal revenue is "the addition to total revenue which is due to the additional unit of output."

When a firm is considering what action to take in regard to any change in output, one of the first questions that will be asked is: "Will this change increase profits?" The comparison that will be made is the change in cost and the change in revenue. These changes are known in economics as "marginal cost" and "marginal revenue."

It is obvious that by adding less to a firm's costs than to its revenue, profits will be increased. If the change in output results in higher costs than revenue, profits will be decreased. Thus any condition which will "alter" the relation between marginal costs and marginal revenue will cause a change in the maximum profit position.

Type of tax. It follows logically from the marginal analysis that a fixed tax (or any tax which does not vary with output) will be very difficult for the monopolist to shift. The monopolist is usually making a surplus over costs, so he will not go out of business even though his profit is reduced. Lump-sum taxes and net income type of taxes are illustrations of the most common taxes which do not vary directly with output; and they do not affect marginal costs.

Lump-sum taxes, such as a license fee, are the same amount regardless of the amount of output. As such, neither the marginal costs nor

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[12] Edward Chamberlain, *The Theory of Monopolistic Competition* (6th ed.). Cambridge: Harvard University Press, 1948, pp. 56-70.

[13] Joan Robinson, *Economics of Imperfect Competition.* London: The Macmillan Co., Ltd., 1934, p. 5.

marginal revenue will be affected by them; therefore the "maximum profit" position of the firm will not be changed. A net income type of tax is difficult to shift, for the amount of the tax cannot be ascertained until the firm's operations for the tax period have been completed; even then an income tax does affect marginal costs. It gets at that which is clearly "net." Taxes which vary with output are the ones which are easiest to shift. They are best represented by "unit" taxes on production or sales. They have a tendency to increase marginal costs and thus narrow the spread between marginal revenue and marginal costs.

Table I

COST, PRICE AND PROFIT CONDITIONS "BEFORE" UNIT TAX

Output	*Unit Cost*	*Total Cost*	*Price*	*Total Revenue*	*Gross Profit*
7	11	77	20	1.40	63
8	10	80 →	18	1.44 →	64
9	9	81	16	1.44	63
10	8	80	14	1.40	60
11	7	77	12	1.32	56

In Table I is given an example of price and output conditions exclusive of a tax. It will be noticed that the maximum gross profit is with an output of 8 units. In Table II all the conditions of Table I will remain the same except that a unit tax of 2 will be added. For example, the unit cost of output of 7 will rise to 13 from 11.

Table II

COST, PRICE AND PROFIT CONDITIONS "AFTER" UNIT TAX

Output	*Unit Cost*	*Total Cost*	*Price*	*Total Revenue*	*Gross Profit*
7	13	91 →	20	1.40 →	49
8	12	96	18	1.44	48
9	11	99	16	1.44	45
10	10	1.00	14	1.40	40
11	9	99	12	1.32	33

From a comparison of the gross profit for the various quantities of output in the two tables, it is noticeable that the maximum gross profit position of the firm has changed. Where before the unit tax was levied the firm would operate with an output of 8 units to maximize its profits. it will now be more profitable to reduce its output to 7 units and raise the price to 20 cents. Under this analysis the 2-cent tax would be shifted under the monopoly conditions.

Multiplicity of conditions. To completely analyze all of the possible conditions which might affect the shifting of a tax, it would be necessary to consider the various combinations of all of the factors given in Section I of this Chapter as being of importance in the shifting of any tax. Time and space will not permit a consideration of all the possibilities. How-

ever, in each chapter having to do with the economics of particular taxes, analytical consideration will be given to the shifting and incidence of each type of tax.

SHIFTING AND MONOPOLISTIC COMPETITION

As has been noted previously, monopolistic competition is a relatively new addition to value theory. Unfortunately, little has been done to extend the theory of monopolistic competition to the field of shifting and incidence or vice versa. Briefly, this new theory claims that actually most firms are operating in some position between the extremes of pure competition and pure monopoly. In his exposition of the new theory, Professor Chamberlain primarily distinguishes two main cases which he calls the "large-group case" and the "small-group case."

In the "small-group case" there are relatively few firms competing; the price of the product is less than under monopoly, but a surplus over costs is still present, as in monopoly.[14] Under these conditions, the incidence should be similar to that which has already been discussed under monopoly.

In the "large-group case" there are many competitors who are selling a slightly differentiated product. This case more nearly approximates competition than monopoly, with the price of the product higher than under competition, but no surplus exists over costs.[15] Since no surplus exists to absorb the increased costs, shifting and incidence would seem to be similar to that already discussed under pure competition.

An Appraisal of the Prevailing Theory of Shifting

The fact that the Neo-classical theory of shifting and incidence has been called the prevailing theory does not mean that its conclusions have gone unchallenged. Even from the time that theory was first stated by Alfred Marshall, there have been dissenters and critics. Some economists have challenged the entire marginal analysis, claiming that it is true only in a limited number of instances, if at all.

The following criticisms of Neo-classical theory of shifting and incidence have been offered by various authors.[16] Some authors have offered criticism to point out exceptions to the general rules of shifting; others point out the limitations of the prevailing theory; and still others attempt to overthrow completely the current theory.

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[14] Chamberlain, *op. cit.*, p. 102.

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

[16] Many of the ideas in this appraisal are an adaptation from Groves, *Financing Government* (rev. ed.). 1945, pp. 137-141.

1. *Insufficient weight is given to the government's influence in the market.* The prevailing theory assumes that there are no obstacles to the free play of all of the forces in the market. For many years in the railroad and public utility industries, at least, the government has had regulatory boards which must pass on the rates and service which can be charged and given. In many other industries the government also requires that certain working conditions be maintained and certain minimum wages paid. Fair trade laws are another example of government influence.

It is easy to see that if a firm is operating near the minimum wage floor in its labor payments, the chances for backward shifting are reduced. Fair trade laws will likewise affect forward shifting. Current theory assumes free play to price, supply, and demand. With forces other than supply and demand actually affecting the market price, conclusions reached by means of the long-run marginal analysis approach must be modified.

2. *Effects of expenditure of tax money on demand and costs.* There tends to be an inadequate emphasis on the effects of government expenditures both on the demand for goods and services and on cost structure. Regardless of how the government spends the money, there will still be reverberations felt throughout the economy. Money spent by the government just doesn't disappear without a trace as did the rats in the story of the Pied Piper of Hamelin.

If the government builds a new road or a new power dam, there will be a change in the demand for labor. There will also be an increase in the demand for the materials which are needed for the project. This type of demand will be experienced in the short run, but there can also be changes in the demand pattern in the long run. The electrification of an area such as that which resulted from the TVA (Tennessee Valley Authority) will tend to increase the demand for electrical appliances in this area.

It is also possible that decreased costs may result after the expenditure of the tax money. Governmental services may be offered to business free, or at so low a fee that many businessmen who otherwise would have had to forego the service (or could have secured the service only through a heavy outlay) are able to take advantage of the assistance. The business aids of the Department of Commerce, which enable the small businessman to operate more efficiently, and the fruit frost warnings of the Government Weather Bureau can be cited as examples.

3. *Strategic factors.* Criticism has also been raised against the assumption of perfect knowledge and equal bargaining power which is implicit in the Neo-classical theory. Examples that have been cited are the changed bargaining positions during the phases of the business cycle or when wages are set under conditions of "collective bargaining." It is

more difficult to shift taxes in depression than in prosperity and when labor is organized than when it is unorganized.

Although these strategic factors affect the degree of shifting, they cannot be raised to the status of a theory of shifting and incidence. It is much too flippant to explain shifting by saying that the strong will shift the taxes to the weak. If the strong are out to get the greatest possible advantage from the weak, it is difficult to see why they haven't already (that is, before the tax) exploited their advantage to the greatest possible extent. Where there is change in the relative bargaining positions of the parties, weight must be given to this change as a strategic factor, however.

4. *Effect of customary prices.* Current theory assumes that prices are free to fluctuate up or down without having any psychological effect on the buyers or sellers of goods. Certain sellers of low-priced goods which have a frequent sale have found that this is not always so. A good example is the experience the makers of five-cent candy bars have had in the post-World War II period. Attempts to raise the price from five to ten cents in the face of rising costs were met with heavy customer resistance. In many instances it was necessary to reduce the size of the candy bar and sell it for five cents.

In the short run it seems to be a reasonable conclusion that current theory gives inadequate emphasis to the problems of shifting when a good has a "customary" price. In all probability the seller will find it very difficult to shift a tax until he can either convert his plant to a new quality product or can convert his customers by means of a heavy advertising campaign.

5. *Analysis is largely deductive.* There are a few spectacular instances where shifting, incidence, and effects can be isolated and determined without question. In most cases, however, the conclusions are reached through abstract, deductive reasoning. In cases like the 10 per cent tax on State Bank Notes which eliminated them after the Civil War, the tax which stopped the production of phosphorous matches, and a truly protective tariff, the cause is easily discernible.

Where the tax is not heavy enough to eliminate all transactions, any conclusions must be couched with reservations. The mere fact that the price of a good changes by the same amount as a tax which is imposed on the good is not conclusive proof that the tax has been shifted. Other changes in demand or cost may be partially or wholly the explanation of the change in price. There are many forces which influence both the supply of and demand for products, and these forces are changing most of the time. The assignment of a specific result to the cause of tax changes is, to a large extent, an estimate—a judgment often based on an inadequate gathering and appraisal of all the facts. Too often it is based upon "armchair economics" rather than empirical research.

6. *Inadequate consideration of external factors.* The size of the tax in relation to the price of the good and the geographical coverage of the tax are of importance when considering whether the sellers will even try to shift the tax. If the tax is quite small (especially if there is a strong patriotic motive), the seller may feel it is his duty to absorb the tax. If the tax is a substantial percentage of the price or of the total tax bill which the seller has to pay, the incentive to shift the tax burden is much greater.

A tax which under normal circumstances would tend to be shifted may have to be borne by the seller under certain conditions. One city may levy a sales tax and surrounding cities or county districts may not levy such a tax. Dealers within the sales tax city limits may have to refrain from adding on the tax, or they may find that their customers are trading in the untaxed market.

7. *Shifting and the short run.* Neo-classical theory fails to explain shifting in the short run. Yet it is common knowledge that a good deal of shifting takes place quite promptly and without much passage of time. Current theory explains the change in price due to the changed relationship between demand and supply. If demand remains constant, a tax which is imposed will alter the supply conditions, for new capital will not enter the field; or some of the present capital will migrate to new fields. This takes time. Yet when certain taxes (such as the sales tax) are imposed, a change in price is noted almost immediately. Whether this is merely an exception to the general rule or not, an adequate explanation has not been given under the prevailing theory.

At the same time, illustrations can be cited where heavy taxes were paid, but the sellers did not take full advantage of their powers to increase prices. After World War II there was much talk of the phenomena of the "black" and "gray" markets. These markets cropped up (especially in the automobile and steel industries) when the manufacturers set their prices at a figure below that which equated supply and demand. Unscrupulous dealers would buy these commodities and would resell the goods to buyers at figures well above the list prices. Some fear of government intervention may have been present in the case of the steel, automobile, and other industries. Satisfaction with a smaller margin of profit on a large postwar volume may have been a factor. The desire to contribute to postwar stability may not have been entirely absent. The purpose of building good will with the American public could have been a factor. At any rate, current theory does not explain this phenomenon within the framework of marginal analysis and the long-run period. All in all, Neo-classical theory of shifting contains some analytical short-comings.

Conclusions on Neo-Classical Theory

OF WHAT VALUE, then, is the Neo-classical theory of shifting and incidence? Where is it valid and usable? These are questions which should be answered to complete an appraisal of the usefulness of the prevailing theory.

First, it must be concluded that with modern institutions and under realistic conditions, the Neo-classical conclusions are not always correct. This is especially true in the short run when the reactions are not always similar to those which the prevailing theory assumes.

Second, Neo-classical value theory has often been used in an illegitimate manner by various writers to further their own purposes. The theory of shifting and incidence and "value" theory as developed by the more competent writers of the Neo-classical school were used to explain what would happen to the price of a "single commodity" under different conditions. One of the conditions explicitly assumed not to change in that value theory was the value of money—the general price level.

In the modern exchange economy, marginal analysis will explain only a part of the price of a commodity; changes in the quantity of money and many other factors must be considered. At the same time, it is not wise to reject the only analysis which is of use in explaining why certain prices change and others do not in a given period.

We may conclude that the Neo-classical theory is of use in explaining the actions and reactions of individual commodities. It is not a legitimate use of shifting and incidence theory, or value theory either, to extend the conclusions (which apply to an individual commodity) to the economy as a whole. This is a sin of which the better writers have not been guilty.

It is, of course, implicit in the second conclusion given above that the prevailing theory is useful as a point of departure and is helpful as a tool and system of analysis. The prevailing theory, like any tool, gives the best and most accurate results when it is used for the purposes for which it was designed. And like any tool it is useful only so long as better tools are not available.

Finally, Neo-classical theory can be useful and helpful when the assumptions of the theory exist in the real economic world. There are segments in our economy where conditions approximating pure and perfect competition sometimes prevail. Where that is true, Neo-classical theory as applied to shifting and incidence in taxation can make a contribution to our understanding of tax burdens, their location, and the distribution of tax burdens.

Summary and Conclusions on Shifting and Incidence

THE THEORY of shifting and incidence deals with the question of who pays the taxes and the question of why some people are able to shift the burden of taxes to others. Owing to the many influences which are always at work, it is impossible to lay down a few simple laws. Rather, the study of shifting is to find certain *techniques* and *tools of analysis* with which to approach the problem. Certain factors are of more importance than others and should be given primary consideration. These factors are: (1) the type of tax imposed; (2) cost conditions in the industry; (3) the extent to which the industry is competitive or monopolized; and (4) the nature of the demand for the product.

The following principles can serve as helpful guideposts in analyzing shifting and incidence problems:

1. Taxes can only be shifted through transactions and changes in price or quality.
2. A general or universal tax is more easily shifted than a special tax.
3. A tax per unit of output (one which affects costs) tends to be at least partially shifted and is more easily shifted than lump-sum or income taxes.
4. The more *inelastic* the demand, the greater are the possibilities of shifting; the more *elastic* the demand, the weaker are the tendencies toward shifting.
5. A tax which falls on *marginal producers* tends to be shifted.
6. The longer the time period under consideration, the more likely the tax is to be shifted.
7. The larger the tax in relation to the selling price (unless it is prohibitive), the more likely it is to be shifted.
8. Taxes which fall on surpluses are less likely to be shifted.
9. In decreasing cost industries when unit taxes are applied, prices tend to rise more than the amount of the tax; in increasing cost industries, prices tend to rise less than the amount of the tax.
10. The more influence the government exerts in the market, the less the principles of shifting apply, and the more important transformation effects and other factors become.

There has been no effort in this chapter to discuss the shifting and incidence of particular taxes because it was deemed more logical and effective to treat that subject directly in conjunction with each type of tax later in the book. Therefore, in the chapters dealing with the "economics of the particular tax" will be found "sections" analyzing the shifting, incidence and effects of the various taxes in relevant detail.

5

The Role of Administration in the Taxing Process

MANY A FINE *tax theory will continue to be a mirage until and unless we can embody the tax theory in appropriate laws, rules and regulations, administrative structure, trained personnel and the consonant pattern of official and taxpayer behavior. The purpose of taxation is not its administration; but without the administration, none of the purposes of taxation can be achieved.*

—LUTHER GULICK.[1]

Overview

NO TAX or tax system is self-operative; therefore, the quality of the administration becomes both relevant and significant if the exercise of the taxing power is to produce revenue. Good administration cannot guarantee the success of a tax law, but it is often a condition precedent to an effective tax. A good tax law can often be wrecked by poor administration. On the other hand, a mediocre tax law can be made to work tolerably well by competent administration.

The field of tax administration includes the steps or stages involved in the application of the tax, the organization necessary to administer it, and the principles and techniques under which the tax law is carried into execution. This chapter will be particularly concerned with the broad, general principles of tax administration. A more detailed account of the administrative principles and problems of particular taxes will accompany the separate treatment of those taxes.

Tax administration is the vehicle through which legislative policy is converted into the "going concern" for collecting the revenues of government according to an orderly and rational plan. In this chapter the reader will be given the opportunity to observe and analyze (1) the basic

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[1] Luther Gulick, "Basic Goals of Tax Administration," in *Income Tax Administration*. New York: Tax Institute, Inc., 1949, p. 13.

purposes of tax administration; (2) the strategic significance of administration in the whole taxing process; (3) the essential steps in tax administration; (4) tax administrative organization; (5) the basic principles and techniques; and (6) some of the more disturbing problems in tax administration.

In addition, the reader will become aware of how important good administration is in achieving justice and equity in taxation. He will also consider the role of economics and the courts in the total tax administrative process. Finally, he will be made conscious of the import and relevance of administrative feasibility as a matter to be weighed in relation to the various types of taxes.

What is Tax Administration?

TAX ADMINISTRATION is a two-pronged operation—one on the part of the tax administrative machinery of government and the other on the part of the citizen. It consists of tax administration and tax compliance.

Tax administration must operate in relation to two types of taxes based upon the mode by which the taxes are assessed. The first is the "administratively assessed" type, such as the general property tax. Here the tax administrative agencies take the initiative, assess the value of the tax base, determine the amount of the tax, and generally assume heavier responsibilities than the taxpayer, whose biggest function under such a tax is to pay the tax bill. The second is the "self-assessed" type such as the personal income tax. Under this tax the taxpayer takes the initiative, assesses himself on a prescribed tax return, reports the assessment, and pays the tax. In relation to this type of tax, the heaviest duties of the administrators have to do with audit, review, and ultimate enforcement.

TAX ADMINISTRATION

Broadly stated, tax administration is the process by which the agents of the taxing government carry into execution the tax laws and the legislative intent implied in the laws. It involves the assessment of the tax liability, the enforcement of that liability, and the collection of the tax due. It is the process by which the revenues are brought into the public treasury—that is, transferred from private hands to the use of the public economy.

TAX COMPLIANCE

Tax compliance involves all the duties, expense, time, and trouble incurred by the taxpayer in meeting his tax responsibilities. Today, with our extensive use of income, business and inheritance taxes, self-reporting

and taxpayer returns, taxpayer participation in the tax administrative process is indeed an important one. Good tax administration attempts to keep at a minimum the burdens and expense of tax compliance.

The Strategic Significance of Tax Administration

TAX ADMINISTRATION is strategically important in a number of ways. First, the success or failure of any given tax is determined largely by the effectiveness and precision of the administrative body in handling that particular type of tax. Second, in its daily work the administrative agency is ideally situated to discover the shortcomings and inequities of a tax law and to bring them to the attention of the legislature.

Third, the knowledge that taxes are being ably and equitably administered gives a large boost to taxpayer morale and the acceptance of tax burdens. Fourth, effective administration minimizes evasion and thereby lessens the burden on the honest taxpayers.[2]

And finally, tax administration is becoming increasingly significant in carrying out "fiscal policy," especially in relation to those taxes which are useful counter-cycle instruments.

The Basic Tasks in Tax Administration[3]

THERE ARE a number of basic tasks which must be performed regardless of the type of tax to be administered; they assume the character of certain steps that must be taken in order to carry out the tax law. Among these tasks are: (1) getting full taxpayer coverage; (2) determining the tax base; (3) assessing the tax itself; (4) collecting the tax; and (5) auditing and ultimate enforcement.

GETTING TAXPAYER COVERAGE

One of the basic tasks of tax administration (whether the tax be property, income, inheritance, sales, or excise) is to account for all those who have tax liabilities under the law and to get them on the tax rolls. Sometimes this is done directly by the assessors (as, for example, under

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[2] Tax Institute Symposium: *Income Tax Administration.* New York: Tax Institute, 1949, p. v. (Alfred G. Buehler in the Foreword.)

[3] Many of the ideas in this section were procured from Walter W. Heller, *State Income Tax Administration,* an unpublished Ph.D. dissertation, University of Wisconsin, 1941.

the property tax in which case each piece of taxable property is placed upon the assessment roll). In the income and inheritance tax field the self-reporting method is used, and it is only when a citizen fails to report that the administrators must take steps to get him on the particular tax lists.

DETERMINING THE TAX BASE

Before a tax administrative agency can proceed very far with its work, it must determine the *tax base* for each type of tax and for each taxpayer affected by the given tax. In the case of some taxes, especially the consumption taxes, this is merely a recording and addition process. In the case of property and inheritance taxes, it is a delicate task of economic valuation—a task that involves careful analysis and judgment. In the income tax family, tax base determination is largely an accounting process. Tax base determination is clearly the most vital step in the tax administrative process. It is a step that involves a knowledge of economics, the exercise of good judgment, and the practice of fair play.

ASSESSING THE TAX ITSELF

Once the tax base has been arrived at, the task of assessing the tax itself is a relatively simple one. It usually involves the application of a flat rate to the entire tax base (as in the case of the general property tax), or a system of graduated rates to various segments of the tax base (as under income and inheritance taxes.) For all the self-reporting taxes this function is usually performed by the taxpayer in the first instance, and his report is subject always to ultimate assessment by the tax administrators. In the case of the general property tax, this step is performed entirely by the taxing authorities.

THE TASK OF COLLECTION

The ultimate purpose of the entire tax administrative process is the collection of the taxes to meet the expenditures and the responsibilities of the various units of government. The collection process should be devised so as to be simple and convenient. Favoritism should be completely eradicated and delay and general carelessness should not be tolerated in the system. The exact amount of the tax should be clearly shown, or if the tax lends itself to self-reporting, the form should be comprehensible to the average layman. The deadline for tax payment without penalty should be widely publicized, and the place of payment should also be distinctly designated.

In all the dealings with the taxpayer concerning the collection of taxes, the relations should be friendly, courteous, but firm. Definitely, the collection process should not add psychological burdens to the economic burdens of paying taxes.

THE TASK OF ULTIMATE ENFORCEMENT

Ultimate enforcement practices and techniques are necessary to obtain compliance from those who might elect to avoid their share of the tax burden. Taxpayer morale and general conformity to tax policy would disintegrate if the administration's inability to enforce its policy became generally apparent. Therefore, a regular procedure for ultimate enforcement must be available and made generally known to the taxpayer. This procedure must be re-enforced by the appropriate penalties for the failure to meet final responsibilities. The type of procedure and the character of the penalties must necessarily differ with the character of the tax. The methods and procedures of audit, review, penalties, and ultimate enforcement will be delineated in some detail in relation to several of the more important taxes in later chapters.

Administrative Characteristics of Good Taxes

EARLIER IN THIS WORK we discussed many of the characteristics of a good tax. At the time we omitted to treat a number of them which are relevant to effective tax administration. Adam Smith, writing in his *Wealth of Nations* in 1776, was very cognizant of the administrative characteristics of good taxes, for three of his famous "four canons" of taxation dealt with issues of administration: he gave us the principles that taxes ought to be (1) certain, but not arbitrary; (2) convenient to pay; and (3) economical to collect. To these characteristics, modern fiscal experience has added other qualities to be desired in taxes: (4) administrative feasibility; (5) simplicity; and (6) moderation.

Basic Principles of Tax Administration

"ADMINISTRATION has to do with getting things done; with the accomplishment of defined objectives."[4] In essence, the administration of taxes is the activity undertaken by trained administrators after the basic legislative provisions have been enacted into the law. It is the actual functioning of the taxing process which determines in large part the effectiveness of the administration. What are some of the basic principles which must play a dominant role in effective tax administration? Profes-

[4] Luther Gulick, "Science, Values, and Public Administration," in Luther Gulick and L. Urwick (eds.), *Papers on the Science of Administration.* New York: Institute of Public Administration, 1937, p. 191.

sor James W. Martin has suggested the following classification of activities which experience has shown to be essential in tax administration: (1) planning, (2) organizing, (3) directing, and (4) representing the revenue agency.[5]

TAX ADMINISTRATIVE PLANNING

Good tax administration requires that the details involved be anticipated, co-ordinated, and, if possible, rehearsed before the actual process takes place. Anticipation means to explore possible problems before they arise and to find solutions which may be applied when the difficulty comes into being. It means that through careful study the number of personnel needed for an assessment job must be determined. It means that the period during which assessment is to be made should be in relation to the labor market for temporary help. It means that forms must be prepared and the number of forms determined. Exceptions to the general rules must be incorporated in a plan.

TAX ADMINISTRATIVE ORGANIZING

The inter-relations between the various specialized tasks in the administration of a revenue system must be integrated. The grouping of these functions into a co-ordinated whole with defined authority and responsibility is part of the organization process. These inter-relations must mean more, however, than that displayed in a well-executed organization chart which pictures graphically the place of units and men in an agency. Good organization implies an understanding by the individuals involved of their place in the group and the place of their group in the total picture of government.

TAX ADMINISTRATIVE DIRECTION

Elements of effective direction in administration include the functions of command, co-ordination, and control. Plans must be executed upon established authority. The authority to plan, to assign duties, and to direct activities is generally referred to as a function of command. Issuance of instructions, setting up over-all objectives, building work programs, determining rules and regulations are all in this element.

Plans must be co-ordinated with other governmental activities. In some jurisdictions the tax collecting and the tax assessing officers are separate; this means that for maximum service to the public, co-operation between the two must be more than passive. Legislative bodies must be part of the whole in determining the ultimate tax rate, in sitting as a board of equalization, or in determining a new source of revenue which affects administrative planning.

[5] James W. Martin, "Tax Administration Activities," in *Proceedings*, National Tax Association, Sacramento, 1948, p. 93.

TAX ADMINISTRATION AND PUBLIC RELATIONS

There is probably no other governmental agency which has such close relations with the citizen as the agency devoted to the collection of taxes. From the federal collector in a large governmental center to the deputy assessor who leaves the tag giving the estimated value of personal property which he has never seen, the impact is felt by the taxpayer. Within the tax unit there is the matter of keeping the legislative bodies aware of the taxing situation, and there are the frequent contacts with the community groups. There is the over-all effectiveness of the agency as seen through the eyes of the public. This aspect of serving the interest of the public is not to be minimized.

Tax Administrative Organization

IN OUR COMPLEX MODERN SOCIETY the concept of a single tax collector is grossly out of date. The tax administrative process requires a well-planned structure and organization with its top controlling agencies, its area divisions, and its local branches. Under our federal system of government, it has been necessary for each level of government (local, state, and federal) to develop its own administrative machinery. Furthermore, because of the complex character of some of our taxes, special agencies have had to be created to administer particular taxes.

FEDERAL TAX ADMINISTRATIVE ORGANIZATION

In the federal government, the Treasury Department is charged with the general administration of federal taxes through the Bureau of Customs and the Bureau of Internal Revenue. The former collects all customs and the latter collects all other federally levied taxes (such as excise, income, and death taxes). The Bureau of the Customs is administered by the Director of Customs, and the Bureau of Internal Revenue is directed by a Commissioner of Internal Revenue who, appointed by the President, promulgates regulations for general application in tax cases and hears administrative appeals.

During the fiscal year of 1948 the Bureau of Internal Revenue collected $41.8 billion in revenues, $31.1 billion of which came from income and profits taxes. During the same period, as a direct result of enforcement efforts, the Bureau made additional assessments of $1.9 billion. The total cost of administration amounted to $183.7 million, which was $4.3 million less than was actually appropriated for the purpose. The cost of collecting $41.8 billion amounted to 44 cents per $100 of collec-

tions, which was 8 cents less per $100 than the previous year.[6] In 1948 the total cost of administration amounted to only 9.6 per cent of the additional assessments; in other words, the direct enforcement efforts of the Bureau produced "additional revenue" equal to ten times the cost of running the entire Bureau.

STATE TAX ADMINISTRATIVE ORGANIZATION

State Boards of Equalization. State tax administrative machinery did not appear in organized form until the 1850's when a number of mid-western states established state boards of equalization. However, state boards of equalization with their large, *ex officio* or elected memberships were not suited to the exacting tasks of tax administration. Beginning in the 1890's, one state after another began to set up state tax commissions to replace the more unwieldy boards of equalization. These new agencies usually possessed small, full-time, appointed memberships.

State tax commissions. The state tax commission has become the most common form of state tax administrative agency. Though the title of the agency has changed in some states and though functions have expanded, it prevails in essence in more than forty states. (Every state except Florida now has some state official or agency specifically charged with the tax administrative functions.) In the latter state the functions are scattered about in miscellaneous state departments—such as the Secretary of State's office, the Comptroller's office and the Board of Conservation.[7] The tax commission does not always have complete administrative control of all the taxes, however. In the early years of this century, its functions were largely associated with the general property tax: (1) central equalization of local assessment; (2) the direct, original assessment of railroad and public utility property; and (3) supervision of original assessment by the local assessors.

The powers of the tax commissions have grown beyond their original property tax functions. Many now administer such taxes as personal and corporate income taxes, inheritance taxes, excise taxes, and often several others. Unfortunately, there has been a tendency to permit various taxes to be scattered about a number of other state departments in many of the states. There is a dire need at the state level for the development of a single, co-ordinated and integrated department of taxation. Within the department it is sound tax administration to have specialized divisions to administer the major taxes.

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[6] U. S. Treasury Department, *Annual Report of the Commissioner of Internal Revenue*, Fiscal Year Ended June 30, 1948. Government Printing Office, Washington, D. C., 1949, pp. 6-7.

[7] *Florida Statutes, 1947*, Sections 193.31, 209.10, 561.05, and others.

Machinery for tax appeals. In many states the right to appeal on tax matters is first to local boards of review (on the property tax), next to the department of taxation, the tax commission or state board of equalization, and then to the courts. However, in some states, and Wisconsin is a good example, a special agency known as the State Board of Tax Appeals exists as a quasi-judicial body that specializes in tax issues. It will usually have appellate jurisdiction in tax issues from the local boards of tax review and the state tax administrative agencies. Even here, however, there almost invariably exists the right to final appeal to the courts.

Tax research and investigation. A function which not too many state tax administration agencies have developed is that of tax research and investigation. This is true largely because the legislatures have failed to appropriate funds for the purpose and, therefore, existing staffs have had their hands full carrying out their administration and collection functions. In some states (such as New York and California) more research is now being done.

A research agency can collect, interpret, and publish tax data and statistics; it can make continuing and special studies on state fiscal problems; it can appraise the economic effects of the various taxes on the state economy; it can generally advise the governor and the legislature on the repeal of existing (or the passage of proposed) tax legislation. State legislatures should awaken to the wisdom of reasonable appropriations for fiscal research and investigation.

LOCAL TAX ADMINISTRATIVE ORGANIZATION

Assessors and tax collectors. At the local level the core of administration machinery is the local assessor and the tax collector. Since the great bulk of local revenues comes from the property tax, most of the structure, functions, and problems of tax administration are associated with the general property tax. In the smaller communities the entire tax administrative machinery consists of these two small offices. In our larger cities and counties these offices really assume the proportions of large scale machinery. The assessor's offices are highly departmentalized agencies with large staffs. The tax collector's offices likewise are becoming more departmentalized and mechanized with various types of business machines.

Need for structural and functional reorganization. Thus far, as cities and counties have been permitted to use other forms of taxation, the task of administration and collection is usually delegated to the tax collector or local treasurer. With this change in responsibility, tax administration at this point may become a hit-and-miss affair. In spite of its increasing significance, little attention has been given to developing

city and county tax administrative organization along more sound structural and functional lines. The time may not be far off when it will become necessary in our larger cities and counties to set up fullfledged departments of taxation, integrated and departmentalized so that they can perform their duties efficiently, economically, and with good public relations.

CENTRALIZATION VS. DECENTRALIZATION

No rigid type of organization can be stamped as the ideal type for the particular job of tax administration. The structure of the organization must give consideration to economic, social, and political demands which make structural rigidity undesirable.

A highly centralized agency can provide unity of procedure throughout a vast area and can provide a corps of expert personnel capable of handling highly technical matters. Supervision of personnel may be an easier task in a centralized unit and may eliminate one or more levels in the organization hierarchy. On the other hand, decentralization of tax administrative units allows a familiarity with local conditions and gives an opportunity for greater service and convenience to the taxpayers.[8] The proper balance between centralization and decentralization is something which must be adjusted in relation to the particular type of tax and other social and economic conditions surrounding its enforcement.

Tax Administrative Personnel

IT IS SIGNIFICANT that in an address on the "Fundamentals of Tax Administration" given at the 1948 National Conference of the National Tax Association, the first three of six principles were specifically directed toward the individuals who make up a tax administrative organization. Personnel in a well-planned organization, it was said, should be classified according to duties to be performed, and stability of employment and upgrading of employees should be provided, within statutory limits, in recognition of meritorious service. In the second place, to maintain high administrative standards, minimum requirements of education and experience should be adopted commensurate with the requirements and compensation of each job classification; and well-defined rules should be set up for advancement in grade and compensation. Finally, systematic training programs should be adopted, particularly for those employees dealing directly with taxpayers, and more particularly for those engaged in determining and settling tax liabilities.[9] All personnel except those in

[8] A. H. Rowland, "Canadian Experience in Decentralization of Administration," *Income Tax Administration*, p. 108.

[9] John K. Speck, "Fundamentals of Tax Administration," *Proceedings*, National Tax Association, 1948, p. 90.

the policy-making and executive positions should be under the merit system.

A staff of competent, alert, well-paid personnel is a condition precedent to effective and fair tax administration. Such a staff, therefore, must be built up, trained, and retained in the public service. However, promotions should not be made on false administrative standards. Due regard must be given to the rights and interests of the taxpayers. The capacity to "haul in revenue" should not be the controlling criterion upon which to base promotions. The promotion of tax civil servants should be made upon qualitative as well as the quantitative handling of cases.

Tax Administrative Techniques

THE LEGISLATURES and the tax administrative agencies must be constantly on the lookout for ways and means by which to carry out the purposes of the tax laws. Therefore, there have been developed various techniques by which the tax administrative work is carried on. Several of these have already been mentioned in connection with the basic task of ultimate enforcement. Many of these techniques can best be discussed in detail in connection with the particular tax to which they are relevant and useful.

However, a brief summary of those techniques will be of general value here. Among these techniques are: (1) assessment techniques, relevant for "valuation of property" under the property tax and for determining the "amount" of tax under the income tax; (2) self-reporting and the tax return which put a good deal of the responsibility upon the taxpayer in the first instance; (3) information-at-the source, a technique which puts a burden upon payers to supply the government with tax data and thus cuts down tax evasion; (4) collection-at-the-source and current collection, a practice which keeps the revenue flowing in regularly and compels payers to pay the taxes due from employees at regular intervals throughout the year; (5) the use of installment payments under the income and property taxes; this increases the convenience to the taxpayer and steadies the flow of revenue to the government; (6) exchange of information between the states and federal government aids both in auditing and checking tax evasion; (7) the "doomage power" and net worth assessment are strong tools in the hands of government when the taxpayer does not supply adequate information—they give the government the power to assess arbitrarily and thus throw the burden of proof upon the taxpayer.

Among other techniques which will be discussed in the relevant places are public inspection of returns, the use of tax ferrets and informers, tax liens, and tax oaths.

Basic Problems in Tax Administration

THE THREE BASIC PROBLEMS that plague all tax administration are delinquency, evasion, and avoidance. All of the purposes of taxation can be defeated if the tax is not well-enforced and ultimately collected. A recognition and a statement of the character of these problems as they relate to tax administration in general is appropriate in this chapter.

TAX DELINQUENCY

Any tax becomes delinquent when it is not paid on the last day designated for payment. Tax delinquency usually arises for several reasons: (1) economic inability to pay at the time; (2) negligence and an irresponsible attitude toward the payment of taxes; and (3) a willful intent not to pay the tax. This whole problem is extremely important from two points of view: (a) during the period of the delinquency the unit of government which had the right to expect the revenue is without those tax resources to perform its functions and meet its responsibilities; and (b) if the ultimate enforcement is carried out, the taxpayer may have rights and reasons that should be considered before property is taken and severe penalties assessed.

If the failure to pay is due to the economic inability, then the taxing laws and authorities should not move too fast and thus do unwarranted harm to the taxpayer. Opportunity should be given to pay in installments, a reasonable period of redemption should be granted, and even reasonable extensions of time should be granted if the taxpayer shows an honest disposition to do what is right. In the long run, however, the obligation should and must be met in full.

Where the failure to pay the tax is caused by negligence and an irresponsible attitude, stronger methods should be brought to bear to enforce the payment "on time." Often the negligence of the taxpayer may have been induced by tax collection methods. If the latter is the case, then the methods should be improved and made more exacting. Permitting tax liabilities to accumulate only intensifies the straits of the taxpayer and creates embarrassing problems for government. Furthermore, extreme leniency is unfair to those taxpayers who pay promptly, and it can affect taxpayer morale. Therefore, the consequences of failure to pay should be made known to the taxpayer, all procedures and steps should be clearly defined, and all dates and periods should clearly be specified so that the taxpayer can govern himself accordingly. All periods of redemption should be reasonable, but they should not run on indefinitely.

TAX AVOIDANCE

Tax avoidance is a device whereby the taxpayer escapes the consequences of the tax by arranging his property, income, and business affairs in such a way as to take advantage of the weaknesses and loopholes in the tax law. The tax avoider arranges to sidestep the law by procedures which may be contrary to the intent of the legislature but nevertheless do not violate the "letter of the law."

Tax avoidance is made possible by the lack of careful drafting of the tax law by the legislature and by leniency in the interpretation of the tax laws by the courts. Both the legislatures and the courts have made their contributions to creating and opening up loopholes in the tax laws. The practice of side-stepping tax responsibilities through the loopholes results in an unfair distribution of the tax burden and a certain recession in taxpayer morale.

The basic solution lies in the careful drafting of the tax laws. This means that legislatures must be aided by staffs of experts who will conduct a thorough research into all the aspects of the proposed tax law. It requires extensive hearings so that all the possibilities and consequences can be "aired" and brought to the surface by those who might be affected by the law.

TAX EVASION

Tax evasion is the outright, illegal failure to pay taxes by nonreporting or by false reporting in relation to particular taxes. It involves the willfull intent not to pay one's tax obligations according to the tax laws. Any system of tax administration that permits more than a very minor fraction of evasion should be completely reexamined and reorganized. Extensive evasion can do more to destroy taxpayer morale and undermine the whole tax administration process than any other administrative error.

The remedy here requires an adequate, competent and well-trained staff and sufficient funds to operate it. Legislative parsimony here can be very costly in the long run. The right proportion of the staff should devote its time to auditing and investigating all returns and taxpayers where there is any reasonable suspicion of evasion. Once the willful intent to evade has been established, then firm and unyielding application of the penalties must be forthcoming. Only by such methods can the tax burden be distributed fairly, taxpayer morale maintained, and effective tax administration operated.

Tax Administration and Tax Equity

FISCAL AUTHORITIES usually place a good deal of emphasis upon fairness and equity in taxation and discuss analytically the whole issue of the distribution of the tax burden. Most of the discussion on justice in taxation is usually in relation to the nature of particular taxes, the theory upon which they are levied, and the type of tax rate pattern that is used. Too often it is overlooked that in the final analysis, fairness and equity depend a great deal upon the "quality" of administration applied to the tax. One phase of that equity arises from having a large enough staff to insure full taxpayer coverage. One fiscal authority makes the following statement on this point:

> If the tax collector is directed by law to dig so deeply into my pocket that only his elbow is showing, I want to be very sure that there are enough more like him, sufficiently trained and properly indoctrinated, to reach as far as the law requires into your jeans. I am aware it costs much money to give me such assurance, but it is a small price to pay for protection against favoritism and arbitrariness, the precursors to tyrannous conduct.[10]

The principle in tax equity alluded to above may be stated in another way: "Effectiveness with which a tax law is enforced constitutes a determinant of its equity." [11] Taxpayer equity demands that tax administration be objectively executed. With all the discussion of tax policy and tax equity that has taken place, the principle still remains that no matter how carefully conceived a tax may be, it is never any better than its administrators.[12]

Equity and administration are inseparable entities that are interdependent upon each other for their respective characters. A sense among taxpayers that they have been discriminated against may have a more serious effect on morale than the establishment of high tax rates. With the job of the administrator being that of collecting only the amount which is justly due under the law (which is in the long run advantageous to the honest taxpayer), it evolves that there is no real conflict between the administrative official and the taxpayer. The tax administrator and the taxpayer must learn to live together.

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[10] George W. Mitchell, "Tax Administration: Objectives, Methods and Tests of Adequacy," *Proceedings*, National Tax Association, 1948, p. 45.

[11] James W. Martin, "Tax Administration and Tax Equity," *Proceedings*, National Tax Association, 1947, p. 299.

[12] "Efficient Tax Administration–the *Sine Qua Non* of Tax Equity," *Tax Policy*, Vol. 15, April 1948, p. 3.

Place of the Courts in the Taxing Process

IN OUR SYSTEM of government with its checks and balances, with its desire to protect the property and personal rights of its citizens, and with its recognition of the right to judicial review, it is not surprising that the courts have projected their influence upon both tax policy and tax administration over the years.

Primarily, the function of the courts in the taxing process should be several-fold:

(1) The courts should check the constitutionality of tax statutes and tax administrative acts. This should be the basic function of the courts, and especially the Supreme Court, where the legislature has provided special quasi-judicial boards of tax appeal and tax courts. The function should be to protect against unconstitutional invasions of the rights of the taxpayer. The Supreme Court should say in this highly technical field (as it has recently said in the field of public utility regulation) that tax issues should be left to bodies of experts—unless a constitutional question is involved.

(2) The second basic purpose of the courts should be to interpret and aid in applying tax statutes. Here it should be as much the function of the courts to carry out the intent of the legislature (assuming no constitutional issues) on tax policy and purpose as it should be to endeavor to protect the rights of the individual taxpayer.

(3) The appellate courts should accept the "findings of fact" of the lower courts and the quasi-judicial boards of tax appeal and tax courts. They should restrict themselves largely to questions of law.

(4) The courts should not indulge in "judicial legislation"—that is, they should not "make tax laws" of their own.

The Role of Economics in Tax Administration

IN THE AREAS of tax policy and tax planning, it has long been recognized that economics and economic principles are highly relevant and vital. Legislatures regularly give consideration to those principles in framing tax legislation. In the field of tax administration, however, until quite recently it was the administrators, the lawyers, the accountants, and the clerks that held sway. Now there is a greater realization that economics can be a tool useful in administering tax laws and collecting taxes.[13]

[13] Wirth F. Ferger, "The Role of Economics in Federal Tax Administration," *National Tax Journal*, Vol. I, June 1948, p. 97.

The tax statutes are becoming so complex and diffuse in scope that the expert advice of trained economists is more essential than ever before. So many of the issues of taxation and its administration are bound up with economics that the administrator takes serious risks when he is not properly advised on the economic aspects of his problems. The valuation of property for property and inheritance tax purposes, for example, is essentially an economic operation. The determination of "what is income" is likewise a question of economic analysis. Working out rate scales under ability-to-pay theories of taxation again is a matter of economic calculus.

Trained economists can be of service in the analysis of underlying conditions prior to the passage of legislation, in observing the effects of a new tax for signs of undesirable consequences, and in tracing the shifting of a tax from its original impact to its ultimate situs. The economist in a tax administrative agency may be called upon to determine the justification of tax refunds, to establish what constitutes normal profits in a base period for excess profits tax purposes, and to appraise the economic justification for various claims made by taxpayers in order to get exemptions, deductions, and credits.

More and more problems in tax administration are coming up each year that require economic analysis. In our day and age the trained economist has become a necessary adjunct to every tax administrative agency—local, state and federal. The agency that fails to recognize this is making its own work more difficult and is running serious risks in administration and in achieving tax equity.

Conclusions

THE ROLE of administration in taxation is becoming increasingly important. It is now recognized that good administration is a condition precedent to the success of any tax law. Tax administration is of strategic significance in the taxing process in that it can bring to light ways and means of improving the law; it can contribute to a wholesome taxpayer morale; it can lighten both the psychological and economic burdens of taxation; and it is an important element in over-all fiscal policy.

Moreover, good tax administration can make for greater tax equity and fairness; for regardless of the essential justice of the tax law itself, equity will not be realized if administrative organization and methods are lax and inefficient.

Finally, fair treatment and good public relations between the taxing agency and the public will lubricate the whole taxing process; it will aid in collecting the necessary revenue for governments with a minimum of friction and with an optimum of distributional justice.

Part Two

THE TAXATION OF PROPERTY

VI. THE ECONOMICS OF PROPERTY TAXATION

VII. HOW THE PROPERTY TAX IS ADMINISTERED

VIII. PROPERTY TAX PROBLEMS AND REFORMS

6

The Economics of Property Taxation

THE POSSESSION *of property furnishes so obvious a basis for the distribution of the costs of government or so obviously invites the exactions of the necessitous ruler, that it is not surprising to find that the property tax is among the oldest of taxes.*

—FAIRCHILD, FURNISS, AND BUCK.[1]

Overview

THE GENERAL PROPERTY TAX is the very backbone of local tax systems in the United States. It is peculiarly an American development, for in no other country in modern times has it achieved such significance as a source of revenue. Nevertheless, the tax has grown into great disrepute from the position it held during the nineteenth century.

The purposes of this chapter shall be: (1) to analyze the revenue significance of the property tax to the various units of government within our federal system; (2) to analyze the economic basis of the general property tax; (3) to review and define the various kinds of property taxed and some of the economic problems that arise in taxing each type; (4) to appraise the *in rem* character of the property tax and the economic consequences of that character; (5) to review the principles and problems associated with the jurisdiction to tax property; (6) to investigate the standard of property valuation; (7) to analyze and appraise the merits and demerits of the property tax; (8) to investigate the shifting and incidence of property taxation; (9) to appraise the property tax as an instrument of fiscal policy; and finally, (10) to discuss the future of the property tax on the American scene.

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[1] Fairchild, Furniss, and Buck, *Elementary Economics*. New York: The Macmillan Co., 1930, Vol. II, p. 375.

The Fiscal Significance of the Property Tax

Over-all significance. The general property tax still occupies an important though a slowly-declining relative place among American taxes. It is only within the last ten years that it has slipped from its position as a leading over-all revenue producer. In 1932 property taxes collected by all units of government amounted to about $4.5 billion, or somewhat less than 50 per cent of the total collections. In 1941 it contributed about 31 per cent of the total tax collections.[2] Under the impact of war and postwar taxation by the federal government, the proportion has dropped to a much lower percentage.

The federal government and property tax. Because of the constitutional provision that all federal "direct taxes" must be apportioned among the several states according to population, the federal government has never utilized the property tax very extensively. It attempted to do so several times during the nineteenth century but was never successful in the actual collection of revenue. The federal government has not been able to levy the tax directly. The property tax, therefore, is practically of no fiscal significance to that unit of government. Property taxes may be levied under federal jurisdiction in "federal territories and districts," however.

State property taxes. Since the close of the last century, property tax revenues have been of a declining significance to state governments also. There has been a conscious effort on the part of state governments to withdraw from the property tax field. In 1900 over 50 per cent of all state revenues came from this tax. In 1948 only one state, Nebraska, received over 20 per cent of its tax revenues from this source (27.5 per cent). Five other states, however, raised more than 10 per cent this way. About 24 states received less than 5 per cent of their total revenues from the general property tax. In the same year fifteen states (including California and Wisconsin) did not rely on this tax for revenue at all, although some of these states administered the general property tax on particular types of property such as railroads, public utilities, and mines.[3]

Local property taxes. Property taxes are the very substance of local tax structures. The local units are not sovereign and therefore can only levy such taxes as they are permitted by the state. All states, however, have permitted the local units a good deal of latitude in levying property taxes. But aside from this, until recently they have had little other power to tax. In 1946 the local units collected about $5 billion in property

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

[3] *Tax Systems* (12th ed.). New York: Commerce Clearing House, 1950, p. 307.

taxes. That probably represented about 93 per cent of all local tax revenues and about 60 per cent of all local revenues (tax and non-tax).[4] It must be remembered that the local units, especially the school districts, now get substantial aids from the state governments. The conclusion is, of course, that the local units are highly dependent upon the property tax for revenue—more so than any of the other units.

The Economic Basis of the General Property Tax

The general concept of property. In making an analysis of the economic basis of the property tax, two questions emerge: (1) What is property? and (2) What is the general property tax?

In legal contemplation, "property" refers to "title" and "ownership." It is in the nature of a "bundle of legal rights" with respect to something which can be owned and possessed. It implies the right of dominion, and control over the use, possession, and enjoyment of goods or things. It further implies the right to "exclude" all others.

But the word "property" is often used to designate the very object itself—the land, the building, the automobile, or the jewelry. These objects are, when accompanied by possession, but the indicia of invisible rights. One of the issues that is bound to arise under a property tax is: Are we taxing the "thing" or the "rights"? There is no consistent definition of property in American tax law.

Very closely associated with the legal problem of distinguishing between substance and rights is that with which the economist must wrestle —the necessity of distinguishing between "property" and "wealth." Wealth consists of material things plus such "intangible rights" as do not reduce the rights of others in substantive things.[5] Patents, royalties, trade marks, good will, and franchises are such rights. They can be designated as nonrepresentative of other property (as contrasted with stocks, bonds, notes, and mortgages, which may represent or be secured by other forms of property). Nonrepresentative intangibles are "net wealth" because there is no double counting of the same thing.

The general concepts of the property tax. This confusion in the concept of property is further complicated by the lack of clarity as to what the property tax is intended to be. Is it intended to tax "property" in the legal sense of a bundle of rights and therefore tax all legal rights

[4] *The Economic Almanac for 1949.* New York: National Industrial Conference Board, 1948, p. 164.

[5] Jens P. Jensen, *Property Taxation in the United States.* Chicago: University of Chicago Press, 1931, p. 49.

in full? Or is it intended to be a tax on "wealth," so that each owner would be taxed only on his "net wealth" or "net equity"?

Our property tax statutes do not give us a clear-cut answer to these questions. Originally, the property tax was intended to be specific—not general. Specific types of wealth were designated as subject to the property tax. Those kinds of property not enumerated in the statutes were exempt. Little by little, the transition to a general property tax was achieved. Recently, however, (by exemption in some states) the tax has become essentially one upon real property.

In its broadest interpretation the "general property tax" was (and still is in many states) a tax upon all property, tangible and intangible, which is endowed with value in exchange.[6] The "general" character of the property tax is evidenced in the phraseology of the state constitutions and statutes on the subject. It is not uncommon to find the provisions worded as follows: "All property, real and personal, within this state, not specially exempt, shall be taxed in proportion to its value. The word property as used in this section is hereby declared to include moneys, credits, bonds, stocks, dues, franchises and all other matters and things, real, personal, and mixed, capable of private ownership." [7]

From this it can be seen that the general property tax is broad and inclusive; it is not geared to tax only "net wealth" and "net equity"; it covers both tangible and intangible, representative and nonrepresentative personalty. In America there have developed two main theories as to the character of the property tax. First, the property tax should be "universal"—that is, "all property" possessed of exchange value and capable of private ownership should be taxed. The second theory is that it shall be "uniform"—that is, all property shall be taxed at full value or an equal percentage of its full value and at equal rates. This concept of uniformity was insisted upon because it was originally thought that all property was homogeneous in character and therefore equally able to bear taxes. In actual practice, since 1900 both of these theories have been modified considerably, so that in most states the property tax is not nearly as universal or as uniform as it was during the last quarter of the nineteenth century.

The Kinds of Property Taxed

BASIC TYPES OF PROPERTY

Real property. One of the most fundamental forms of property is that which is designated as "real" property. The word "real" comes from the Latin word *res*, which means "thing." For early peoples "land" was the "thing." At common law, land was the first type of property

[6] *Ibid.*, pp. 48-53.

[7] A condensation and paraphrasing of Art. XIII, Sec. I of the California Constitution.

recognized. In all states and their subdivisions, real estate situated within the territorial limits of the taxing districts is subject to taxation unless it is expressly or implicitly exempt. Furthermore, the separate "interests" which different individuals may have in the same land (such as where one man owns the basic fee or title to the surface, another owns the timber growing on it, and still another the mineral below the surface) may each be subject to the general property tax.[8]

But real property includes much more than bare land. It includes land and generally whatever is erected or growing upon or affixed to the land. Real property is looked upon as something that is "immovable" and relatively fixed in its location. In all jurisdictions, therefore, all buildings and other improvements on land are taxed as part of the land and not separately. Growing crops, standing timber, and mines and minerals in place are taxed as part of the land.

Personal property. The other basic type of property is that which is called "personalty." Its distinguishing characteristic is that it is separate or separable from realty and that it is "movable." The best examples are automobiles, furniture, clothing, livestock, jewelry, stocks, bonds, and so on. The line of distinction between realty and personalty is not always clear. "Mobility" or "immobility" is a relative matter, but it is a fairly reliable test in relation to the great bulk of real and personal property. As we shall see later, in some states the distinction between real and personal property is quite relevant and significant. This is especially true in those states where certain types of personal property are exempt from the general property tax.

REAL AND PERSONAL PROPERTY DISTINGUISHED

In those states where the property tax is still truly a "general" property tax, the distinction between "real" and "personal" property is not too significant because "all" property is assessed in the same manner and taxed at the same rate within any given tax district. However, many states have modified their property taxes quite materially. Some states have placed certain personal property in a special classification and tax it at low, flat rates; some exempt certain types of personal property, and others exempt practically all personal property from the tax. But the line of distinction between real and personal property is not always clear. In the states where personal property is exempt, claims are continually being made that given assets are personal property and are therefore exempt under the law. This distinction also becomes important in the taxation of national banks, for under the federal law there is no provision for the taxation of the personal property of banks. It is then that the

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[8] T. M. Cooley, *The Law of Taxation.* Chicago: Callaghan and Company, 1924, Vol. II, p. 1218.

distinction becomes very important in terms of tax dollars, and it then becomes necessary for the courts to draw the line of demarcation between the two types of property.

The courts usually take three factors into consideration in determining whether given property is real or personal: (1) the degree of physical annexation to the realty; (2) the adaptation of the use with real property; and (3) the intention to annex the property in question to realty.

Generally, there is a strong tendency to follow the law of fixtures under which, when equipment and other assets are attached to a building, they become part of that building.[9] Usually equipment which is movable and merely plugged into an electric connection will not lose its character as personalty. For purposes of taxation, however, the legislature may specify what shall and shall not be classified as personal property.

THE ECONOMICS OF REAL PROPERTY TAXATION

From the point of view of economic origin and characteristics, real property consists of land and improvements on land. Land is a basic "natural resource," relatively fixed in supply, incapable of migrating, and appropriated or purchased by man rather than created by him. Land values may increase while the value of the buildings on it may be declining. Improvements on land, on the other hand, are in the nature of "capital"; and in order to compound capital man has to save, risk, and labor. Some types of capital can migrate, most capital depreciates, wears out, and must be replaced; and its market price (if the product is reasonably available) cannot go above its cost of reproduction.

These are basic economic differences between the two types of real property. In scientific tax construction the economic characteristics of the two types of property are relevant and they should be taken into consideration when property tax laws are framed.

Land (because it is fixed in supply and because of its immobility, etc.) can bear a heavier tax burden without serious economic and social consequences. Buildings and improvements (because man has to save, risk, and labor to establish them) are more sensitive to the repressive effects of tax levies. On the other hand, a lighter tax burden can have a stimulating effect upon building and improvement expansion. Then, too, the shifting, incidence, and effects of the property tax burdens upon the two types of property can be quite different.

At present in most American property tax jurisdictions, very little emphasis is placed upon these economic considerations in setting up property tax structures. A few jurisdictions, based upon economic considerations, impose a lighter tax on buildings and improvements than on land, but that practice is still rare in this country.

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[9] *Trabue Pittman Corp. v. Los Angeles County*, 29 Cal. 2nd 385 (1946).

THE ECONOMICS OF PERSONAL PROPERTY TAXATION

Based upon its substantive and economic characteristics, personal property falls into two basic classes—tangible and intangible. Tangible personal property is that type of property which has a physical, substantive existence in its own right. It is any movable property possessed of a body that is not representative of something else. Much of it can be hidden and concealed from the view of the property tax assessor; some of it is in the nature of consumption goods; some of it is in the form of production goods that yield a money or service income. It includes a wide range of goods and commodities such as clothing, furniture and furnishings, jewelry and other personal effects; books, automobiles, athletic equipment; producer's and merchant's inventories; business furniture, fixtures and equipment; farm draft animals, machinery, tools and movable transportation equipment—in a word, anything movable that one can lay one's hands on for consumption, enjoyment, or production.

The second main division is intangible property. This category can be further broken down into "representative" and "nonrepresentative" intangibles. Intangibles are "bundles of legal and contractual rights," usually in the form of some paper instrument.

"Representative" intangibles are those which are "evidences of" or "representative of" interests in other forms of property (real or tangible personal property). If the latter were to be destroyed, the representative paper instruments would lose their value. The best examples are notes and mortgages, stocks, bonds, deposits, and book credit. Since these instruments are representative of interests in other property which may already be taxed, double taxation usually results in relation to representative intangibles.

The second group of intangibles are known as "nonrepresentative" intangibles. They are incorporeal rights which do not diminish the rights of others in material things. Such rights as patents, royalties, trade-marks, good will, and franchises fall into this category. To tax these under the general property tax does not result in double taxation. Both types of intangibles, however, are easily concealed and, therefore, are subject to a great deal of tax evasion.

The "In Rem" Character of the Property Tax

THE LEGAL and administrative approach to the general property tax is that it is an "impersonal" tax, a tax *in rem*—against the "thing." Those taxes—the impact of which is upon things, business, and transactions—are usually looked upon as impersonal. This is to be contrasted with such

taxes as income and poll taxes, which are recognized as highly personal in their impact. The economic burden of all taxes in the final analysis falls upon persons, yet there are administrative, social, and economic differences in the consequences of these two types of taxes.

There are several bits of evidence, especially of an administrative character, that help to demonstrate that the tax is on the property *(in rem)* rather than on the person (*in personam*): [10] (1) Real property can only be taxed in the district of its location. (2) In the assessor's offices the property is listed for assessment purposes according to its "legal description" (lot 5, block 16 of the Henderson subdivision in the city of Hancock), rather than by the names of the owners. (3) The property serves as the security for the payment of the tax; sometimes it is the sole security, so that on default, the action is against the property by tax sale, etc. "The land stands accountable to the demands of the state." [11] (4) The taxes upon the lands are charged to the "legal" owners rather than the "equitable" owners (such as mortgagees). If the true owner cannot be found, the occupant can be requested to pay the tax. (5) The owner is not permitted to offset his debts and mortgages against the assessed value of his property. This was discovered by a taxpayer in New York in the early 1900's.[12]

In the economics of tax thinking, the *in rem* character of the tax means that there is no effort to tax "net equities." The legal title holder to the property must pay taxes on the full value of the property in spite of the fact that his equity may be only a fraction of the full value. In many states the mortgagee's interest is also taxed—a situation which may result in double taxation. The *in rem* approach completely disregards ability and taxes the mortgagor on a value that he does not possess.

The Jurisdiction to Tax Property

IN OUR FEDERAL SYSTEM of government with 48 states, 3,000 counties and 16,000 incorporated cities and villages, there must be some rules for determining "which" unit shall have the right to tax "what" property. One authority has rather sardonically said that "stripped to stark simplicity, jurisdiction to tax is a phase of dividing the tax spoils." [13] Nevertheless, a body of rules for establishing the right to tax is highly necessary. These rules have come to us from the common law and have been modified by our legislatures and courts.

[10] Jensen, *op. cit.*, pp. 104-5.
[11] *Ballard v. Hunter*, 204 U. S. 241 (1907).
[12] *Padell v. City of New York*, 211 U. S. 446 (1908).
[13] Charles L. B. Lowndes, "Rate and Measure in Jurisdiction to Tax," 49 *Harvard Law Rev.* 756 (1936).

One of the first concepts the courts worked out to aid in the determination of which units of government have the right to tax the property is the concept of *legal situs.* (This means the recognized legal "location" of the property.) It is necessary to establish the *legal situs* of the property before any unit can lay claim to the right to tax. The basic and original principle establishing jurisdiction was that the property had to be "within" the territorial boundaries of the taxing unit. The next problem was that of establishing the *legal situs* of the "different types" of property under varying circumstances.

Jurisdiction to tax land. Since land and the improvements attached thereto are by their very nature stationary and fixed in their physical location, there is no difficulty in determining *legal situs.* Land and improvements, therefore, can only be taxed in the district where they are physically located. The legal theory back of this concept is that the power of taxation is exercised upon the assumption of an equivalent service rendered to the taxpayer in the protection of his person or property, or that other public conveniences in which he or his property shares are offered. The Supreme Court early in this century confirmed this theory when it said:

> If the taxing power be in no position to render these services, or otherwise benefit the person or property taxed, and such property is wholly within the taxing power of another state . . . the taxation of such property within the domicile of the owner partakes rather of an extortion than a tax and has been repeatedly held by this court to be . . . a taking of property without due process of law.[14]

Jurisdiction to tax tangible personalty. Tangible personalty, like realty, is taxable in the district where the property is located and not at the domicile of the owner. However, since personal property is movable and is moved about from one tax district and even one state to another, a question of fact often arises as to where the *legal situs* is. Some reasonable rules had to be developed to meet the various sets of facts. Mere temporary presence in a taxing district does not give rise to the right to tax. The fact that an automobile is in another jurisdiction on assessment day does not give jurisdiction to tax, even though the automobile was present for some time both before and after assessment day. The general rule is that tangible personal property can be taxed where it is regularly used and kept.

Jurisdiction to tax intangibles. The taxable situs of intangible personal property is more difficult to determine. The present underlying principle is derived from an old legal axiom, *mobilia sequuntur personam*—movables follow the person, or intangibles follow the person. Under this principle, the stocks, bonds, and mortgages a man owns are supposed to

[14] *Union Refrigerator Transit Co. v. Kentucky,* 199 U. S. 194, 195 (1905).

follow him; so that wherever he makes his domicile, that state will have the right to tax. However, in recent years the courts have increased the jurisdiction of the states to tax intangibles by holding that any state which gives protection or benefit to the intangibles, no matter how small, may tax. This means that because some bonds may be in a safety deposit box within a state, that is sufficient to give the state the right to tax. At the same time the state of the domicile of the owner may also lay claim to some revenue; the net result is the possibility of double taxation of the same intangible by two different taxing units.

Furthermore, under the decisions of the courts, intangibles may acquire a *business situs* by virtue of the manner in which they are used in the conduct of the business, even though they may not be physically within the state; it is sufficient if they are managed and controlled from within the state.[15]

It will be observed, therefore, that the task of determining the taxable situs of intangible property interests in a complex credit economy is often a difficult one. The possibility of having several states taxing at the same time is not remote. Territorial multiple taxation exists in no small volume to increase tax burdens and to multiply inequities.

The General Theory of Property Valuation

ONE OF THE FUNDAMENTAL economic problems associated with the use of the property tax is that of determining the *tax base*. Broadly stated, the *tax base* is the "value" of the property. In economics and in life, things are considered to have value because they render services which can satisfy human wants. In that phase of economics which deals with the value of *property*, things are recognized to have value because of their ability to render services as a residence, as a place to conduct a business, or because they possess the ability to command money or other property in exchange.[16] These benefits and services from property come about from the exercise of the "powers of ownership" by those who presently own the property or by those who would seek to own it in the future. The task of the legislatures in working out the theory and standard of valuation for property tax purposes has not been an easy one. In many jurisdictions the concept of valuation has become quite confused.

Development of the ad valorem concept. In the early 1800's the property tax as administered in many states, and especially the western states, was a "specific acreage tax"—so many cents per acre regardless of

[15] *Wheeling Steel Corporation v. Fox*, 298 U. S. 193 (1936).

[16] James C. Bonbright, *Valuation of Property*. New York: McGraw-Hill Book Co., 1937, p. 14.

the value of the land. Gradually, however, with the development of many other forms of property, the tax was transformed into an *ad valorem* tax and assessment on "market values" became the general rule in our property taxation.

Statutory standards of valuation. Pursuant to the "market value" concept, the state legislatures began to frame the statutory standards of valuation which were to be the guides for the assessors in administering the property tax. In all states the *base* for property taxes was made the "asset value" of the property *as of* a designated assessment day. But the legislatures in phrasing the standard attached many qualifying adjectives to the term "value" and thus added to the subsequent confusion in the interpretation of the standard. The property tax statutes of the various states express the standard in a myriad of different ways. Common among the statutory expressions are "fair market value," "actual cash value," "true cash value," "fair cash value," "true value," "full cash value," and a number of others. Often appended to these value expressions is a clause which says that the taxable value shall be the price which the property would bring in a free market on sale between a "willing buyer and a willing seller."

The various states have applied their respective standards in different ways, and thus the valuation standard and process has become somewhat more confusing. Some states use the "full" fair market value as the actual property tax base—that is, the property is assessed at 100 per cent of the fair market value. Other states will assess at 50 per cent of their particular standards, some at 60, some 80, or 90 per cent. Some even go so far as to assess at 100 per cent for state purposes and at a lower percentage for local purposes. This practice of assessing at a "fraction" of the full value will necessitate a higher tax rate, and it is believed that the legislature will be more conservative in voting appropriations. These are the standards which the citizen must attempt to understand, the assessor to administer, and the courts to interpret.

Judicial interpretation of the standards. Standards set by legislatures naturally are tested in the courts when taxpayers feel aggrieved. The "fair market value" concept of assessment has had its share of judicial testing (again, often to the further confusion of the citizens as well as the assessors).

And yet, many cases also arise in which market value proves unworkable as a basis for property tax assessment. This is particularly true of properties constructed for particular purposes. Such properties may be quite valuable for their purposes, but buyers in the market may not have use for the properties for those purposes. It is when the market value standards are applied to this kind of property that special complications arise and the courts are asked to intervene.

Some of the better examples of this type of property are golf courses,

stock exchanges, "home office" insurance buildings, expensive homes built in small cities, and so on. Very often the assessors attempt to get at the value of the property to the owners, and then the owners complain and ask judicial assistance.

A leading case involving the valuation of the "home office" of an insurance company peculiarly constructed for its purpose held that the assessor had to use the "fair market value" standard, even though this resulted in a valuation substantially below what the building was worth to the company for "home office" purposes. The Wisconsin Supreme Court took the strict view that the "statute" required "sale value" and that the court could not indulge in judicial legislation and permit anything else.[17]

However, even the Wisconsin Court has eased up on the standard in a roundabout way. In a later case the court held that factors such as book value, the price at which the property had been listed for sale, the amount of insurance carried, and other evidence of extrinsic value could be "considered" in arriving at "sale value." But the warning was that the assessor must always be working toward the "statutory standard" of sale value.[18]

In contrast with the position taken by the Wisconsin Court is that adopted by the New York courts on a "special purpose" building, the New York Stock Exchange. The court in the case met the objection that market value means sale value by "construing" that tax statutes call for "full value" and by holding that market value was to be resorted to only under circumstances that reflected the full, true value. The court was not too meticulous, however, in how it defined true or full value.[19] Since then courts in other states have also been more liberal in their construction of "fair market value" statutes.

Analysis of the Merits and Demerits of the Property Tax

THE GENERAL PROPERTY TAX has been criticized by taxpayers and fiscal authorities more than any other single tax in the entire American tax structure. That it has its fiscal advantages for certain units of government no one can deny. That it has its weaknesses is also equally patent. In analyzing its merits and demerits, it is logical to classify the analysis into two categories: (1) that associated with the very "theory" or "sub-

[17] *Northwestern Mutual Life Ins. Co. v. Weiher*, 177 Wis. 445, 188 N. W. 598 (1922).

[18] *State ex rel Flambeau v. Windus*, 208 Wis. 583, 243 N. W. 216 (1932).

[19] *People ex rel N. Y. Stock Exchange Bldg. Co. v. Cantor*, 221 App. Div. 193, 233 N. Y. Supp. 64, aff'd, 248 N. Y. 533, 162 N. E. 514 (1928).

stance" of the tax, and (2) that related to the "administration" of the tax. When the merits of property tax are appraised in this manner, a more thorough and systematic evaluation can be made.

MERITS ON THE THEORY SIDE

Benefits received. The theory of benefits received has been used to justify the general property tax at least in part. The benefits to real property from local expenditures fall into two main classes: (1) direct services rendered in relation to the property, and (2) performances which tend to increase real estate values.[20]

There are certain annual services performed by government which "directly" benefit property as such. Included in these are garbage collection, sewage systems, street maintenance, the pruning and spraying of street trees, and to a lesser extent police and fire protection. Fire protection both reduces losses from fires and lowers the cost of fire insurance.

There are other functions of government which benefit the owners of property directly or indirectly and thus raise property values. Among these are the maintenance of schools, playgrounds, parks, hospitals, libraries, swimming beaches, and pools. These services, though they are intended for the use of persons, may indirectly benefit property and enhance its value, especially when the improvements are in reasonable proximity to the property. When the latter types of improvement are paid for out of general property tax funds (as they sometimes are), the tax can easily be justified in part on the grounds of benefits received.

Fiscal advantages. From the point of view of state and local units the general property tax possesses substantial fiscal virtues. It produces large volumes of revenue in a reliable and reasonably predictable manner. The yield is quite steady even into depression periods. The tax base and the rates can be adjusted from year to year to meet the needs for revenue, whatever they may be. Finally, the property tax is well-suited to local use. The property is located within the local taxing district; most of it cannot migrate very easily. This means that the local units can reach it and administer the tax better than any other single tax.

CRITICISMS ON THE THEORY SIDE

Property tax poor measure of ability-to-pay. Though the argument is advanced that property is evidence of ability to pay, upon more careful scrutiny, such a generalization appears too broad and loose. Gross property holdings may or may not represent ability to pay taxes. If it is income-producing property, it may possess that ability. On the other hand, if the property is non-income property, if it is heavily mortgaged,

[20] Edwin H. Spengler, "The Property Tax as a Benefit Tax," *Property Tax.* New York: Tax Policy League, 1940, pp. 165-173.

if it is unoccupied, if the owner is "property poor," if the property is quite old, then the ownership of property may *not* represent ability to pay at all. It may represent a "bundle of fixed charges." In the case of most tangible personal property there is very little correlation between ownership and ability. Furthermore, the property tax is a tax *in rem*, and therefore owners are not allowed to deduct debts and liabilities attached to the property. The better consensus of authority is that the ownership of property does not necessarily represent ability to pay current annual taxes.[21]

Property tax poor test of benefits received. A stronger case can be made for the property tax on the ground of benefits received than ability-to-pay. But even here the foundations are not very firm. The first difficulty lies in the fact that there exists no clear calculus by which benefits can be determined, especially under a "general" tax such as the property tax and the "general" services rendered by local governments with property tax revenue. It is extremely difficult to justify state property taxes on the benefit theory, because state governments render few services which inure directly to the benefit of property. Even at the local level the service rendered to personal property (except automobiles) is probably less than that supplied real property—which means that the correlation between taxes and benefits is even less.

Furthermore, many of the services rendered with the proceeds of the general property tax are to "persons" and are personal in character—education, health service, police protection to persons, recreational services, and others. On the whole, too large a proportion of property taxes goes for non-property services to justify the "full" property tax on the benefits principle.

General property tax results in double taxation. In those states (and there are still many of them) where both real property and intangible personal property are included in the property tax base, the possibility of double taxation arises. Since the property tax is a tax *in rem*, the full assessed value is taxed to the legal owner of the property without any reduction for an outstanding mortgage. At the same time the mortgagee-creditor is taxed on his mortgage interest. There is only one piece of real property involved, yet two taxes are paid. This is especially inequitable to the legal owner, because he pays the full tax on the property even though he has only a partial "equity" in the property. (In addition, he may be forced to pay a higher rate of interest because the mortgagee may shift his tax to him at the time of entering the mortgage agreement.)

Inconvenient as to timing. Another theoretical weakness of the general property tax is that it is inconvenient as to timing. Certain types of property, such as natural-resource property, may go for long periods

[21] Clarence Heer, "The Property Tax as a Measure of Ability," *Property Taxes*. New York: Tax Policy League, 1940, pp. 155-164.

without returning income to the owner. Nevertheless, the owner is obliged to pay the general property tax each year. Owners of forest lands often experience this type of burden. In depression periods, much rental property stands unrented, small business places are unoccupied, plant and equipment is idle: yet the general property tax marches on, taking its tax toll without any correlation to income from the property.

Property tax undifferentiated in impact. The "general" property tax, where it exists as such, is indiscriminate in its impact upon all forms of property regardless of economic characteristics. In many states every conceivable type of property is included in the tax base. It attempts to be "universal" and "uniform" and treats all property as one homogeneous mass. Consumption goods such as homes, furniture, cars, and personal effects are lumped together with production goods such as rental property, plant, equipment, raw material, and business inventories. Farm lands are grouped with urban real estate. Residential property is treated along with commercial and industrial property. Improvements made by man are treated the same as the land supplied by nature. In truth, general property is a heterogeneous mass unscientifically treated. There are economic bases for differentiating the various types of property, but these are disregarded.

Property tax burden on housing. Under a general property tax the very thing that democratic nations attempt to encourage in their citizens is burdened. Residential property bulks large in the property tax base of all urban areas. Taxes constitute a substantial fixed charge that all homeowners pay directly and renters pay indirectly. In periods of unemployment the weight of that burden increases and often contributes to the loss of mortgaged property by the debtor-owner.

Property tax regressive in effect. It is true that nominally the general property tax operates under a proportional rate—a "flat rate," regardless of the amount of property. However, when the amount of tax paid by the small property owner and low income earner is related to his income, the tax becomes regressive in effect. (That is, the tax absorbs a larger proportion of his income than is true of the recipients of larger incomes.) It is said to hit the little fellow harder.

MERITS ON THE ADMINISTRATIVE SIDE

From the point of view of the local units of government, the property tax possesses some advantages of an administrative character. The great bulk of the property is usually "within the jurisdiction" of the taxing unit. Real property is within plain view and cannot migrate. It, therefore, becomes the tax which the local units are in a better position to administer than any other. The local units are in a position to protect themselves (in case property owners do not pay their taxes) by acting upon the property under the tax lien and tax sale.

CRITICISMS ON THE ADMINISTRATIVE SIDE

Assessment inequalities "within" same district. The weakest link in the property tax administrative process lies in the "valuation" of the property and in establishing the *tax base.* For various reasons, errors and inequalities creep into the assessment process, with the result that it is not uncommon to find material differences in the valuation of essentially similar pieces of property in the same taxing district. Bribery, friendship, politics or honest error may account for the inequalities. These inequalities produce serious inequities—they lighten the burdens of some and expand the burdens of others. The uniformity required by law breaks down in the administrative aspects much to the disrespect of the property tax and the demoralization of the taxpayer.

Assessment inequalities "between" tax districts. Another form of inequality creeps in where several levels of government have a right to a part of the property tax in a given tax district. Under these circumstances the local assessor tends to "undervalue" the property in his district in order to reduce his district's share of the tax going to the overlying central unit, usually the county or the state. This is called "competitive undervaluation," and when it occurs it means that the property owners in the undervalued district do not pay their fair portion of the central unit's share of the property tax and that the taxpayers in the other districts pay proportionately more. This is clearly an inequality that must be adjusted.

Property tax regressive in effect because of way administered. The property tax can be regressive in effect because of the way the property is assessed. There is some tendency among assessors to assess properties of small value quite accurately, partly because the average assessor is familiar with property values in the lower valuation brackets. On the other hand, there is also some tendency for assessors to "undervalue" the more high-priced properties. This may be because they are not familiar with high values or because the property owner is influential in the community and therefore influential with the assessor also. The regressivity comes from the fact that small property pays more than its proportionate share, whereas the big property holder pays on an assessed value much smaller than it ought to be.

Property tax stimulates tax migration. It is true that "real estate" when subjected to taxation cannot migrate to lower tax areas. However, many forms of intangible personal property can be withdrawn and sent to lower tax communities. Bank deposits are often withdrawn just before assessment day to avoid taxation. Even in the case of real estate, a form of migration takes place. When the property taxes in our large cities become quite high, the taxpayer himself may migrate to a lower tax area (usually out in the "county" or a suburban area). This is often called

"tax colonization"—large numbers of people migrate away from the high property taxes in the cities and colonize outside where public expenditures are kept low in relation to the tax base. This means then that the tax rates can be kept low.

However, these people usually continue to work in the city and although they enjoy many services from city governments, they contribute nothing to the cost of the services enjoyed; the taxpayers in the urban districts have to bear the entire burden. In addition, in some states, California included, the people living in the cities actually help pay for many of the municipal services rendered by the county government out in the unincorporated areas. The city people do this when they make their contribution to the county tax levy.

Evasion of property tax. Generally speaking, there is no serious evasion of "real property" taxes, although sometimes pieces of property are accidentally omitted from the assessment roll. Under the "general" property tax, in many states, however, tax evasion is a real problem in relation to both "tangible" and "intangible" *personal* property. In such states as Illinois, where all forms of personal property are included, the volume of bank deposits reported for tax purposes in Chicago is insignificant compared with the hundreds of millions in deposits known to be in the banks. The experience has been quite similar in most states. In many places the assessment of intangibles is a recognized joke and has had a great deal to do with the increase in the disrepute of the property tax.

The indictment of the general property tax is quite convincing both as to its theory and substance and as to the way it is administered. No tax in the entire state and local tax structure is in such need of a scientific overhauling as the general property tax.

Shifting and Incidence of Property Taxes

BECAUSE OF ITS IMPACT upon a large number of types of property, the general property tax presents a range of possibilities of shifting. Two of the most important concepts in the science of economics are income and wealth. Both income and wealth are measured in terms of money. Income, or real income, is the flow of money, or goods and services through a period of time. Wealth is a stock or inventory at any particular time. To understand the theory of the shifting of taxes on property, it is necessary to understand the distinction between these concepts. Property constitutes a stock or inventory of goods; some is used directly in consumption; some in the process of production; some merely gives satisfactions, and some creates income.

The shifting of taxes on land. In the usual discussion of land it is contended that because the supply of land is relatively fixed, shifting is not likely to occur except in the form of *tax capitalization.* Land, however, receives an income called rent, and if the supply of land which is actually used can be shown to vary with the amount of tax, a tax on land could be shifted.

There is no agreement among recognized authorities on the matter of whether land rent does or does not enter into price. Regardless of whether it does or does not, if the imposition of a property tax causes the marginal farmer to "give up the ghost," it seems that at least a portion of the tax will be shifted. Less land in cultivation will reduce the supply of produce and tend to increase the price of produce and land.

It is generally recognized that upon the *sale* of land a form of shifting known as *tax capitalization* tends to take place. The prospective buyers tend to discount the future anticipated taxes which reduce the income from land, and so they offer a lower price for the land. In effect, the seller is forced to absorb the future taxes by accepting a lower price for the land. But even this may not occur if all other forms of investment are affected by the same tax. Tax capitalization is most likely to take place when other investments are not taxed equally with land.

Shifting of taxes on buildings. Shifting in the case of a tax on buildings may well depend upon whether the buildings are owner-occupied or rented out. If a property tax is levied on the owner-occupant of a building, there is little he can do to avoid bearing the burden except to keep down the assessed valuation.

A great number of buildings are held for rental. How will a property tax affect rents under these circumstances? If rent depends on the supply of and demand for dwelling units, there would seem to be little effect in the short run. In the long run, however, if the higher property tax cuts into the profits from rental services, it will tend to curb the construction of additional rental units. Over a period of time, this will affect the supply of housing adversely. Then, with a steadily-rising population the demand for housing may increase. Under those circumstances landlords may be able to raise rents and thus shift property taxes. Another way in which owners react with the advent of higher taxes is to postpone upkeep and repairs. This causes the property to deteriorate and is one of the ways that the supply of buildings is reduced.

If the rental property is sold, subject to higher taxes which reduce income, then, of course, there arises the possibility of *tax capitalization,* again in the manner and under the principles stated above.

Shifting of taxes on goods in hands of consumer. If a property tax is levied on goods after the consumer has purchased them, there is little that the consumer can do about it. Taxes are shifted through changes of prices in transactions. Once goods have reached the hands of the ultimate

consumer, they have come to rest for the purposes of use and enjoyment. The most that the taxpayer could do would be to ask for higher wages, but that is unrealistic and is likely neither to occur nor to succeed.

Shifting of taxes on business inventories. If the property tax on business inventories is permanent and is levied on all competitors, there is a likelihood that it will be shifted. Under these circumstances, businessmen will consider the tax a part of the cost of doing business and will thus raise their prices sufficiently to cover the tax. This will definitely tend to be the case in the long run (and if migration to lower tax areas is not available). Businessmen cannot ignore the character of the demand for their product, however. If that demand is quite elastic, the possibilities of shifting become less.

Shifting of taxes on intangible property. In some states intangible personal property is still subject to the property tax. The usual experience with a large fraction of this property is that the tax is evaded, not shifted in the usual sense. However, if the intangibles are ferreted out and taxed, shifting can occur only through a change in the price of the intangible or in a change in the rate of return upon it. This is especially true of stocks and bonds upon sale and transfer; it also occurs in connection with notes and mortgages at the time the contract is entered into. The process would tend to lower the market price of stocks and bonds in existence and to raise interest rates on mortgage loans. Other factors such as the relative burden of the tax upon other forms of investment and government policy in relation to the interest rate also affect the final outcome.

Effects of property tax and its shifting. The effects of the general property tax and its shifting are too numerous to review in detail here. Many of them have been treated in connection with an appraisal of the property tax earlier in the chapter. However, a few concrete effects should at least be indicated. The property tax and its incidence have had some adverse effects upon the construction of rental housing and especially low-cost housing for the low-income people. The tax has caused a good deal of migration of citizens away from the cities and has motivated the establishment of tax colonies in suburban areas. It has stimulated the construction of smaller houses and buildings. This is especially true of the so-called "taxpayers" in some large cities where old buildings are torn down and business buildings of one or two stories are constructed in their place. Tax capitalization has had the tendency to depress real estate values, and thus it has discouraged investment in them. In some instances buildings have been torn down, while still useful, in order to reduce property taxes.

Conclusions on property tax shifting. The conclusions which can be drawn in relation to the shifting and incidence of property taxes must be stated in the form of tendencies and generalizations. In general,

though, the taxes on business seem to be more shiftable than those which fall upon the ultimate user or consumer. Taxes on buildings and improvements appear to be more easily shifted than taxes on land. Finally, the more universal and uniform the impact of the tax on the various classes of property, the more likely it is to be shifted.

Property Taxes as an Instrument of Fiscal Policy

THE POSSIBILITIES of using the property tax as a counter-cycle instrument are quite negligible for several reasons: (1) the property tax for constitutional reasons cannot be used by the federal government—the unit which is best adapted and experienced in the use of "fiscal policy"; (2) the state and local governments (which use the property tax extensively) have not yet learned to apply the philosophy of fiscal policy, and they are not very well-adapted to the use of counter-cycle policy; and (3) the property tax by its very nature and administration is not suited to use as such an instrument.

The first two reasons are self-evident, and so let us analyze the third, which goes to the theory and economics of the property tax as it relates to fiscal policy. The annual assessment and collection of the property tax presents little chance for flexibility and adjustability to the ups and downs of the business cycle that are so necessary if the tax is to be an efficient fiscal policy instrument. Even if it were feasible to adjust assessed values up and down quickly and to manipulate the property tax rates to meet the needs of counter-cycle policy, to do so in relation to the property tax would only increase the inequities of the tax. It would increase the burdens of property owners on factors that bear no relation to ability-to-pay or to business cycle behavior.

Furthermore, and a bit more specifically, the correlation between "taxable" property ownership and personal income is not very strong. Much intangible personal property of the income-producing variety (stocks, bonds, notes, and mortgages, etc.) is exempt in many states. This makes up a substantial portion of the total property in a modern industrial nation. Therefore, even if counter-cycle elasticity were injected into the administration of the tax, it would have little effect upon investment and even less upon consumption.

Conclusions

IN SPITE OF ALL the criticisms that can be brought against the general property tax, it is not likely to disappear from the American scene for a long time to come. More and more state governments will probably

withdraw from use of the property tax. But at the local level the tax is as firmly entrenched as ever, and it is the very backbone of local tax structures. It will be continued and maintained for several reasons: (1) efforts will be made to improve and reform the tax; (2) the difficulty of using alternative taxes is serious—local units must get new taxing power from the state governments; they cannot tax at will; some of the alternative taxes are just as inequitable as the property tax itself; (3) the tax has become an established institution at the local levels—that will not be easily changed; and finally, (4) the tax does raise a large part of the revenue that local units need. By and large it does meet the test of "fiscal adequacy," and as long as the need for revenue is great it will not be abandoned.

That does not mean that it should be continued in its present unmodified form. Its indiscriminate character, its distributional defects, the difficulty of applying it to intangible and even tangible personal property, and its administrative weaknesses—all these shortcomings require that constructive efforts be applied to its improvement. The tax is not beyond redemption. It can still be made an equitable and workable tax for local units of government. Its reconstruction will be considered in a later chapter.

7

How the Property Tax Is Administered

THE PROBLEM *of determining an acceptable value of property for tax purposes is naturally the central issue in the satisfactory operation of an ad valorem tax on property.*

—HARLEY L. LUTZ.[1]

Overview

THE ADMINISTRATION of the general property tax is the process by which property is assessed as to its value (tax base), the tax rate is levied on that value, and the tax payments (amount of tax) are collected for public purposes. Frequently the same property tax base serves as the revenue support for a number of units of government.

The major phases of property tax administration which come under consideration in this chapter are: (1) The *original assessment* of the value of the property subject to tax, which is the most strategic phase of the whole property tax procedure. (2) *Tax review*, or individual equalization, which gives the individual property owner an opportunity to seek adjustment if he feels that his property has been over-assessed. (3) The *levy and collection*, the process by which the legislative agency places the annual property tax liability upon the community and by which the administrative agency levies and extends that liability against each piece of property and then proceeds to collect both the current and delinquent taxes. (4) *Central equalization* (as distinguished from individual equalization), which has for its purpose the removal of inequalities arising between the various taxing districts because of the *competitive undervaluation* practiced by local assessors.

This chapter should give the reader an understanding of the mechanisms, principles, and problems of these phases of property tax administration.

[1] Harley L. Lutz, *Public Finance* (4th ed.). New York: D. Appleton-Century Co., 1947, p. 391.

SECTION I

The Original Assessment of Property

Units of Government Charged with Administration

THE GENERAL PROPERTY TAX serves as the main source of revenue for practically all types of local units of government. The same property tax base often serves as the financial support for a number of local units at one time. For instance, in the City of Los Angeles, the property tax yields revenue to the city government, the county, the city school system, the flood control district and the Metropolitan Water District. In other large cities the number of units claiming part of the revenue is even greater.

In the United States at the present time there are about 160,000 local units which are associated with the administration, collection and use of the tax. Cities, villages, towns and townships, counties, school, drainage, irrigation, flood control, sewage disposal, park, water, and many other types of districts are interested in the general property tax as a source of revenue. About two-thirds of the states still depend upon it for some support, and all of the states retain some administrative functions in relation to it.

TYPES OF ASSESSMENT DISTRICTS

Primary assessment districts. In considering the units of government responsible for local assessment functions, two types of assessment districts must be recognized and understood. The first of these is designated the "primary" assessment district or, as the name plainly indicates, that governmental unit carrying out all the original or primary assessment functions for all of the contiguous governmental units within a fixed geographical area, such as the county or the city. Thus, in the western and southern sections of the United States the county serves as the "primary" assessment district.

In New England the township performs the functions of primary assessment, whereas in other parts of the country cities, villages, and boroughs frequently act in that capacity. In the states where the county unit exists, it is ideal for that unit to function as the primary assessment unit because it eliminates competitive undervaluation of property by the subordinate units within the county. It further assures that each unit within the county bears its fair share of the county property tax levy.

A situation which gives rise to special problems is that in which there

are a large number of independent, primary assessment districts within the county (or within the state where the state levies a property tax), and the assessment placed on property in each primary district serves as the basis for the central (county or state) property tax levy. In that situation there arises the tendency for local assessors to *under-assess* the property in their districts in order to avoid part of the central unit burden. This gives rise to the need for central equalization.

Overlapping assessment districts. Of lesser importance is the "overlapping" assessment district. Such units constitute assessment districts within the primary assessment areas. They are by no means contiguous, and they exist in town and city areas that have wrested a measure of local autonomy from state governments. They are permitted to assess their property in addition to those assessment operations carried out by the primary districts. Needless to say, such duplication of effort is administratively inexpedient and by all tenets of a sound assessment organization should be abandoned.[2]

Revenue-claim districts. Many of the smaller and special types of districts do not have positive functions in connection with the administration of the property tax. Their main claim is to a share of the revenues. Usually, their administrative functions consist of accepting the valuation placed upon the property by the primary or overlapping assessment agency, determining the amount of revenue needed to meet the budget for the district, and then calculating the rate that is to be applied on the tax base within the district. School districts seldom serve as assessment districts, although there are a few hundred in the country which perform that function. Generally speaking, that is also true of the many special districts (such as park or drainage districts) throughout the country.

The General Administrative Procedure

THE PROPERTY TAX CALENDAR

Although a more detailed discussion of the phases of assessment and administration will be undertaken later in the chapter, they can best be understood if they are viewed in relation to the over-all procedures followed in the execution of the general property tax. This aggregation of steps has been more or less uniformly called the "Property Tax Calendar."

Under this convenient heading fall various operations involved in administering the general property tax: (1) the original assessment of

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[2] National Association of Assessing Officers, *Assessment Principles.* Chicago: R. R. Donnelly & Sons, 1938, p. 16.

property; (2) assessment review; (3) central equalization; (4) the general levy; (5) the compilation and extension of rates against individual property; (6) the collection of the tax; and (7) the provisions for final appeal to the quasi-judicial and judicial bodies as required by the due process provisions of our federal and state constitutions.

The original assessment. The first step in the taxing process is the assessment of the property against which the tax is to be levied. Property assessment consists of three basic functions: the discovery, the recording, and the valuation of property. Before property may be taxed, it must be sought out and discovered. This is a task requiring a high degree of ingenuity and resourcefulness on the part of the assessor. After the property has been located, proper descriptions and means of ownership-identity must be gathered and recorded. This information concerning the property must be collected with great care and accuracy, and it must be maintained in an up-to-date form if the essentially difficult operation of valuation itself is to be carried out in an equitable fashion.

The statutes usually require that the assessor assess all property lying within his district as of assessment day. The assessment work begins shortly after the first of the year in most states and often continues actively until about June 30th in the larger primary districts. Since it is physically impossible to appraise all of the property in one day, the assessor customarily assesses all of the property *as of* the designated assessment day regardless of when the actual work is done. Assessment day usually occurs in the spring of the year. April 1st and May 1st are common dates in many states. In California assessment day falls on the first Monday in March. The technical significance of the date is that if the actual valuation of a man's property takes place after that day, he can be assessed on only that part of the property in his possession on that day. Anything that he acquires after that date will be assessed the next year.

Review of original assessment. Upon completion of valuation, the assessment rolls containing the assessed value of property in a given district are compiled, and such figures are made available to the property owners. This, however, is not the final step in the assessment. The "due process" clauses contained in the federal and state constitutions require that property owners be given a hearing before an impartial body; and the owners must have ample opportunity to contest any assessed valuations that they have reason to believe are inequitable and unjust.

Generally, each local assessment district (whether primary or overlapping) has its own special or *ex officio* review agency. In the West, where the county serves as the primary assessment district, the County Board of Supervisors constitutes itself as the Board of Review and usually sits in that capacity during July. In the smaller assessment districts, in

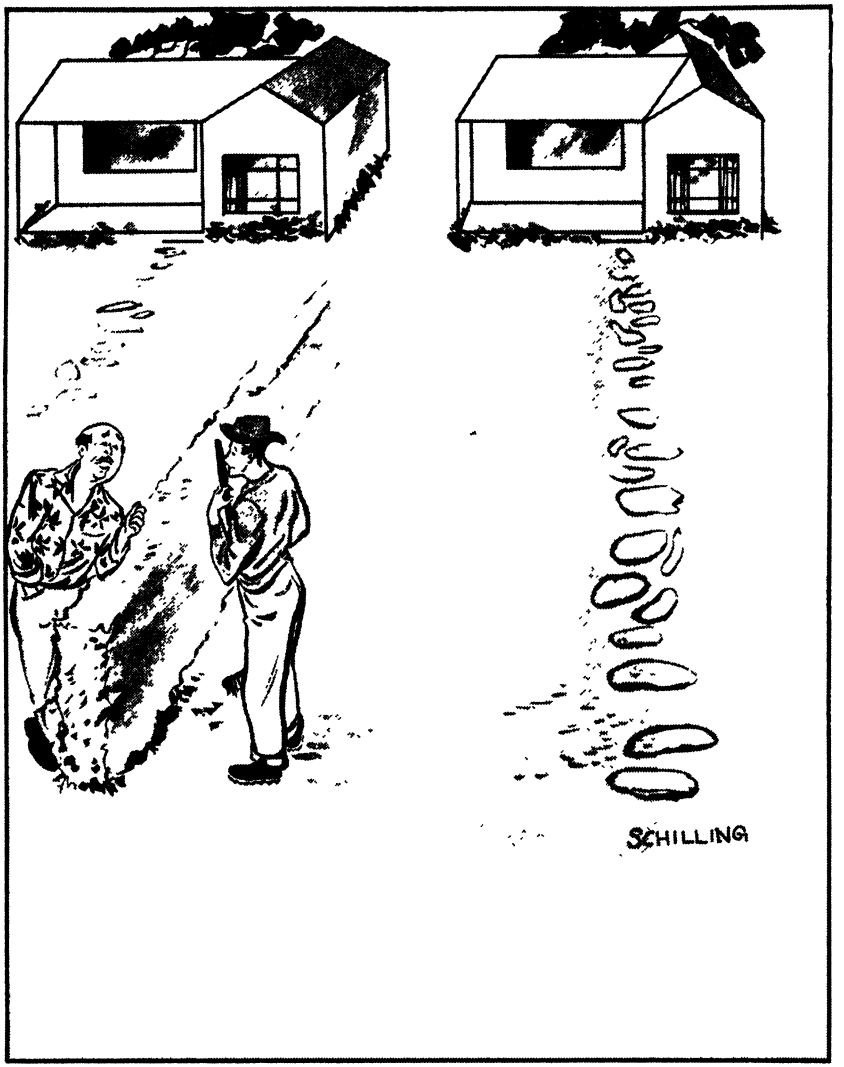


FIGURE 13. *It's none of my business, Joe, but what are they assessing, your dugout?*

other parts of the country, review bodies often consist of *ex officio* members: mayor, city attorney, members of the city council, town chairman, clerk, and supervisors. The reviewing body generally has power to alter assessments on the grounds of unjust valuation, faulty classification, or clerical errors.[3] However, the burden upon the property owner is that of demonstrating that his property has been assessed at a ratio of

[3] National Association of Assessing Officers, *Assessment Organization and Personnel.* Chicago: R. R. Donnelly & Sons Co., 1941, p. 36.

assessed to true value that is higher than the general level of assessments in the community. It is not sufficient that he thinks that it is "too high" or that it is higher than his neighbor's.

In performing the review and equalization functions, the boards may have the right to act on their own initiative or only on appeal by individual property owners. The practice differs in various parts of the country. In some jurisdictions, the board possesses no power to alter assessments except upon sworn testimony of taxpayers and other witnesses. In others, it may make adjustments upon its own motion. The latter practice is justified as a necessary check upon the assessor.

Central assessment and equalization. Upon completion of the local review, duplicate assessment rolls are submitted to the central assessment or equalization agency which, in most states, is a state-or-county-operated organization. Under central equalization, the assessed valuations from all local districts or units are correlated and adjusted in order that each district may be assigned its just share of the central unit (state or county) tax burden.

The important thing to remember here is that the purpose of central equalization is to remove competitive undervaluation among assessment districts. The whole subject will be more thoroughly explored in a later section of this chapter.

General levy. Before a tax may be placed against the citizenry's property, such tax must be authorized by the legislative body empowered to do so in each taxing unit. This is the "general levy" or statement to the effect that a tax will be levied against the property specified in the legislative enactment. Under most conditions the legislature also determines the extent of the tax in one of two generally accepted forms. The popular body may set a definite sum to be collected, or it may state a definite rate of taxation to be levied either in percentage form or as a "mill rate." This rate is designated as a definite maximum number of mills to be collected on every dollar or hundred dollars of assessed valuation.[4]

Determination of rate for each unit. After the general levy by the legislature of the taxing unit, the tax rate must be determined. If the central unit or state body has enacted a flat percentage or mill rate to be levied against all property within the state for central unit purposes, the process of calculation is greatly simplified. The legislatively-determined figure is forwarded to the local districts for extension against the individual property parcels along with the rates for local purposes. However, if the popularly elected body merely states a "sum" to be collected from the state as a whole—a definite amount to meet budget expenditures, for example—actual calculation of the proportion of the levy and rates for

[4] W. B. Graves, *American State Government.* Boston: D. C. Heath and Co., 1946, pp. 521-2.

each unit must be effected. Thus, if district "A" possesses 5 per cent of all property value in the state, that district would be required to raise 5 per cent of the funds authorized by the legislature. If the total amount to be collected were $2,000,000, district "A" would collect 5 per cent of that figure or $100,000. Assuming the total assessed valuation of the state to be $500,000,000, district "A" would have a $25,000,000 assessed value or 5 per cent of the total state value. The tax rate would then be computed by the following formula:

$$\frac{\text{Amount of Tax to be Raised}}{\text{Tax Base (Assessed Value)}} = \text{Rate}$$

$$\frac{100{,}000}{25{,}000{,}000} = 0.4 \text{ per cent or 4 mills}$$

Each taxing unit (city, county, school district, etc.) would have to go through the same procedure and establish its particular tax rate.

Combining into a single rate. Before levies can be made against each parcel of taxable property, the central unit rate must be combined with those of the local area. Thus, the state rate will be 0.4 per cent, that of the county 1.6 per cent, for example, that for the city 2.3 per cent, and other minor districts with taxing power (i. e., school or drainage districts) may require 2.1 per cent; in such a case the combined rate of district "A" would be 6.4 per cent. This combined rate is slightly high. However, the rate in the City of Los Angeles has recently been over 6 per cent.

After this figure is determined, it is *levied or extended* against each parcel of taxable property in the taxing district. This consists of multiplying the assessed value of each property parcel by the combined rate. The resulting figure will constitute the tax bill of each property owner.

Collection of taxes. The ultimate aim of a property tax is to secure revenue with which the state and local government can be financed; consequently, the most efficient and well-organized agency of assessment is of no avail if the collection of such taxes is carried out in a makeshift or haphazard fashion. For this reason every precaution must be exercised to render collection procedure efficient.

Efficient collection requires attention both to the convenience of payment by the property owner and the safeguarding of funds by the government. Convenience of payment is often achieved by means of instalment plans of a semiannual or quarterly nature and by conveniently located branches for receiving tax payments.

The agency responsible for collection of revenue may be a branch of the assessing organization or an independent branch of governmental administration created especially for the task. Such collection is, in most cases, handled on the local level; the collection agency forwards state funds to the designated state revenue department or remits local collec-

tions in toto, in which case the state returns prorated allotments to local units of government.[5]

Collection of delinquent taxes. Every consideration should be given the citizenry in extracting authorized taxes; however, the state and its local units of government must have funds with which to operate and furnish the numerous services demanded of them. Therefore, individuals who fail to meet their tax obligations when due must be dealt with in a firm and orderly manner.

Most communities levy "delinquent" penalties of about 6 per cent for late payment of taxes. Some add extra "redemption" penalties if the tax is redeemend after "sale" of taxes to the state government.

In regard to the "sale of taxes," two general patterns prevail with respect to the ultimate enforcement and collection of real property taxes. One might be called the "state purchase approach," and the other the "private tax certificate approach."

In many states of the Union after a given period of delinquency, the delinquent taxes are sold to the state government. In this way the local units get the revenue with which to perform their functions; and the state government holds the right to collect the taxes on redemption by the taxpayer, or the right to sell the property for taxes, interest, and penalties at the end of a stated statutory period. The property is usually sold by the state to the highest bidder above a certain minimum. From the county tax collecter the purchaser receives a "tax deed" giving him legal title to the property, but this deed does not absolve him from other claims upon the property such as private liens or public "special assessments."

In other parts of the country, especially in the Midwest, the delinquent tax is sold to the county, and from there is sold to a private purchaser, usually to the purchaser who agrees to accept the lowest rate of interest on the "tax certificate" which he receives at the time of purchase. The tax certificate gives the purchaser a lien on the property. The property owner has the privilege of redeeming the property from the certificate holder within a stated period of time, usually three to five years, by payment of the tax plus interest.

If redemption is not made within the required time, the certificate holder may gain legal title to the property either by following a stated procedure (which does not involve court action) or, in some states, by foreclosing the tax lien on the property in a court of competent jurisdiction. The so-called "warranty deed" which results from this foreclosure is usually more difficult for the former property owner to challenge than is the ordinary tax deed procured by the non-judicial procedure.

[5] William J. Shultz and C. Lowell Harriss, *American Public Finance.* New York: Prentice-Hall, Inc., 1949, p. 357-8.

Under both major procedures outlined above, the units of government themselves may frequently acquire title to the tax delinquent property if there are no private purchasers.

The "tax certificate" approach is more subject to abuse than the state or county purchase approach. Often there is no bidding on the rate of interest which is to be accepted, with the result that a higher rate is usually allowed to the certificate holder. Lawyers, real estate men, and other "insiders" usually speculate in the certificates. Furthermore, they "grab up" the certificates to the better parcels of property, and the local units go without revenue on the rest.

Final appeal. In addition to the review of local assessment described previously, tax-paying citizens may appeal to additional tribunals even after the tax has been levied and extended against the individual's property. For taxpayers who feel they have been dealt with unjustly, most states provide quasi-judicial bodies in the form of tax commissions or review boards for examination of individual cases or investigation of entire districts upon the request of a stipulated number or percentage of the citizenry. If such review is not acceptable to the appellant, he may carry his case to the regular courts which have final jurisdiction and powers of settlement—very often right up to the state supreme court. For those states not providing intermediate quasi-judicial tribunals, tax appeals may be carried directly to the regular courts for litigation.[6]

Local Assessment Machinery and Tools

Assessment organization. The organizational machinery and tools with which the assessment function is carried out are diverse and complicated. Those of paramount importance and in most prevalent use will be discussed below.

The local assessing agency is headed by an assessor, usually an elected but in some cases an appointed officer. In small assessment districts the entire organization will consist solely of the assessor and perhaps one or two clerks.[7] In larger areas with much diversification of property, the assessing organization may take on large and highly integrated proportions. Such organizations may be formed on a geographical basis, with departments for various geographical areas carrying out all functions within the given area, or a functional basis may be used with departmental formation according to the nature of work to be carried out.[8] For

[6] A. Bristol Goodman, *Assessment Administration in Wisconsin*, unpublished Ph.D. dissertation, University of Wisconsin, 1942, pp. 265, 267, 270.

[7] National Association of Assessing Officers, *Assessment Organization and Personnel*, p. 123.

[8] *Ibid.*, pp. 23-27.

instance, in Los Angeles County the assessor's office is organized and specialized on the basis of the type of property to be assessed. The office therefore contains land, buildings, business personal property, residential personal property, marine and oil divisions—together with a number of auxiliary administrative divisions such as a veterans' division, a map division, a public service division, a correspondence division, and several others.

In the case of a large organization, the assessor will act as an executive officer with deputy assessors heading the various departments in the organization and performing the actual spade work of assessment.

Tools and techniques of assessment. Because of the exacting and complex nature of the assessment function, its successful execution is highly dependent upon well-trained personnel supplied with data, skillful techniques, and the proper tools with which to work.

The assessor's office must be adequately equipped with maps of the assessment district. Such maps take two primary forms: lot and block maps and land value unit maps. Lot and block maps, used particularly for the assessment of land, show the location and size of each lot within the assessment area. These maps should also contain appropriate grids by which accurate location and legal description may be determined and recorded without elongated geographical notations. Land value unit maps, also utilized in land assessment, give "key values" for each block. The key is usually the value of a lot of a given size and depth in the center of the block. These key values are usually built up over the years out of the sales and valuation experience of the assessors in the given areas.

Another instrument helpful as a valuation guide-stick is the depth-factor table. Such a table is constructed out of the observations of the assessors. It indicates in given subdivisions of the city just how much, on the average, a stated increase in the depth of the lot will add to the market value of the lot. Quite useful also in the assessment of corner lots is the corner-influence table. This shows how corner locations affect the market value of the lots; the differences in value are often expressed as given percentages "higher" than the center lots.

The more efficient assessors' offices now set up special files for each piece of property, especially improved property. In the file may be a continuous data sheet which reveals the economic history of the property just as an abstract of title reveals the legal history of a parcel of property. It will show when the improvement was built, what additions have been made, any destructions by fire, the sale price on each transfer of the property, and so forth. Some assessors like to have a photograph of each improved property in their files so that they can "view" it right in the office.

For the assessment of real estate, tangible, and intangible personal property, the assessor's office should have accurate and up-to-date informa-

tion regarding market values of real estate and other property along with accepted rates of depreciation. Further data to be used in uncovering intangibles—namely, public records and monthly reports of state and federal securities commissions—should be available to aid in the difficult task of discovering intangible property. In the appraisal of business inventories, access should be had to the company's books as well as some of the original documents of purchase. State and federal income tax returns also reveal information that is valuable on inventory valuation, because the income returns require information on the inventory at the beginning of the year, at the end of the year, and on goods purchased during the year.

The actual process of assessing property is divided into three definite stages. The first of these is the discovery or ferreting out of the property to be taxed. In the case of land and improvements this is a comparatively simple task. For the discovery of personal property, tangible and intangible, much astuteness and ingenuity is required of the assessor. Many states require all property owners to file property inventory statements annually for all taxable property (real and personal, tangible and intangible) in their possession *as of* assessment day.

During the discovery phase, information of all types regarding the property to be assessed must be gathered in a rapid and accurate manner. Such data must contain the age of property, type of structure, income, location, and other information pertinent to its valuation. Recording this information in an accurate and administratively-expedient fashion is the second stage in the assessment process. These records serve as a basis for the third or valuation stage. At this point the property under consideration is given its assessed value; such value then serves as a tax base upon which a specified rate will later be levied and extended.

Supervision of Local Assessment

UNTIL RECENT YEARS, supervision of primary local assessment by any central unit of government was completely lacking. However, some state governments have recently provided varying degrees of supervision, much of which was strongly protested by autonomically-minded units of local government.

The methods of supervision have generally taken a variety of forms. They include instructional meetings for local assessors, seminars, field trips and visits by the District Supervisor, the development of assessors' manuals, and other similar devices.

In some states supervision is practically nil. In others, supervision is limited considerably, consisting mainly of advice and printed matter suggesting procedures and principles to be followed. Many states possess

extensive powers to supervise and regulate the local assessment organizations, but this power is not exercised because of a lack of funds to make such supervision effective. Wisconsin has been able to break through the local autonomic and financial barriers and achieve gratifying results by supervision.[9] Sometimes the state tax commission or department of taxation serves as a basis for the supervisory organization with its appointed supervisors, each responsible for a number of counties.

Direct state assessment, as advocated by some authorities, may not be desirable. Nevertheless, some middle-of-the-road policy of local assessment supervised and instructed by agents of the state tax commission seems to be a logical, feasible, and fruitful course.

The Standard of Valuation and Its Administration

OF THE THREE primary functions of local assessment (i.e., discovery, recording, and valuation), valuation of property is by far the most difficult operation. We have already discussed the standard of valuation used in the various states in arriving at the property tax base. By and large, valuation is the concept of fair market value of the property, or what the property would bring in a free market on a sale between a willing buyer and a willing seller. We shall now observe how that standard is administered and consider briefly the methods used to ascertain fair market value in relation to different types of property.

The assessment of land. Three methods are used for land valuation: the sales method, the income method (both of which are primary), and the comparative method, which is a secondary or derivative procedure of the first two.[10] The *sales method* consists of using the price for which a piece of land has been sold or offered for sale as its assessed value. Such price quotation must be of a fairly recent nature and free from coercion, duress, or other characteristics of a forced sale in order to render an accurate market value. The *income method*, of course, considers the income produced by a piece of land in reckoning its fair market value. Such income is capitalized according to the current rate of return on the particular type of land under valuation. In using the *comparative method*, one parcel of land to be assessed is compared with a like parcel whose value has already been ascertained. The essential factor to be

[9] H. M. Groves and A. B. Goodman, "A Pattern of Successful Property Tax Administration: The Wisconsin Experience–I. State Supervision," *Journal of Land and Public Utility Economics*, Vol. 19, No. 2, May 1943, pp. 142-152. See also Francis J. Shannon, "Assessment Improvement Program in Kentucky," *National Tax Journal*, Vol. 3, September 1950, pp. 233-241.

[10] National Association of Assessing Officers, *Urban Land Appraisal.* Knoxville: King Press Inc., 1940, p. 3.

regarded in this comparison is that the two parcels are in all major respects quite similar. When minor differences exist they are usually compensated for by adjustments in the final valuation, with such adjustments being made in relation to the differing aspects. The particular method used by the assessor depends upon the type of information available on the given piece of property. The goal to be reached by these methods must always represent fair market value, however.

Assessment of buildings and improvements. Again the three methods enumerated above are used to varying degrees for the valuation of buildings and improvements. More important however, and in some respects more scientific, is the *replacement cost method.* By replacement cost is meant the fair and reasonable cost of rebuilding or replacing various types of structures at the time the appraisal for assessment purposes is made. This method, more so than the preceding one, deviates from the market value concept as such; however, cost of replacement must consider the market value of material and labor for construction. Such cost in the long run will determine the market value of a replaced structure. Insofar as this aspect of construction cost is considered, replacement cost does adhere to the concept of fair market value.

Assessment of personal property. Tangible personal property is generally assessed at the value declared by the owner or as estimated by the assessor. Both, as required by law, must represent fair market value. Tangible personal property of a business nature is usually valued on the basis of figures from the owner's most recent inventory. Such property in the process of manufacture (and having no market value in its incomplete state) is valued according to the labor and material thus far expended with allowances for overhead cost.

Intangible personal property, such as stocks and bonds, is assessed also at fair market value. Stocks and bonds listed on exchanges or commonly bought and sold "over the counter" can easily be valued at their market price on assessment day. In assessing such securities that are not involved in current market transactions, market price is determined upon the basis of book value, fair or par value, or by capitalization of the income from such intangibles.

Assessment the Weak Link in Property Tax Chain

IN MANY RESPECTS local assessment has proved to be the weakest link in the property tax chain. This has a ring of irony when one realizes that accurate valuation of property is the crux of equitable tax administration. Ironically, too, the assessment function is by far the most complicated and difficult process in the entire property tax structure.

The flaws in local assessment are manifold. Overlapping assessment districts create much duplication of work and expense. As a result of the numerous, frequently small assessment districts, compensation is too low to attract the caliber of men who should be doing the assessment work: insurance appraisers, real estate appraisers, accountants, and engineers. In most states there are no statutory qualifications for the assessor's office, except in the few states where assessors are chosen through civil service.

Functionally, we find a massive hodgepodge of unstandarized methods and techniques used by the various assessment districts. This fact and the absence of adequate central supervision renders the assessment function vulnerable to incompetence and even to local corruption. As we discovered, the general property tax has serious weaknesses on its substantive and theory side also. The least that can be done, if the tax is to be continued, is to improve the quality of its administration and thus make it more palatable and workable.

SECTION II

Central Equalization under the Property Tax

The Need for Central Equalization

ALTHOUGH THE STATE CONSTITUTION might declare that "property shall be uniformly assessed at its fair market value," in actual practice ideal uniformity does not exist. The assessor in the village of X may assess real estate at 100 per cent of its fair market value, the assessor in the city of Y in the same county may assess similar property at only 60 per cent, whereas the township assessors may have a tendency to assess at only 50 per cent of the fair market value. Thus, when the county or the state applies its rate on these assessments for the purpose of getting its share of the property tax, the village of X would bear a larger proportion of the tax because its property is assessed at 100 per cent. This discrepancy in assessed valuations between taxing districts is known as "competitive undervaluation," by the city and the townships in this instance. The system of central assessment or central equalization has been developed to remove the inequalities in the assessment of property between different taxing districts and to make certain that each tax district pays its fair share of the central unit taxes.

NATURE AND PURPOSE OF CENTRAL EQUALIZATION

The equalizing process of central equalization. The highest level in the equalizing process is variously called "central assessment" or "central equalization," and it involves the equalization of assessed values *between districts as such* for the purpose of apportioning the taxes between the various units of government within the central units. In central equalization it is desired that each unit within the county (or state, as the case may be) pay its fair share of the county levy and each county pay its fair share of the state levy. The functions of tax review and central equalization should be clearly distinguished. One is an equalization process for individual pieces of property; the other is an equalizer between tax districts.

Causes of competitive undervaluation. The local assessor has a natural tendency to undervalue. This tendency stems in part from the desire to avoid conflict with taxpayers that would inevitably result if he were to overvalue property.

A second cause of undervaluation arises from the county and state levies on the local districts. When the county tax rate is levied on valuations of local district assessors, the assessor is inclined to undervalue the property in his district in order to reduce the amount of tax that his district would pay to the county. Similarly, a state levy encourages undervaluation of both counties and local districts.

Another practice of county and state administration creates a third tendency towards the undervaluation of property. This comes about when state aid is granted to the county or city in inverse proportion to the assessed value of the county. This is especially true of grants-in-aid for education.

Thus it is the administrative practices of both the county and state that lay the foundation for the "game" of competitive undervaluation. Central equalization is designed to combat the resulting interdistrict inequalities, thus assuring that each district within the central unit pays its fair share of the central levy or receives its appropriate share of state aid.

The Machinery of Central Equalization

Governmental units interested in central equalization. As one might conclude from the previous discussion, practically all units of government should be vitally interested in central equalization. States are concerned that the state tax be proportional to the property in counties; county interest arises from the state's levy on the county and its levy on the city;

and so on down the administrative hierarchy. Primary interest in central equalization, however, occurs at the state and county levels where the agencies of equalization are established.

Administrative agencies responsible for central equalization. At the state level the administering agencies are variously called the "Tax Commission or Commissioner," "Board of Equalization," or "Board of State Assessors." These agencies are composed of from one member (in Georgia, Massachusetts, and West Virginia) to twenty-four members in Nevada. The usual agency is composed of three members, although there is neither a standard number nor a standard procedure in the selection of these members. Some boards contain only elected members, others contain only appointees, and still others are a mixture of elected and appointed members.[11] At the county level the task of equalization is usually performed by the equalization committee of the county board of supervisors.

The Techniques and Process of Central Equalization

METHODS OF OBTAINING TRUE VALUE

Unscientific methods. The validity of a central equalization, whether by a county or a state agency, rests upon a proper criterion of true market value. How can a central agency, perhaps miles from the property, determine the true market value when a local assessor who is thoroughly familiar with local values has so much difficulty? The task is not easy, and even the best method is not a substitute for a good original assessment. However, several methods have been developed. An early technique starts with the local assessed values as a base. Corrections are applied to the base in the light of statistics on wealth, population, and other pertinent data. This process involves a great deal of judgment and discretion and is a loose approach to the problem. In a second method, termed "decision by hearings," the central agency acts upon evidence presented by the local districts. This approach has also proved unsatisfactory.

Sales sampling method. A third method of arriving at true value is the sales sampling method. Here the voluntary sale of real estate becomes the "sign-post" by which all central assessment procedure is guided. In this method a representative sample of recent voluntary sales is taken within the tax district whose assessed valuations are being checked. The aggregate "assessed value" of the sample within a single district is then divided by the corresponding "sales value" of the sample within the same

[11] Jens P. Jensen, *Property Taxation in the United States.* Chicago: University of Chicago Press, 1931, p. 364.

district. The resultant percentage is the ratio of assessed value to true value within that district. Let us assume a sample of 100 properties which had been recently sold for an aggregate of $1,000,000. In checking these properties against the tax rolls, their aggregate assessed value is found to be $700,000. The ratio of assessed value to true value would be 700,000 ÷ 1,000,000, or 7 ÷ 10, or 70 per cent. It would appear, therefore, that the assessor for the district has been "underassessing" the property in his district about 30 per cent (assuming that in a given state assessed value is supposed to approach "true value" and not some fraction thereof.) Once the percentage to true value is known, it is a simple task to equate the two values at any level. The ratio determined for the sample is assumed to be the correct ratio for the entire district. When the process has been performed for each district, a centrally levied tax can be uniformly and equitably distributed.

Methods of apportionment. There are two main methods of apportioning the taxes between the various taxing districts. The essential difference between them is that under the first method, the central unit determines for the local unit the amount of taxes it must raise for the central unit, with instructions to set the tax rate accordingly; under the second, large numbers of individual assessments are corrected on the assessment rolls to make possible a uniform rate for the centrally-levied taxes.[12]

In the first procedure, the central unit (county) through a central assessment would determine the "true value" of all the property within its jurisdiction. Then, having determined from its budget the amount of taxes it requires, it would apportion this burden among the various underlying units in the ratio that the "true value" of the underlying unit bore to the "true value" of the central unit as a whole. These percentages would then be used to apportion the "central tax levy" among the various tax districts in the central unit. Thus if any underlying unit actually had 20 per cent of the "true value" of all the property in the county within its borders, then said underlying unit would have to bear 20 per cent of the central tax levy, whatever it might be.

A more extended example illustrates how this would work for a county in which four townships made up the primary assessment districts. For example, let us assume a county tax requirement of $690,000 that must be levied on the four townships within the county. The original assessment as conducted by the township assessors placed a $20,000,000 "assessed value" on township A; a $40,000,000 "assessed value" on township B; a $60,000,000 "assessed value" on township C; and a $100,000,000 "assessed value" on township D. Thus, the county has an "assessed value" of $220,000,000. The central assessment performed by the county, however,

[12] Groves and Goodman, *op. cit.*, p. 308.

showed that township A had a "true value" of $25,000,000; B a "true value" of $40,000,000; C a "true value" of $80,000,000; and township D had a "true value" of $200,000,000. From this it follows that the "true value" for the county as a whole is $345,000,000 and that the local assessors had assessed at 80, 100, 75 and 50 per cent of "true value," respectively. Under this method of apportionment, the county would request 25/345 of $690,000 or $50,000 from township A; $80,000 from B; $160,000 from C; and $400,000 from township D.

The next step would be that of calculating the rate of tax that would have to be levied in each township on its "assessed value" in order for that township to pay its fair share of the county levy. It must be noted that this type of central equalization will not change the "assessed values" of the various townships. Those values would remain the same, and the "true value" of each township would merely be used to determine the proportion of the central levy the given township would have to bear.

Therefore, using the formula $T \div B = R$ in determining the rate for each township, the apportionment work proceeds. For township A, "T" equals $50,000—that is, the amount of the county levy which must be borne by the township. The county "rate" as applied to the township would be $50,000 ÷ $20,000,000 = .25 of 1 per cent for township A; .20 of 1 per cent for township B; .27 of 1 per cent for township C; and .40 of 1 per cent for township D. Under this method of central equalization, the adjustment would be made in the "rate" for those townships which were underassessed. In other words, the "rate" would be somewhat higher for each of the underassessed townships. The "assessed" valuation would not be disturbed; nor would the "assessed" valuation for each taxpayer be affected. The deficiency in assessed value would be made up by the higher "rate." It should perhaps be noted that in some parts of the country these "rates" are expressed in "mills"—a mill being one-tenth of a cent or one 1000th of a dollar. For township A, then, the central rate would be 2.5 mills per dollar of assessed valuation.

The above system of apportionment, currently employed in Wisconsin and Michigan, though not widely used, is less complex in actual operation than the second procedure. In the second method, the central unit proceeds under the assumption that the "assessed values" for the underlying units are correct or will be corrected to equal true value. Knowing how much revenue is needed, the central unit then figures the tax rate. Each underlying unit would then pay the same rate. Once again, assuming a county budget of $690,000 and a corrected true value of $345,000,000, the county tax rate for the townships would be $\frac{\$690,000}{\$345,000,000}$ or two mills. The board of equalization would make changes *en masse* in the "assessed values" of the various townships in our illustration as follows: the assessed

value of A would be increased from $20,000,000 to $25,000,000; B would remain unchanged; C increased from $60,000,000 to $80,000,000; and D increased from $100,000,000 to $200,000,000. The equalizing process would then continue as to individual properties within each township. Individual assessments would be changed by the local boards of review to raise the assessed value of each township to the assessed value as set by the county.

While we have assumed the county as the central levying unit for the purpose of illustration, either method of apportionment may be employed by the state in its central levy on the counties.

Central Equalization as Practiced in the States

THE ONLY STATES able to employ an over-all central equalization are those that have either a state property tax or state grants-in-aid based on local assessments. Although California does not levy a state property tax, the railroads and utilities are centrally assessed, and a form of central equalization is practiced.[13]

Central equalization is probably one of the weakest elements in the entire property tax administration in the majority of states. Too often the functions of central equalization and tax review are mixed and confused. Very often the adjustments are made on the basis of inadequate knowledge and by rough judgment. In some states it cannot truly be said that anything that approaches effective central equalization even exists. Over the country as a whole, the central equalization process is a hit-and-miss, unscientific procedure that could stand a thorough overhauling.

The Advantages of Effective Central Equalization

EFFECTIVE CENTRAL EQUALIZATION can be of strategic significance throughout the entire assessment process. It can have a salutary effect upon "original assessment" in the smallest assessment district by exposing those assessors who are underassessing and by demonstrating to the assessor that assessment at true value does not mean higher taxes for his district. Assessment experience has demonstrated that full-value assessment results in more consistently competent assessing jobs than underassessment.

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[13] See Malcom M. Davisson and William K. Schmelzle, "Equalization of Property Tax Assessments in California," *National Tax Journal*, Vol. 3, September 1950, pp. 221-232; see also Eugene A. Myers and Randall S. Stout, "Recent Trends in Property Tax Equalization," *National Tax Journal*, Vol. 3, June 1950, pp. 179-186.

A state of general undervaluation makes the task of determining whether there is overassessment very difficult for the taxpayer. It also makes it very difficult for him to prove his case before a board of review or a court. Therefore, a thorough central assessment will contribute materially to the maintenance of the morale and uniformity of the whole assessment process.

Conclusions

SOME CRITICS condemn the central equalization system as a makeshift compromise that has not been performed too well. Some of them would go so far as to centralize the whole assessment and administration of the general property tax in a top state agency. They would have the state perform all original assessment in the first instance and thus eliminate the conflict and duplication of effort. *Prima facie* this might seem like a sound suggestion. Practically, however, it is not sound.

In the first place, there would be a great deal of local resistance to that kind of centralization. The property tax is a tax that is essentially "local" in character and logically belongs to the local units because the very tax base under it is anchored in the local community. The great bulk of the revenue goes for local purposes. The over-all administration of the tax can therefore be best managed from the local level. Any effort to administer the tax from the state level completely would require an extremely large central administrative staff. The task of assessing all of the property in the state by one central agency would be enormous.

Complete centralization is not the answer. The property tax "belongs" to the local communities. Its basic assessment should be centered there. The property tax should be developed as a tax locally levied, assessed, and collected, but centrally supervised and equalized. The state department of taxation should supervise local assessment so as to improve the quality of that function. It should perform the state central equalization function and supervise equalization at the county level. The state agency should undertake to assess directly specialized types of property such as railroads, public utilities, and certain types of mineral property.

Finally, the state tax administrative agency should serve as a quasi-judicial appellate body for aggrieved taxpayers and tax districts. The property tax is not beyond recall on its administrative side. Many things can be done to make it operate more effectively and equitably. Given sound property tax classification, the exemption of certain types of property, state assessment of specialized types of property, scientific central equalization and intelligent state supervision, the property tax can be made to work with a reasonably high degree of competency and acceptability.

8

Property Tax Problems and Reforms

THE DEFECTS *of the American property tax are, it would appear, beyond remedy.*

—C. F. BASTABLE.[1]

Overview

AS THE READER now well knows, the general property tax falls far short of perfection as a tax institution. The judgment of the British public finance professor, C. F. Bastable, to the effect that the American property tax was beyond remedy seems a bit gloomy; yet, it is borne out to some extent by the experience that many American cities have had with the property tax since the turn of the century.

Even E. R. A. Seligman, our own leading fiscal economist during the first quarter of the twentieth century, voiced very strong convictions on this tax: "*Practically*, the general property tax as actually administered is beyond all doubt one of the worst taxes known in the civilized world." [2]

Should this tax be endured, reformed, or abolished? Most of our local governments, however, have no effective *alternative*, at least not in the short run. Therefore, many state and local units of government have endeavored to lighten the burden and improve the equity and administration of the tax. In some states it has undergone considerable adjustment in recent years. These modifications have developed along several main channels:

(1) the classification of property according to its character and the purpose for which it is used; (2) the exemption of certain types of property for constructive social reasons; (3) the improvement of the ad-

[1] C. F. Bastable, *Public Finance* (3rd ed.). London: Macmillan and Co., Ltd., 1922, p. 475.

[2] E. R. A. Seligman, *Essays in Taxation* (8th ed.). New York: The Macmillan Co., 1913, p. 62. (Italics his).

ministration of the tax; (4) the use of tax limitations to put a ceiling on the rates of the property tax; (5) the development of supplementary or replacement taxes to take some of the load off the property tax.

Though a number of worth-while adjustments in the property tax have been developed, their adoption has been by no means universal. Furthermore, there remain many unsolved problems in the property tax field. Among those which this chapter will touch upon are problems of tax collection procedure and taxing merchant's inventories (including chain stores). There are many others that merit the attention of the fiscal experts.

The Classification of Property

IT IS THE THEORY of the *general property* tax that all property is sufficiently homogeneous to be lumped together indiscriminately and taxed at a uniform rate. Through the years, however, this point of view has been increasingly challenged. The recent growth of a more complex modern economy has created a great diversity rather than uniformity in the economic, social, and administrative characteristics of property.

Whereas in early American history the great bulk of property values were in real estate and tangible personal property, the rapid growth of modern corporations, banking, and general business has created an expanding volume of intangible property rights. In addition, it is now realized that even the different types of tangible property (such as land, improvements, and the various kinds of personalty) present strikingly different economic characteristics. These differences in turn have made most attempts at *uniform* taxation under the general property tax not only inequitable but impractical.

PURPOSES OF CLASSIFICATION

In recognition of the differences in the economic characteristics of the various types of property, a number of states have attempted to classify property in such a way as to make the tax more scientific and equitable. The basic purposes of classification have been several: (1) to classify property for tax purposes so as to give consideration to the different economic characteristics of the several types of property; (2) to promote greater administrative expediency through diminishing evasion, promoting complete assessment, and obtaining more revenue (this has especially been the objective in giving a special classification to intangibles); (3) to create greater equity through a better adjustment of the tax to the earning power of the property and the ability to pay of the owners; (4) to encourage desirable economic effects as, for example, giving special classification and tax treatment to improvements and resi-

dential property, the differential taxation of forests to encourage their conservation, and the encouragement of special classes of industry such as Louisiana's law encouraging factories utilizing wastewood products. These objectives are on the whole socially desirable, and when classification is used to achieve them, they are to be commended.

METHODS OF ACHIEVING CLASSIFICATION

The differentiated tax treatment of different types of property can be achieved in several ways: (1) by the use of different ratios of "assessed valuation" to "true value" for different types of property—such as 40 per cent for platted urban real estate, 30 per cent for rural real estate, etc.—followed by the application of a "uniform rate" of tax; and (2) the assessment of certain types of property uniformly at full true value and then the application of a special "rate" to that valuation; this is commonly done with certain types of personal property, especially intangibles.

METHOD OF OPERATION

Frequently the distinction is made between *comprehensive* and *partial* classification. Partial classification usually involves applying classification to one or several special types of property. Separate treatment of intangibles is the most common type of partial classification. In most cases some or all intangible property is taxed at a specially low mill rate (usually at no more than 5 mills) or $.50 on each $100 of valuation. A few of the states classify tangible personalty as well as intangibles. New York and Wisconsin exempt all personal property whether tangible or intangible. Wisconsin, however, does *not* exempt tangible personal property used in the conduct of a business.

On the other hand, *comprehensive classification* categorizes property for differential treatment much more thoroughly and applies it to a whole range of different types of property. There are only six states which may be said to have comprehensive classification: Minnesota, Montana, Virginia, West Virginia, Kentucky, and Ohio. Each state has a different method of classification. Because in 1911 Minnesota was the first to adopt such classification most discussion has centered upon her statutes.

Minnesota example. Minnesota accomplishes its classification by many means. Eight major classes of property have been set up upon which the percentage of assessed to true value is varied. There are additional classes differentiated through *in lieu* taxes (such as railroads, which pay gross receipts *instead of* property taxes) and through different rates. Some classes and parts of classes are exempted.[3]

Those classes distinguished by different ratios of assessed to true value include iron ore, mined or unmined (50 per cent); household furnishings,

[3] Adapted from Chapter 273 of *Minnesota Statutes*, 1941.

wearing apparel, etc. (25 per cent with a $100 household exemption); rural real estate and some unplatted land, implements and machinery, goods and wares of merchants and manufacturers, and other specified items (33⅓ per cent); grain and grass seed and other agricultural products in the hands of producers and not held for sale, horses, mules, and assets used exclusively for agricultural purposes, and all agricultural tools, implements, and machinery used by the owner in any agricultural pursuit (10 per cent); unplatted real estate used for the purpose of a homestead (20 per cent up to a value of $4,000, 33⅓ per cent on the excess); platted real estate used for purposes of a homestead (25 per cent up to a value of $4,000, 40 per cent on the excess); other urban real property and all personal property not embraced in any of the other classes (40 per cent). It must be noted, however, that once the assessed value of the given property has been arrived at according to its classification and ratio, it is taxed at a "uniform rate" along with all other property.

Classes of property taxed at special *ad valorem* "rates" and assessed at "full value" include money and credits, taxable at 3 mills (exempt since 1943); shares of joint-stock land banks, taxable at 5 mills; mortgages taxable by a registry tax of 1.5 mills on maturities up to five years, 60 days, and 2.5 mills on maturities over five years, 60 days, in lieu of all other taxes. Motor vehicles are taxable at 2.2 per cent of value with a minimum tax of $5 or $7.50, depending on the weight of the car.

NET RESULTS AND EVALUATION

Experience indicates that the segregation of *intangibles* has been warranted both administratively and for reasons of equity. Although lower rates have not materially increased the total yield, they have increased the amount of property reported on the assessment rolls. The greater equity resulting from the reduction of both double taxation and the penalty on honesty has undoubtedly been beneficial. Yet many claim the reform has not been carried far enough. By far the preponderance of intangible property even where taxed at a low rate still escapes taxation, whereas double taxation still exists in more than a few states. This leads many to clamor for the complete exemption of all intangible property from taxation (as provided in New York and Wisconsin) and capturing the ability-to-pay represented by such property through an income tax. By such means, it is claimed the administrative problems will be solved and a fair tax substituted.

The case for classification of *tangible* personal property, however, is not strong. When classification has been based upon sound administrative, economic, or social reasons it is undoubtedly justified. In Minnesota, for example, since iron ore is a gift of nature and subject to depletion, a high assessment appears defensible. The low rate on household goods, in common with that on intangibles, is intended to prevent evasion of

assessment. In times of chronic agricultural depression, special treatment of agricultural property would appear justifiable. But frequently the rates and assessments have been juggled according to the desires of strong pressure groups, narrow local interests, and administrative custom.

Property Tax Exemptions

SOME STATES have attempted to improve the quality of the general property tax by granting exemptions for certain types of property. Whereas some state constitutions or statutes limit classification, most of them permit some sort of property tax exemption. The probable reason for this is that economic, social, political, and ethical justifications of property tax exemption have historically seemed strong.

THE THEORY AND PURPOSE OF PROPERTY TAX EXEMPTION

The theory behind property tax exemptions is that some types of property have special characteristics which make it socially advantageous to exclude them from taxation. There are many justifications offered for exemptions. These include economic, political, social, ethical, and administrative aspects. Among the more common purposes may be found the following: (1) to prevent intergovernmental taxation; (2) to encourage activities which would otherwise be supported by government; (3) to promote desirable social undertakings; (4) to influence the location of industries; (5) to improve property tax administration and compliance; (6) to avoid double taxation; and (7) to reward services rendered, such as veterans' property exemptions.

Some exemptions are not basically for such socially desirable purposes. Many are the result of political pressure or to legalize an existing administrative situation. Nevertheless, even where each individual exemption may itself appear justifiable, the cumulative effect of many such exemptions may frequently be ethically and financially undesirable.

THE GROWTH IN THE EXTENT OF EXEMPTIONS

Once property tax exemptions are engraved on the statute books and sanctioned by the community, their removal becomes almost impossible. For this reason the continued increase in tax-exempt property has been looked upon with concern.

During the depression of the 1930's, when state and local governments were seeking new revenues, the exemptions from property taxes were estimated from Department of Commerce figures to be almost 20 per cent of the total value of real estate in the United States. This created a serious problem at that time. Since then there has been a steady increase in the value and the proportion of tax-exempt property. The depression

of 1932 encouraged agitation by harried taxpayers for relief in the form of homestead exemptions permitted in thirteen states. World War II added over 10 million possible candidates for the veterans' exemption now allowed in 21 states. It is estimated that in some capital cities exempt property runs as high as 30 per cent of the total.

KINDS AND USE MADE OF EXEMPTION

The great variety of kinds of exemptions is revealed by the classification into ownership divisions. Exemptions include governmental, industrial, agricultural, individual, institutional, and various miscellaneous types. Each major type of exemption may be broken up into numerous sub-classes. Exemptions are usually patterned to the economic needs and problems of the particular states. The great variety of treatment accorded by the states even to the sub-types becomes apparent from a glance at the following summary table.[4]

Type of Exemption	*No. of States Allowing*
Industrial	
a. Specified products	5
b. Specified property under varying conditions	17
c. Mechanics tools	12
Individual	
a. Homesteads	13
b. Veterans	21
c. Householders	x
d. Personal property	x
x not available	
Miscellaneous	
a. Machinery, Feed and Seed	17
b. Vessels	7
c. Mining Property	5
Agricultural	
a. Specified products	16
b. Agriculture Associations	24
c. Farm animals	12
d. Farm improvements	7
e. Forests and orchards	15
f. Growing crops	7
Institutional	
a. Educational Property	All
b. Charitable Institutions	All
c. Religious Institutions	All
d. Cemeteries	All

All states must allow governmental exemptions. In practice, every state also allows institutional exemptions for educational, charitable, and religious purposes as well as for cemeteries. Little uniformity is apparent in the remainder of the exemptions.

HOMESTEAD EXEMPTIONS

Under the theory that home ownership should be encouraged and for purposes of relieving the tax burden upon lower-income groups, many

[4] K. P. Sanow, "Property Tax Exemption," *State Government*, April 1946, p. 108.

states during the depression years exempted from taxation $1,000 to $5,000 of the value of each home which was "owner-occupied." Generally the exemptions were blanket money exemptions to a certain value or a certain area, sometimes with fractional exemptions above that. Occasionally it is possible to get a prorated exemption for living in your own apartment house.

Such exemptions have had unfortunate consequences. They have seriously cut into the tax base of many communities and threatened the very services which such property needs. They appeal to group prejudices. They shift a greater proportion of the tax burden to tenants. Replacement taxes may be more regressive. Such exemptions reduce the feeling of financial responsibility of a large proportion of voters who must decide on public expenditures. They ignore the principle of benefits received.

For these reasons it appears advisable that the whole approach to homestead exemption be re-examined. It may be sounder social policy to give a short-term exemption on new houses. This has a stimulating effect on new construction and will thus ultimately expand (rather than reduce) the tax base. At the same time it gives the home-owner some relief during a critical period.

VETERANS' EXEMPTIONS

Twenty-one states exempt certain values of veterans' property ranging from $500 in Florida to $5,000 in New Jersey. The experience of California exemplifies some of the problems met.

Legal support for veterans' exemptions has been established in California in two cases where the opinion of the court held that "Legislation having for its purpose the giving of a benefit to soldiers who have served their country in time of war is uniformly recognized as the application of public money for a public purpose, even though the benefit is conferred after the service is completed." [5]

The loss to the local units of the state of California in 1947 was $26,000,000 in revenue. About 393,000 veterans took advantage of the law, for an average exemption of $756.[6] However, it is estimated that the current veteran population is 1,600,000. This indicates the extent to which exempt valuation can yet grow, and the loss of revenue must be made up from some source other than the property tax.

INSTITUTIONAL EXEMPTIONS

Institutional exemptions include churches, charitable and benevolent fraternal organizations, literary and scientific societies organized on a

[5] *Veterans Welfare Board v. Riley*, 188 Cal. 607 (1922). *Allied Architects Association v. Payne*, 66 Cal. Dec. 597 (1923).

[6] *Annual Report California State Board of Equalization*, 1946-47, pp. 67-68.

nonprofit basis, colleges, universities, and cemeteries. These exemptions are usually from all property taxes except special assessments. The presumption is that the institution in question is performing duties which the state itself is bound to discharge and that the general public benefit is greater than the loss in taxes.[7] It is based further on the theory that organizations such as schools and churches enhance and increase the value of surrounding property, thereby indirectly contributing to the tax base.[8]

INDUSTRIAL EXEMPTIONS

From the viewpoint of the entrepreneur, the tax rate on prospective factory sites is an important item in determining the most advantageous location.[9] Knowing this, cities often engage in competitive reductions and generous exemptions to business firms in order to bring the industry into the area to provide employment for the local citizens. The argument advanced is that it is less costly in the long run to subsidize the industry than to finance large relief rolls during depression.

The question may be raised as to the justification of subsidies to producers that are submarginal in operation in order to enable them to compete with more efficient firms, or the wisdom of attracting business to an area for which it is not suited with regard to other factors. Furthermore, when the practice becomes widespread, the competitive benefits cancel out, while the industries already established and the remainder of the tax base are left to bear the brunt of the tax burden.

EXEMPTION PROBLEMS AND ABUSES

Specific abuses. The problems of exemptions are already apparent: the drastic reduction of the tax base and extra burden upon the remainder; the frequent regressiveness and unsuitability of replacement taxes; the incentive to avoidance and evasion; the resulting tax delinquency in time of depression; the intensification of the financial problem through property tax limitations; and the inequities which frequently result.

In addition to these problems, abuses of the privilege of exemption have grown in recent years. Examples have been cited of universities and colleges that own title to business property for rental income purposes and gain the exemptions. Another abuse is that under which a corporation or manufacturer conveys title to the exempt institution, renting back the property and deducting the rent from income as a business cost, while the school is exempt from the property tax.[10] The ownership of a maca-

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[7] *Laymond Foundation v. Louisville,* 232 Ky. 259 (1929).

[8] "Real Property Tax Exemptions of Educational Institutions," *American City* (Prepared by Nat'l. Inst. of Maine Law Officers), July 1945, p. 115.

[9] W. B. Spriegel and R. H. Lansburgh, *Industrial Management.* New York: John Wiley & Sons, Inc., 1947, p. 48.

[10] "Schools Tax-Free Business," *United States News,* Jan. 9, 1948.

roni company by New York University is a case in point. A university in Missouri served as a holding company for heavily mortgaged, but valuable property in St. Louis. The banks and financial institutions holding the mortgages sought to gain tax exempt status by having the owner convey title to the university.[11]

Under the veteran's exemption there is a tremendous leakage of revenue. Multiple exemptions are pyramided within families; declared value is substantially below the actual value owned by the veteran who wishes to qualify for the exemption; assets (especially intangibles) are concealed or undeclared. Little effort is made by the assessor to submit a figure approximating in value the property owned by the veteran.

Combating exemption abuses. In order to combat the growing abuse, several tests and standards have been applied (and withstood court action) to determine the status of property claiming exemption. Most common of these is the "use test" by which property is found exempt or nonexempt. In order to meet the test, the property cannot be used for commercial purposes. Twenty-two states require educational institutions to meet this test, nineteen require charitable institutions, and twenty-nine require other organizations to comply.

A second test requires that no private gains, realized or expected, may accrue to private individuals. New York requires this; Florida and Oklahoma allow educational institutions organized for profit to receive exemption; Arizona allows the institutions (but not individuals) to make a profit. A third test allows no profits to be made by the institution.

A fourth test limits the area and valuation of the property owned. California allows a maximum of 100 acres for institutions and $5,000 actual value for the veterans' exemption. New Hampshire places a $100,000 value limit on institutional property, and Rhode Island limits the area to one acre.[12]

APPRAISAL AND CONCLUSION

The problems and abuses of exemptions demand that a reappraisal be made of the whole theory. It is obvious that ever-larger proportions of the population are finding socially-valid excuses for exempting more of their property from taxation. Political expedience makes it simple. How many kinds of activity can be found that do not create some benefit to society or require some reimbursement?

The line between property deserving of exemption and that not deserving is an arbitrary one. Perhaps it should be drawn much more strictly. Many types of exemptions where the disadvantages appear to outweigh the advantages should be removed as rapidly as possible. Otherwise, supporting property tax exemptions on grounds of equity is pure farce.

[11] Carey McWilliams, "Real Estate Goes to College," *Nation*, May 18, 1946.
[12] *American City*, July 1945, p. 115.

That is not to say that there are no legitimate reasons for granting exemptions—there are. Where those legitimate reasons exist, the exemptions should be retained. What is needed is a redefinition of what should be exempt and a *restatement* of the *purposes* and *limits* of the exemption policy.

Property Tax Limitations

WHY LIMITATIONS HAVE DEVELOPED

Since the beginning of the century, and especially during the great depression of the 1930's, a militant campaign, spearheaded by real estate groups, has succeeded in establishing through constitutional provision and statute much lower and more restrictive property tax ceilings. The movement during the depression was greatly assisted by the wave of tax delinquencies and the economic distress at that time. As a result of this campaign, every state (except the New England states and Maryland) now has property tax limitations on counties and other local governments.

The reasons given for such limitations are frequently compelling. They are: (1) to reduce state and local taxes on real estate in general; (2) to force a broadening of the tax base and a redistribution of the tax burden; (3) to reduce or prevent an increase in the volume of public expenditures or services; (4) to encourage the assessment of property at full value and the reduction of inequalities in assessment; and (5) to improve the market for real estate through the probable capitalization of any tax reduction.[13]

KINDS OF TAX LIMITATIONS

Tax limits may be imposed by constitutional, statutory, or charter provision. Those imposed by constitutional provision are quite rigid and cannot be modified very easily even in an emergency. This type is clearly not to be preferred. The statutory type has at least some chance of change by a subsequent legislature if the conditions warrant it. Tax limits vary substantially from state to state, but in general they fit into several broad classifications.[14] Some state units use one method exclusively; others combine several types.

Limitation to a fixed maximum rate of tax. Tax limits which state a fixed maximum "rate of tax" on property are the oldest and most common variety. In general, these limits may take three forms.

First, there is the blanket or over-all rate limitation. This provides that

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[13] Simeon E. Leland, "Alternatives: A Constructive Outlook," *Property Tax Limitation Laws*. (Glen Leet and Robert M. Paige, eds.). Chicago: Public Administration Service, 1934, Publication No. 36, p. 83.

[14] There is a good discussion of these points in Rodney L. Mott and W. O. Suiter, "The Types and Extent of Existing Tax Limitations," *ibid.*, pp. 41-46.

the aggregate levy on any parcel of property may not exceed a prescribed rate for all governmental units and functions combined. Here, some prorating device is needed to apportion the rate among the various taxing units. The development of this type was largely depression-inspired. West Virginia inaugurated a blanket rate limitation in 1932. Ohio prescribes a maximum of 1 per cent for the combined levies on any Ohio property.

Second, there is the provision of maximum rate limitations for each unit of government. This is the oldest and most prevalent type. One-fourth of the states have mills-per-dollar limitations on property tax rates. Under this type no co-ordination is needed between governmental units because each unit is allotted a prescribed maximum rate.

Third, there are maximum rate limitations for particular purposes or functions. Occasionally such provisions are really grants of power to levy a tax for the named purpose rather than restrictions on that power. In many instances, however, they have been so low as to seriously hamper the given function. In some states this type has been applied to education with disappointing results.

Limitation to a percentage of levy in previous year. For purposes of greater flexibility, approximately a dozen states permit a certain per cent of increase in property-tax rates per year over the rates of the preceding year. This type of limitation is also a depression development. Oregon uses such a limitation by providing that the tax for the current year may not exceed that of the previous year by more than 6 per cent.

EFFECTS OF PROPERTY TAX LIMITATIONS

The declared objectives of property tax limitations were persuasive, but the results have been disappointing and at times disastrous. In general, it is true, government units having tax-rate limitations have tended to have lower property tax rates. Nevertheless, resulting replacement taxes have usually been indirect, regressive taxes. Instead of broadening the tax base and redistributing the tax burden more equitably, that portion of the population least able to bear it was forced to accept a greater share of the total tax load.

Where it was said that tax limits would curb wasteful expenditures it was found that reductions came in essential governmental services which greatly affected the general welfare. Ohio, in fact, was forced to curb educational functions and suspend the operation of some schools. In addition, greater state grants-in-aid used as replacements were frequently conducive to greater extravagance rather than economy.

Wherever possible there was circumvention of the spirit of the law. Public borrowing increased materially. In Ohio, where tax-rate limitations were especially severe, the per capita debt rose from $39.25 in 1910

to $113.84 in 1920.[15] Evasion occurred in other ways. There were increases in property valuations to enlarge the tax base and the creation of new districts to provide new local units with additional taxing and borrowing powers. The increased use of special assessments and special charges for some services shifted the burden back to property.

APPRAISAL OF PROPERTY TAX LIMITATIONS

Property tax limitations have not been very successful. One authority has called them "suggestive of the Chinese philosophy of foot-binding."[16] They have only slightly limited property taxes. They have not created more equitable tax systems. Instead of producing economy in government, they have forced reliance upon public borrowing and state grants-in-aid; and the limitations have forced mismanagement by local officials seeking to provide the services their constituents demanded.

The limitations are often below not only actual needs but also the normal levels of real estate taxation. They have frequently been arbitrarily determined with little research into the effects. Since they are ordinarily uniform in application, they have been unduly restrictive on larger units of government performing costly functions and only slightly restrictive on those units performing a minimum of services.

This does not mean that tax limitations have failed entirely, for they have caused new sources of revenue to be sought. Little-touched groups with the ability to pay have come under substitute taxes. Nevertheless, the same objectives could be achieved in a more promising manner. The attack on expenditures should be made on the expenditures directly rather than on the sources of revenue. If tax limits must be used, they should be kept flexible and reasonable, preferably under state supervision of local finance.

Problems in Tax Delinquency and Collection

THE EXTENT OF TAX DELINQUENCY

One of the strong points often cited in favor of the property tax is its dependability. During the depression of the 1930's this characteristic faltered seriously. The evidence of tax delinquency appeared especially in and around the large cities in fair volume even in the 1920's. The average delinquency ratio for the country as a whole in 1928-29 was about 6 per cent; by 1932-33 it had risen to 17 per cent. However, for cities with populations of over 50,000, it had risen to over 26 per cent in 1933.

[15] R. C. Atkinson, "*Effects of Tax Limitation Upon Local Finance*" (privately printed, Cleveland, 1923).

[16] Mabel Walker, *Property Tax Limitation Laws*, Public Administration Service, p. 1.

In some specific instances, delinquencies ran as high as 40 and 50 per cent. Chicago was particularly hard hit, and its school teachers were paid in "scrip" for several years.

Year-end delinquency in 1938 for cities of more than 50,000 population registered a low of 1.3 per cent, a high of 35.8 per cent, and the average had fallen to about 10 per cent. However, there still existed an "accumulated" delinquency in terms of the current levy that was quite substantial. The low was 4.7 per cent, the high 190.7 per cent and the average about 43 per cent.[17]

During the 1940's current urban tax delinquency had fallen to relatively negligible proportions, and the "accumulated" delinquency was also substantially reduced. Especially in the large cities there still continues to be a certain amount of short-run delinquency due to negligence, ignorance, and real estate speculation.

THE CAUSES OF TAX DELINQUENCY

The reasons for tax delinquency are numerous and interrelated. In any given situation of delinquency the basic causes will not appear clear-cut. The following outline, however, distinguishes the main factors antecedent to and concomitant with actual delinquency. These factors fall into six groups: (1) economic distress, (2) ineffective administration, (3) ineffective legislation, (4) excessive burden on the property, (5) intentional delinquency, and (6) negligent delinquency. A good deal could be said about each of these causes, but it would seem more profitable to analyze the problems of tax delinquency and to seek methods of preventing delinquency and of enforcing collection.

PROBLEMS IN PROPERTY TAX DELINQUENCY

When heavy tax delinquency comes in the depth of a depression, serious fiscal problems arise for the local units of government, and difficult problems of how to handle the delinquency present themselves. Heavy delinquency cuts off a substantial portion of local revenues. City services are curtailed, salaries are reduced or unpaid, employees are laid off, salaries of school teachers may be paid in "scrip," and the risk of defaulting on municipal bonds becomes imminent. All in all, the functioning of the local units of government is seriously impaired.

Furthermore, as the backlog of delinquencies pile up, the more difficult it becomes to enforce collection. To put the delinquent property up for tax sale would further shatter real estate markets for many communities. Not only that, but very few buyers with "ready cash" are available in such periods. Usually, only the better properties are "picked up" on tax sale and the remainder continue delinquent. When a good deal

[17] Frederick L. Bird, "Relation of Tax Collection Methods to Delinquency," *Tax Policy League Symposium*, New York, 1939, p. 255.

of the delinquency is due to general economic distress, it is difficult to take severe action against the unfortunate ones.

IMPROVEMENT OF DELINQUENCY ADMINISTRATION

The experiences of the depression years centered the attention of both property taxpayers and officials on the serious character of the delinquency problem and the need for drastic improvement in the handling of the whole matter. Existing law, machinery, and procedures seem to be inadequate. There is no single answer to the solution of the problem. A number of measures seem to be required—some of them should operate in the prosperous periods and before depression delinquency begins to hold sway. A number of useful recommendations can be outlined: (1) use efficient collection methods and installment payment; (2) modernize the record system; (3) be sure that the delinquent penalties penalize; (4) limit the period of redemption since unlimited redemption is a boon to real estate speculators; (5) use the "tax receivership" approach for income-producing delinquent properties such as hotels, apartment buildings, etc.; (6) make provision for payment of property taxes in advance of the taxable year.

Miscellaneous Property Tax Problems

TAXATION OF INTANGIBLES

The rapid growth in the amount of intangible personal property has helped contribute to the breakdown of the general property tax. The taxation of representative property rights such as stocks, bonds, mortgages, deposits, money, and book credit has created special problems of assessment and widespread evasion and avoidance of the property tax with a resultant revenue loss.

Problem of assessing intangibles. The very nature of intangible personal property makes it easy to conceal from the assessor in a safety deposit box or by migration. The assessor cannot force the taxpayer to list his stocks, bonds, the cash surrender value of life insurance policies, and annuities owned. The tax in effect is a tax on honesty. Even when some of the intangible property is reported, it is sometimes difficult to assess correctly its real value if an active market for its sale is lacking. Another assessment difficulty is in finding a measure to evaluate the worth of such corporate assets as franchises, good will, patents, and copyrights.

Double taxation of intangibles. When both the real and intangible property and the "representative property" rights are taxed, it results in double taxation. An unencumbered piece of land valued at $5,000 will be taxed only at that valuation. If the land is subsequently encumbered with a $2,000 mortgage, it will be taxed at a valuation of $7,000, although

the real value is still $5,000. This situation exists because the law views the mortgage and the mortgaged property as distinct and independent property interests.

Classification of intangibles. Classification of intangibles and taxation at a low flat rate has made the tax burden on them more equitable, but it has not increased appreciably the revenue derived from this source. The most widely used method is to apply a special mill rate to certain classes of intangibles such as money, deposits, and business credits. Various schemes for classifying intangible property are utilized. Minnesota formerly put intangibles into a special classification, assessed them at full value, but applied only a low flat rate of 3 mills to them. Some states assess intangibles at a low percentage of full value and then apply the regular tax rates to them. For instance, Louisiana assesses corporation bonds at only 10 per cent of their true value. Montana uses the same approach for a number of different types of intangibles.

Exemption of intangibles. In many states, the old "general" property tax is becoming more and more a real property tax by the process of exemption. The pattern of exemption policies is by no means uniform, however. A few states have gone so far as to exempt all forms of personal property—tangible and intangible. New York and Delaware fall into this category, but New York does tax special franchises (basically on real estate—pipelines, rights of way, and so on). Wisconsin exempts all intangibles, household goods, motor vehicles, horses, farm machinery, and some miscellaneous property. Tangible personal property used in business, however, is not exempt. Intangibles are exempt completely in a few states; in others, only certain intangibles are exempt: for instance, in California all intangibles go free except "solvent credits" (bank deposits, money, and so on). The National Tax Association's Model Tax Law would withdraw intangibles from the general property tax completely.

Taxation of income from intangibles. Some states exempt intangible property from the general property tax on the theory that such intangibles will be taxed under their income-tax laws. The fact that income from investments must be reported for federal taxation should make it easier for the states to enforce income taxes of their own, but the rates must be kept low to avoid driving taxpayers to other states. This last method is the most simple and equitable plan suggested for taxing intangibles because it does away with the problem of ascertaining the value of securities and bonds, and taxes only a percentage of their income, which is more easily computed.

PROBLEMS OF TAXING MERCHANTS' INVENTORIES

Assessment "as of" a given day. The fact that the property tax laws of most states require that the assessor assess all property "as of" a given

day gives rise to special problems in the taxation of merchants' inventories. Under this principle the merchant can be assessed only on such inventories as are in his possession on the "assessment day"—April 1, May 1, or the first Monday in March as the case may be.

Therefore, it is entirely possible for the merchants to permit their inventories to "run down" just prior to that date. In Los Angeles it is common knowledge that that is what happens in many lines of business. On the day after the first Monday in March, suppliers of goods and materials receive large orders for "rush delivery."

Certain lines of business because of their character have only a depleted stock of goods on assessment day. This is particularly true of coal and other fuel dealers in many states. Those firms which do a heavy spring and summer business, on the other hand, are caught with heavy inventories on assessment day and, therefore, are hit inequitably hard. Stores with relatively moderate stocks and rapid turnover (such as chain stores and others) are not above intrigue. There have been cases in some lines of business where just prior to assessment day inventories have been "trucked out" of the jurisdiction and returned shortly afterwards. Furthermore, chain stores have certain technical advantages under the property tax because of their methods of doing business and because of "single day" assessment. As a result of the various items noted above, further inequities creep into the general property tax.

Average annual inventory. A possible solution to this problem is suggested by the use of an "average" annual inventory rather than a "single day" annual inventory. It could probably be worked out on the basis of the "average" of twelve monthly inventories, "as of" the 15th of each month. This idea has possibilities. It would be more difficult for the merchant to manipulate his inventory twelve times a year, especially when the character of his business may absolutely require substantial inventories at certain times of the year. Even so, the assessor would have to accept the monthly inventory figures of the merchant, otherwise the assessment process would become too expensive. The taxpayers could be kept in line, however, by unannounced, random, spot checks from time to time. The average inventory approach appears both fair and feasible. It might conceivably run afoul of the "uniformity clauses" of some state constitutions.

INEQUITIES BETWEEN INCORPORATED AND UNINCORPORATED AREAS

A particular inequity that arises under the general property tax is that between incorporated and unincorporated areas in many counties in which a large city is located. There is a strong tendency for many city-dwellers to establish homes out in the unincorporated areas, often for property tax reasons.

The inequity is caused by charging the residents of both areas the same proportionate "county taxes" without considering the principle of benefits received. Because of the *urban nature* of many unincorporated areas, the county must furnish the services normally provided only within the incorporated city and paid for by residents of that city. The result is that county citizens enjoy the privileges of city life without paying for them, while such citizens place an additional burden upon residents of incorporated areas in the form of a heavier county tax levy.

Then, when it is remembered that many of the people in the county areas come back into the city to earn their living and to enjoy other benefits at the hands of city government, the inequity becomes even more pronounced. This is a problem which should be approached with the thought of equalizing the tax burdens between the two groups. City income and sales taxes do get some revenue from the "outsiders," but usually this is accomplished only by putting additional burdens upon city property taxpayers. The possibility of consolidating the city and county units of government into a single unit also merits consideration.

Conclusions

THE MANY EFFORTS at reforming the general property tax have brought about both good and bad results. On the whole, property tax classification, when scientifically applied, can improve the equity of the tax. Tax limitation, on the other hand, is a rigid device that in many instances has been carried too far. Reasonable tax rate limitations, however, may serve a useful purpose, but they must be kept reasonable. Selective exemption of certain types of property can also add to the equity of the tax. Again the injunction must be "don't carry them too far."

Many of the improvements in property tax assessment, collection, and administration have been all to the good. Nevertheless, there still remain many problems in this area. The selection of assessors, the assessment process itself, central equalization, and delinquency collections—all can stand substantial improvement.

In addition, many other individual problems still remain unsolved. The property tax is not beyond redemption, but it will require careful study, reappraisal from time to time, and constructive modification for years to come before it can live down the reputation that it has acquired since 1900.

Part Three

THE TAXATION OF INCOME

IX. THE ECONOMICS OF INCOME TAXATION

X. INCOME TAX ACCOUNTING AND ADMINISTRATION

XI. THE TAXATION OF SPECIAL TYPES OF INCOME

XII. INCOME TAX PROBLEMS AND REFORMS

9

The Economics of Income Taxation

ALTHOUGH *personal income is not amenable to precise definition, it has, by comparison with the concept of social income, a much smaller degree of ambiguity. Its measurement implies estimating the relative results of individual economic activity during a period of time.*

—HENRY SIMONS.[1]

Overview

THE CONCEPT of an income tax is not as new as most Americans might think. A 10 per cent income tax was advocated in France by Pierre Boisguillebert and Marshall de Vauban in the early 1700's. In England it appeared in the tax structure as early as the Napoleonic Wars and became a permanent part of the English tax system after 1842.

In the United States, the first federal income tax appeared during the Civil War, but it did not become a permanent part of the federal tax structure until after the adoption of the 16th Amendment in 1913.

This chapter is primarily concerned with the economic aspects of personal income taxation, leaving corporate income taxation to be treated in Chapter 18. It will (1) review the revenue significance of the income tax; (2) trace the history of the American income tax; (3) analyze the concept of income in "economics"; (4) define the concept of income for "tax purposes"; (5) appraise the arguments "for" and "against" the income tax; (6) consider the shifting and incidence of the income tax; and (7) weigh it as an instrument of fiscal policy.

Revenue Significance of Income Tax

AT THE FEDERAL LEVEL

The growing importance of income taxation in the tax systems of all modern nations stands out in bold relief. In 1947, Great Britain derived a

[1] Henry Simons, *Personal Income Taxation.* Chicago: University of Chicago Press, 1938, p. 49.

revenue of £1,281 million from this source, constituting about 30 per cent of the total national tax revenues.[2] The United States, though it has had a shorter history of income taxation than Great Britain, relies on this revenue for its budget expenditures more than any other country. In 1947 it obtained more than $29 billion out of receipts of $44 billion or approximately 65 per cent of the total budget receipts. This, however, is from all forms of federal income taxation.[3] The corresponding figures for the fiscal year of 1948 were $31 billion or 67 per cent.[4] In the same year our state governments collected about $1 billion from income tax sources or 13 per cent of total state revenues. Income taxation alone has never contributed less than 58 per cent of the total national budget receipts since 1942.

Income taxes during World War II played even a more important role in federal financing. The year of 1944 marked the peak of its contribution to the public revenue. A record of 76 per cent of the total national tax revenues came from income taxes that year. In the same year Great Britain derived from this source more than 44 per cent of its total.[5] In the United States with the expansion of the federal personal income tax, corporate net income, and excess profits tax in 1950 and 1951 the proportion of federal income tax collections may again constitute 75 per cent or more of total federal revenues.

AT THE STATE LEVEL

At the state level income taxes are gradually making up a larger dollar volume of revenue and are expanding somewhat as a proportion of total state collections. In 1944 total state income tax receipts amounted to $773 million; and in 1948, $1 billion. The relative percentage of the net income taxes in the total state tax revenues for these years averaged about 13 per cent of the total.[6] In 1950 the net income tax produced $1.4 billion in revenues for the states. This approached 15 per cent of total state collections.

In some states, however, net income taxes (including those on corporations) amounted to more than one-third of total tax collections. In 1949 New York collected 41.1 per cent of its revenues from this source, Massachusetts 48.6 per cent, and Wisconsin 43.6 per cent. Seven other states collected from 15 to 25 per cent.[7] The general average is substantially lower because about fourteen states levied no income taxes in 1949.

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[2] *Statesman's Year Book*, 1948, p. 48.
[3] *Annual Report of the Secretary of Treasury*, 1947, p. 8.
[4] *Ibid.*
[5] *Statesman's Year Book*, 1948, p. 48.
[6] *Statistical Abstract of the United States*, 1948, p. 390.
[7] *Tax Systems* (12th ed.), 1950, pp. 69, 99, 150.

A Short History of the American Income Tax

FROM THE INCEPTION of our government under the Constitution in 1789 down to the outbreak of the Civil War, the federal government met its obligations largely by means of customs duties and the sale of public land. The impact of the Civil War, however, made it necessary to resort to a number of taxes not previously used by the national government. The income tax was one of them.

THE DEVELOPMENT OF THE FEDERAL INCOME TAX

The Civil War income tax. Congress in 1861 levied our first personal income tax as a war measure. This act, however, was so poorly drafted that Secretary of the Treasury, Salmon P. Chase, refrained from carrying it into operation. Congress replaced it with a more workable law in 1862. This act with a series of amendments served as the core of federal income taxation during the Civil War and for a number of years thereafter. Top rates never exceeded 10 per cent.

Since it was a war measure, the tax was abolished in 1872. The Civil War income tax applied mainly to personal income, though certain gross receipts levies were also collected from corporations. The tax was crude and often had to be tempered by reasonable administration.

The tax did not yield as well as had been expected during the War period, but it reached a peak return of about $73 million in 1866. During the time it was in effect, it raised about $375 million or one-fifth of the total internal revenues collected by the federal government during the period. It, therefore, made a fair contribution to financing the War and in reducing the debt in the era immediately after the close of the struggle.

The Income Tax Act of 1894. It was some twenty years after the repeal of the Civil War income tax before such a measure could muster sufficient support to pass Congress again. Grover Cleveland had been elected on a Democratic platform that advocated a tariff-for-revenue-only in 1892. This meant less revenue from customs duties which in turn meant that some substitute revenue had to be found. The income tax had been advocated by several of the more liberal parties (such as the Populist Party in the late "Eighties" and early "Nineties"). The Democrats now adopted it as an element in the Wilson Tariff Act of 1894. The tax applied to both personal and corporate income. Under the Act capital gains, gifts, and inheritances were defined as income and were to be taxable. A $4,000 exemption was granted for personal income and a low, flat rate of 2 per cent was applied to the tax base.

However, the tax was soon challenged before the courts as unconstitutional. The Constitution provides that no "direct tax" shall be laid,

unless in proportion to population.[8] It was argued, therefore, that an income tax was a "direct tax" which had to be apportioned to be valid. The issues involved were fought out before the Supreme Court in *Pollock v. Farmers' Loan and Trust Co.*[9] The first question which had to be answered was: "Is an income tax a direct tax?" A good deal of argument was presented on both sides.

Those who argued that an income tax was not a direct tax presented historical evidence to show that only capitation and real property taxes had been traditionally recognized as "direct." They could even cite previous decisions of the Supreme Court in their favor. In *Hylton v. United States* [10] the Court had held that a federal tax on carriages was not a direct tax, but was an excise upon the "use" of the carriage which did not have to be apportioned. They were able to cite *Springer v. United States* [11] in which the Court had upheld the Civil War income tax and had failed to label it as a direct tax.

Those who opposed the tax argued that in the *Pollock* case the income was "from property" and that a tax upon the income from property was tantamount to a *tax on the property* itself. By a 5 to 4 decision the Supreme Court held with this view and maintained that since the tax fell on income from real and personal property it was a direct tax that had to be "apportioned" to be constitutionally permissible. As a result, the Income Tax Act of 1894 was declared unconstitutional. The effect was that no "federal personal income tax" could be levied until the Constitution had been amended or the Supreme Court had reversed its position.

The Corporation Excise Tax of 1909. The decision in the *Pollock* case by no means stifled the desire for a federal income tax. The idea gained strength during Theodore Roosevelt's two administrations. Finally, in 1909 Congress decided to tax corporations. The tax was levied as an "excise" tax—a tax upon the privilege of doing business as a corporation in the United States. The value of the privilege was to be "measured" by the size of the net income. It provided for a tax of 1 per cent on the privilege where the net income was more than $5,000.

The Act was challenged, but this time the Supreme Court sustained the tax by distinguishing between the "subject" and the "measure." The Court said that the tax really was an "excise" on the "privilege" (the subject) of doing business as a corporation, and that the *income* was merely used to "measure" the value of the "privilege." [12] It therefore held that the tax was not a tax on the income, nor was it a direct tax that had to be apportioned. The effect of the decision was to enable Congress to do

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[8] Art. I, Sec. 9, Cl. 4.
[9] 157 U. S. 429 and 158 U. S. 601 (1895).
[10] 3 Dall 171 (1796).
[11] 102 U. S. 586 (1880).
[12] *Flint v. Stone Tracy Co.*, 220 U. S. 107 (1911).

indirectly what it could not do directly. It further meant that Congress could get at corporation income without an amendment to the Constitution. It did not, however, make possible a personal income tax by the federal government without such an amendment.

The Sixteenth Amendment. In 1913, the Sixteenth Amendment became effective and removed the barrier raised in the *Pollock v. Farmers' Loan and Trust Company* case. The Amendment provided that:

> The 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.

About seven months after the Amendment was adopted, a levy was imposed upon both personal and corporate incomes. A normal rate of 1 per cent was applied to personal incomes above $3,000 for single persons and $4,000 for married persons, and a surtax rate was graduated from 1 per cent to 6 per cent upon incomes in excess of $500,000. This Act was sustained in *Brushaber v. Union Pacific R. R. Co.* in 1916.[13]

During World War I, the exemption was lowered to $1,000 for a single person and $2,000 for a married couple; and the rates were increased substantially. The normal tax rate was 6 per cent on the first $4,000 of taxable incomes and 12 per cent on the incomes in excess of $4,000, whereas the surtax rate was raised to 1 per cent on the first $1,000 over $5,000 and to 65 per cent on incomes in excess of $1 million. From 1919 to 1930 the rates of federal income taxes were reduced several times, but they were increased again in 1932 because of the financial exigency caused by the Great Depression. During World War II the federal income taxes were heavily relied upon to yield the major part of federal revenues.

THE DEVELOPMENT OF STATE INCOME TAXES

Early history. State income taxes can be traced back to the faculty taxes in colonial days. The faculty taxes were a distinctive but crude form of taxation adapted to the simple economic life of colonial society. They were a combination of specific property taxes and income taxes.

The financial panic of 1837 forced some states to adopt state income taxes in order to cope with urgent financial difficulties. The administration of these early income taxes was crude and poor, and only Virginia succeeded in securing material revenue from this source.

The financial exigency of the Civil War caused another wave of imposition of income taxes among states. Most of these state income taxes were imposed on salaries and specific kinds of personal incomes. Needless to say, the administration was weak. When the Civil War was over,

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[13] 240 U. S. 1 (1916).

nearly all states except Virginia, Louisiana, and North Carolina abandoned these taxes.

The features of state income taxes before 1911. The state income taxes before 1911 were generally characterized by the following features: (1) They were administered by local property tax authorities; the administration was crude and weak. (2) They were levied at a flat rate. (3) They were imposed on personal income only, although in a few states corporation income was also subject to the tax. (4) Until the 1840's the so-called income under the income taxes was "presumed income" as measured by "trade" or "calling," rather than actual income. (5) Revenue yields were merely nominal.

The Reform of 1911—the Wisconsin experiment. In 1911 Wisconsin opened a new page in state financial history by launching an entirely new state income tax law. It was imposed upon net income at progressive rates and administered by a strong state tax commission. Furthermore, it provided for decentralized supervision and assessment by trained civil service employees by districts within the state, plus the use of a well-conceived income tax return which was put into the hands of each prospective taxpayer.

The income tax act was a substantial success during its first year, and the revenue far exceeded anything that had been collected by any state prior to that time. Other states soon followed suit and either reformed or enacted income tax laws following this pattern. At present, about three-fourths of the states have individual income taxes, and about as many have corporation income taxes.

Analysis of Concept of Income in Economics

THE PURPOSE of all productive effort is to create social income for the economy as a whole and personal income for the individual. All production results in income for someone. Income is really the "outcome" of all economic effort and the wherewithal to satisfy most human wants. In public finance, income and the concept of income have become the basis for a powerful fiscal instrument. It behooves us, therefore, to examine into the nature of this concept in *economics* a bit more carefully before the concept of income for *tax purposes* is discussed.

Various theories of income fundamentally attempt to answer one question: What is income? Since the days of Adam Smith many theories of income have been formulated. It is impossible to restate all of them here. However, the three well-known and more recent thories of income will be analyzed and appraised.

THE CONSUMPTION OR EXPENDITURE THEORY

The theory itself. Irving Fisher is the author of this theory. Fisher defines income in terms of services received. Income is "a flow of services through a period of time." [14] According to Fisher, "the only true method, in our view, is to regard uniformly as income the service of a dwelling to its owner (shelter or money rentals), the services of a piano (music) and the service of food (nourishment)." [15] He feels that commodities as such have no place in the definition. Income is received only when "service" is rendered—"services" by property or persons. The value of an income is the value of the "services" of which it consists. Briefly stated, income under this view is the "monetary value" of the flow of services enjoyed by an individual within a given period of time. It would be equivalent to his expenditures for current personal consumption plus the services enjoyed from all the durable property owned, such as his home, car, and so on.

Funds directed to savings and investment would not constitute part of his income because he would receive no current benefits or satisfactions from them. The amount and nature of receipts that came across the threshold to him would not be relevant. If a man received $100,000 for his efforts during the year, only that which was spent and consumed would be recognized as income, according to Fisher's definition.

Shortcomings of the theory. The theory seems to possess an enviable simplicity, and within itself it is clear and logical. But a closer study reveals its substantive weaknesses. In the first place, this concept is contrary to the common notion of the market place which deems as income any goods, services, or money that comes within the individual's power to dispose of as he sees fit. A second defect of the theory is the impracticability of its application to the problem of taxing incomes. Under this concept we would have to, using Fisher's own words, "levy taxes on the proceeds of every sale and remit them on every investment. It would be difficult to avoid injustice, evasion, and fraud." [16] Fisher, however, would attempt to make it workable by taxing total individual spendings. The third shortcoming rests in the inconsistency of the service-spending's definition with the traditional use of the term "income," by economists in the theory of distribution. What is distributed and received is not abstract service but concrete wages, profits, rents, and interest. A fourth drawback is related to ability-to-pay. Most fair-minded Americans would shudder to think of what would happen to

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[14] Irving Fisher, *The Nature of Capital and Income.* New York: The Macmillan Co., 1906, p. 52.

[15] *Ibid.*, p. 106.

[16] I. and H. W. Fisher, *Constructive Income Taxation.* New York: Harper & Brothers, 1942, p. 400.

ability-to-pay under such a theory of income. All in all, Fisher's concept of income is unrealistic and difficult to fit to the pattern of American business and economic understanding.

THE FLOW OF GOODS AND SERVICES THEORY

The theory itself. William W. Hewett prefers to include commodities with services in his concept of income. His definition of income is:

> Net individual income is the flow of commodities and services accruing to an individual through a period of time and available for disposition after deducting the necessary cost of acquisition.[17]

This concept of income not only counts the commodities themselves but also the accrual of them in the individual's possession. Hewett's notion of income comes a good deal closer to the layman's idea of income than does Fisher's, and the "accrual" aspect is better understood in the market place than is the "consumption" approach. It is the "coming-in" of the commodities and services that constitutes the receipt of income. The individual does not have to wait until he has enjoyed a "service" from the goods before he can tally his return: the "accrual" of them in the individual's possession is sufficient.

Appraisal of the theory. Several criticisms have been leveled against it, however. The first and foremost is that it involves double counting. Hewett came to his own defense to refute that indictment as not true. It is true, he said, that savings are counted as a part of income in the period in which they accrue, but these savings are never again counted as income. If these savings are invested and interest is earned on them, such interest is a "new increment" of gain and is not the old saving popping up under a new name.

The second objection is that commodities and services, when lumped together, make a heterogeneous combination. A commodity is concrete wealth, whereas a service is an abstract use of wealth. If care is not exercised, double counting might result. Hewett answers this by showing that the fundamental approach to an analysis of income must be through the distribution process. New commodities produced, personal services rendered, and services of durable consumption goods accrue every income period and are distributed. This is the economic background from which income flows and from which men in the market place get their concept of income.

A third weakness seems to be that in any given period certain intangible rights and values flow to the individual which are not covered by the definition of goods and services. The concept, therefore, is not as inclusive as it might be.

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[17] W. W. Hewett, *The Definition of Income and Application to Federal Taxation*, Ph.D. dissertation, U. of Pa., 1925, pp. 22-23.

Hewett's concept seems more acceptable than Fisher's. The total flow of goods and services concept of income is valuable in attempting to measure the "national income" and is used tolerably well for that purpose.

THE ACCRETION OF ECONOMIC POWER THEORY

The theory itself. Robert M. Haig was of the opinion that income is the accretion in one's power to satisfy his wants in a given period of time insofar as that power consists of money itself and/or anything susceptible of valuation in terms of money. More simply stated:

> Income is the money value of the net accretion to one's economic power between two points of time.[18]

This definition has certain characteristics that make it the most practicable approximation of individual income. It does not get too far away from the fundamental recognition of income as a flow of satisfactions and benefits. It defines income in terms of "power" to satisfy human wants rather than in terms of the satisfactions themselves. It has the effect of taxing the recipient of the income when he receives the "power" to attain satisfactions rather than when he decides to exercise that power. There is a definite threshold that is the same for everyone. We say, therefore, that this concept is of the "accrual type" rather than the "disposition type." Savings out of receipts are income under this concept, and the individual's discretion as to what he chooses to do with what "comes in" is not permitted to affect the basic concept of income. This does not violate our sense of equity, because no harm is done. The fact that an individual by the exercise of his own judgment decides to postpone the gratification of his desires is no valid reason for postponing his tax accountability for his income. There is no violation of due process either in the legal or economic sense because the "choice" still rests with the individual to use the economic power as he sees fit.

Appraisal of the theory. This concept squares quite well with the common conception of income as used in the market place. It is broad enough to get at all economically measurable income and yet is not so broad as to be vague and unworkable. It is scientific because it includes all items of a like nature (economic power–money or money's worth); consequently, it is useful for economic and tax analysis. In fact, this is the theory that lies back of our income tax laws today. Each year the legislatures, the courts, and the tax administrative agencies are defining income for "tax purposes" so that it more nearly approaches "the accretion of economic power."

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[18] Robert M. Haig, *The Federal Income Tax.* New York: Columbia University Press, 1921, p. 7.

Analysis of Concept of Income for Tax Purposes

THE DETERMINATION OF TAXABLE INCOME

The Sixteenth Amendment to the Federal Constitution rendered it possible for the federal government to impose income taxes without regard to any census or enumeration, but the amendment failed to state clearly what income shall be taxed, gross or net income, and if it is the latter, how to determine it. Tax statutes do define what income shall be taxed, but only in a very general way. Consequently, the final decision as to what constitutes taxable net income is vested in the hands of the tax administrators and the courts.

THE DETERMINATION OF GROSS INCOME

The first step in arriving at the taxable income is to ascertain the gross income. Not all receipts are a part of gross income. For various reasons —social, political, or economic—the law expressly excludes certain types of receipts from gross income. These exclusions will be discussed in greater detail in a later chapter in connection with "income tax accounting." Barring these exclusions all other receipts must be included in the calculation of the gross income.

Section 22 (a) of the *Internal Revenue Code* contains the general definition of gross income. The heart of the definition is:

> Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . .; of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

It is apparent that this definition of gross income is merely an amplification of what has been stated in the Sixteenth Amendment and adds nothing to the clarification of the concept of income. It defines the gross income in terms of gross income. It only "indicates the purpose of Congress to use the full measure of its taxing power within those definable categories,"[19] and it fails to answer the decisive question in *income taxation*: What is income?

SOME PROBLEMS IN WHAT MUST BE REPORTED AS INCOME

It is easy enough to define income for tax purposes by saying that it is whatever comes in. We have already seen that there are many views of

[19] *Helvering v. Clifford*, 309 U. S. 331, 334 (1940).

it in economics. Businessmen and accountants also develop their views. The legislators and administrators look for theoretical guidance, but of necessity they are more interested in revenue-raising and administrative feasibility than in balanced and consistent theory. Though the concept of income as "economic power" lies back of our tax thinking, it is broad and needs interpretation in literally thousands of situations in which accretions to economic power can arise. It is true that a body of principles is slowly evolving, but it is still far from complete and consistent. Therefore, a review of some of the issues which must be met in deciding what is "income for tax purposes" is in order.

Receipts in kind. The general definition of gross income under the present code expressly includes the receipts in kind as income. It says in part: "gross income includes gains, profits and income . . . of whatever kind and in whatever form paid." Generally in this country, at both the state and federal levels, income does not necessarily have to be in the form of money. Money or money's worth is the true test. The "fair market value" of goods and services received will constitute "reportable income." The forgiveness of a debt for a service or the "recovery" of a bad debt for which a deduction giving a tax benefit has been previously taken will constitute income.

One other element must accompany the receipt of the income, however, and that is: some *consideration* (past, present, and future) must move from the recipient to the other party. If the recipient has not worked, given up something, or done something for the other party, no income arises under our present laws. The transfer is then a "gift," and if the gift is large enough it will be taxed as such.

Irregular receipts. Some receipts (such as prizes and gains from the sale of stocks or bonds) are irregular in nature. Are these receipts income? The answer is in the affirmative. They are regarded as income. Some economists have maintained that receipts must be "regular and recurring" to constitute income—that is, in the form of wages, salaries, rent, interest, etc. But that theory has never taken hold in the legislative halls of this country. Irregularity is no excuse for nontaxability. In Great Britain, in the past, irregular income and even capital gains have not been counted as taxable income.

Illegitimate receipts. Must all receipts be legitimate in order to constitute taxable income? The answer is "No!" All receipts regardless of their legitimacy are income subject to income taxation. Dishonest, fraudulent, and criminal income must be reported for tax purposes. To avoid self-incrimination, however, such taxpayer may refrain from reporting the source. Recently, however, money acquired by embezzlement was held not to be income on the theory that the known embezzler was under a duty to return the funds. However, all income earned in

illegal businesses such as bootlegging, black marketeering, racketeering, and so forth must be reported as part of gross income.

Income must be realized. Again, though the "accretion to economic power" is a background concept to our state and federal income tax laws, we are far from saying that "every" accretion is taxable income. We still place an additional requirement upon the "accretion" before we define it as "taxable income." The receipt must be "realized." The mere increase in the market value of property or capital assets in the hands of the taxpayer does not constitute taxable income. There must be a sale or exchange of the property and a transformation into money, services, goods, or other property. Ordinarily, the taxpayer must get something different from that which he had before. If the receipt is put on deposit for him or is put to his credit so that he can bring it into his own possession by his own acts, it will constitute taxable income.

Receipts from one's own non-exchange services or property. Most people receive non-exchange income from many services that they render for themselves or from property they already own without any exchange with other persons or business entities. Must there be an exchange with other independent entities to produce income? In the United States there has been no consistent answer on this issue. Generally speaking, however, "home-produced non-exchange income" has not been considered "taxable income."

The more common ways in which this "imputed income" can arise are through the ownership of one's own home, the growing of a family garden, the rendition of family services within the home, and the family's occupation of a farm.

Since in this country "imputed income" is generally not taxed, there are those who point out that certain inequities arise as against others who must "purchase" and pay for such goods and services in cash. Therefore it is sometimes said that it is possible for a man to avoid the income tax by owning his own home. This is brought out quite clearly in the case where one man invests $10,000 in a home and another invests $10,000 in stocks and bonds. The first gets the full enjoyment of his home for a year without income tax accountability; but if the second receives dividends and interest, they must be reported as part of his gross income. Furthermore, the home-owner enjoys other advantages. If his home is mortgaged, he can deduct the "interest paid" as well as "property taxes paid" from his personal income tax.

The consumption by the family of the produce from home-gardens and farms present a similar issue. Such families enjoy a "real income" not possessed by those in large crowded cities where all garden stuffs must be paid for in cash at current market prices. Under the federal income tax such "produce income" need not be reported. Wisconsin, however, recognizes such income in a limited way for tax purposes.

Many other situations give rise to such "imputed income." Those who "hire" domestic service are at a tax disadvantage compared to those who perform their own. People who have "expense accounts" associated with a business often pick up a real income which escapes taxation. Those whose children earn incomes just under the amount of the exemption have a real advantage over those who support their children in full. In these days of relatively high rates and low exemptions, these inequalities are material when measured in tax dollars.

Recognition of cost elements. Most income tax laws follow the "net" approach and therefore allow as a deduction all "cost-elements" incurred in producing the income. Those costs which are clearly business costs create no problem and are deductible. Personal expenses, however, are looked upon as the utilization or enjoyment of income and are, therefore, not deductible as cost items.

Appraisal of Role of Income Tax in a Modern Tax System

THE NET INCOME TAX is the most scientific instrument yet conceived for raising revenue in a modern state. It is a tax upon the "net earnings" of all individuals and corporations that come within the scope of the tax law. Both the strength and weakness of the income tax must be appraised and understood if we are to use this tax instrument wisely.

THE CASE FOR THE INCOME TAX

1. The income tax is the most rational tool of taxation in the whole arsenal of tax instruments. Ultimately most taxes come out of somebody's income; there is therefore a strong presumption in favor of those taxes which come out of income directly and in a carefully calculated relationship to the size of that income.

2. Of all taxes, it most nearly approaches one that is self-liquidating. It is paid only by those who in fact have sufficient income in the given tax year. It falls upon those with a margin of ability-to-pay above a minimum standard of living.

3. It conforms most accurately to the standards of fairness and equity in taxation. A tax based upon ability-to-pay meets those standards more fully than any other tax. Income is now recognized as ability-to-pay in its most liquid form and in its truest measure.

4. The income tax can be levied with a reasonable assurance that it will not be shifted. It has the tendency to stay put. It therefore permits a more accurate determination of its ultimate burden, its justice and its effects. The income tax is direct, personal, and fixed.

5. The income tax does not constitute an unfair burden upon those who

are unable to pay, because reasonable initial exemptions can be provided to take care of an adequate minimum standard of living.

6. Even at reasonable rates, an income tax will yield considerable revenue. This has been conclusively demonstrated wherever it has been adopted and properly administered.

7. With adequate administration, tax delinquency among those who pay income taxes usually is a nominal problem.

8. By means of the income tax it is possible to provide an element of progression in the rate structure to offset the regressive effects of other taxes.

9. An income tax affords a satisfactory means of collecting revenues from those who otherwise pay little or no state and local taxes. This is particularly true of salaried people who live in rented houses, flats, apartments and rooms in the cities. The income tax results in reasonable contributions from otherwise non-taxpaying groups in the community.

10. The net income tax automatically relieves new businesses of taxation while they are getting under way. Any new business which has not as yet produced profits is tax exempt as far as the income tax is concerned.

11. A progressive income tax is more efficient in tapping current oversaving in the upper income brackets. This is an aid to reducing the inequalities in the distribution of wealth.

THE CASE AGAINST THE INCOME TAX

The net income tax is not without opposition. Most of the attacks are not directed against the tax itself so much as against its rate structure and the efficiency of administration.

1. Net income taxes are levied at progressive rates. If the graduation is not properly devised and the rates are set too high, the tax is bound to create harmful results to economic incentives and capital supply—by means of which the private economy is kept running and growing. The logical answer to this criticism is, however, that improvements in the techniques of the income taxation might be made in order to avoid the excessive graduation and confiscatory rates.

2. Because of the broad base and numerous sources, the income tax needs high-grade administration, the lack of which naturally results in serious tax evasion and avoidance. It is apparent that this indictment also calls for a strengthening of the administration, not for an outright repeal of the tax.

3. Another objection is that the income tax is an unstable producer of revenue. It can be answered by saying that a certain degree of built-in-flexibility in the federal tax system may be a virtue rather than a defect, for flexibility serves to counteract the economic effects resulting from various phases of the business cycle. Looked at from the point of view of pure revenue-raising and the fluctuation in the volume of revenue,

this criticism seems to be quite valid. However, viewed from the standpoint of fiscal policy, the automatic adjustment to lower levels of income in depression and rising incomes in prosperity is a desired quality.

Shifting and Incidence of the Income Tax

ONE OF THE MOST DIFFICULT problems to deal with in taxation is that of the shifting and incidence of particular taxes. Our knowledge in this area still lacks precision and certainty. It is generally conceded, however, that net income taxes (among all forms of taxation) are the most difficult to shift. The incidence of net income taxes therefore tends to remain upon the net income itself. Owing to the limitation of space, we shall confine our discussion to personal net income taxes. The shifting of business net income taxes will be treated in a later chapter.

MODERN THEORY OF INCOME TAX SHIFTING

Until recently it has been thought that a "personal net income tax" offered strong resistance to shifting. It was reasoned that it was a "net" tax—not a tax on costs; it allowed reasonable exemptions for subsistence; it was upon a final receipt of income, the "net" of which was not determined until after the receipt of the income; and the "net" income as finally calculated was not directly associated with any act of exchange.

As a first approximation it is safe to conclude that personal net income taxes do offer strong resistance to shifting. Several factors aid in strengthening this resistance: (1) The tax is general in character and reasonably "uniform treatment" is given to income from various sources. There are relatively few "tax exempt" sources of income. (2) It is a "net" tax; it does not impinge upon "cost of production" and therefore is not prone to affect changes in relative supplies.[20] In the case where the tax is general and at a relatively low rate, it is borne by the workers. It probably comes out of the margin between minimum subsistence and the attained standard of living.

That does not mean that an income tax can never be shifted. There are economic conditions under which the possibilities of shifting a net income tax are increased. Some of those conditions should be explored.

An income tax may affect the propensity of workers to work more than a given amount—in other words, the tax may affect the supply schedules for labor offerings. This could be true because the marginal incomes of those taxed would be reduced. Workers might prefer greater leisure and less work. In times of full or near full employment, higher

[20] Edward D. Allen and O. H. Brownlee, *The Economics of Public Finance*. New York: Prentice-Hall, Inc., 1947, p. 236.

wages may have to be offered to secure the needed supply of labor. In recent years workers have become extremely conscious of "take-home-pay" and express the desire to be able to retain a given amount of income "after taxes." The fact that taxes are deducted from each paycheck during the year strengthens the worker's understanding of what is happening. The net income and the tax liability are no longer determined three months after the close of the work year. It has not been uncommon for certain strategic workers and salaried executives to demand a given amount "free of taxes."

The above type of reasoning is made even more effective in periods of prosperity and with such institutional factors as labor unions re-enforcing the desires of the workers. Under the above circumstances it is probable that in the *long run* part of the taxes are shifted to the employers and to the consumers of goods in the production of which the taxed labor is used.

In judging the shiftability of income taxes, many factors must be observed: the phase of the business cycle, the demand for labor, the general character of the taxes, the strength of organized labor, the severity of the rate schedule, existing margins of profits, existing margins between subsistence and attained standards of living, the elasticity of the demand for the product produced by the taxed labor, and so on. Each combination of the above factors must be analyzed carefully before accurate conclusions can be drawn.

The Income Tax as an Instrument of Fiscal Policy

WITHOUT ENTERING into a comprehensive discussion of fiscal and counter-cycle policy at this point it might be well to appraise the personal income tax as one of the instruments in that type of policy. It is now generally recognized that the personal income tax satisfies the qualifications of an effective counter-cycle instrument better than most other taxes. There are a number of basic reasons why this is true: (1) The incidence of the net income tax is more dependably known than is the case with many other taxes. Therefore, it can be more easily and accurately determined what the effects of the tax are, and thus it is possible to check as to whether the tax meets the intended counter-cycle objectives. (2) It is a tax the base of which most nearly approaches the total income stream, and therefore it can be made to affect that stream in one way or another depending upon social and economic needs. (3) The income tax can be brought to bear upon both consumption and investment, the two major determinants of income. (4) It lends itself reasonably well to "timing" so as to accomplish certain economic objectives when it is

desirable to achieve them. (5) The tax itself is sufficiently flexible and adjustable so that it can be manipulated in the right directions for policy purposes.[21] Rates can be moved up or down during the various phases of the business cycle to encourage consumption and investment in recession and to serve as a "brake" in periods of prosperity and inflation.

Conclusions

IT IS NOW well-recognized that the personal net income tax is the most rational and scientific of all our tax instruments. It can be adjusted to raise revenue and to achieve constructive social and economic objectives better than any other tax. It is the most nearly self-liquidating of all the taxes. When scientifically adjusted to ability-to-pay, it can be fair and equitable. It meets the qualifications of a useful and effective counter-cycle instrument more satisfactorily than most other taxes. The income tax, therefore, must necessarily be the backbone of the tax system in a highly industrialized economy. To fail to make it so involves a serious risk for both the tax system and the economic system.

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[21] See Philip E. Taylor, *The Economics of Public Finance*. New York: The Macmillan Co., 1948, p. 443, for an analysis of the qualifications of a good counter-cycle tax.

10

Income Tax Accounting and Administration

> WITH THE TENDENCY *for governmental budgets to rise and for taxes to remain heavy, the study of income tax administration becomes more urgent if we are to minimize inequities and attain the maximum of efficiency, certainty, and convenience in revenue administration and compliance.*
>
> —ALFRED G. BUEHLER.[1]

Overview

THE SUCCESSFUL OPERATION of the income tax depends very largely upon accurate and honest self-reporting by the individual taxpayer. The more effectively the self-reporting is done in the first instance, the more successful is the income tax law and its administration. Income tax administration can logically be divided into two major divisions: (1) income tax compliance and (2) income tax administration.

Taxpayer compliance involves a number of operations: (1) an accurate record-keeping of all income-producing transactions; (2) the actual "income tax accounting," or the refining of gross income down to net income by the adjusting for (a) exclusions, (b) exemptions, (c) business deductions, (d) personal deductions, and (e) credits; and (3) the final reporting upon the income tax return to the government. It is one of the functions of good tax administration to make the tax compliance task as simple, inexpensive, and nonirritating as possible.

The second part of the chapter will deal with income tax administration. In this section the analysis of tax administration is made from the point of view of the functions and responsibilities of the public agencies in enforcing the tax law and in collecting the taxes. Here the analysis will be concerned with: (1) the objectives of good income tax administration, (2) administration organization and personnel, and (3) administrative methods and techniques.

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[1] Alfred G. Buehler in the Foreword to *Income Tax Administration, A Symposium.* New York: Tax Institute, 1948, p. v.

SECTION I

Income Tax Accounting and Reporting

ONE OF THE FUNDAMENTAL tasks of every citizen under income tax statutes is that of calculating the amount of his income tax liability each tax-paying period. It is therefore the function of the first half of this chapter to outline briefly the major procedures, problems, and regulations associated with the task of income tax accounting and reporting, especially under the federal personal income tax.

What is Income Tax Accounting?

EVERY INDIVIDUAL TAXPAYER, no matter how simple his income pattern, must account for his income to the government at income tax time. Therefore, he will have to engage in some measure of income tax accounting. Income tax accounting is nothing more than the process of "refining" the gross income within the various categories of receipts down to a net taxable income. The process involves (1) knowing what must be reported as part of the "gross income" and (2) knowing what "adjustments" are allowed in the "refining." The main tools of refinement are (1) exclusions, (2) exemptions, (3) deductions (business and personal) and (4) credits.

Accounting, for tax purposes, is guided by two basic principles: (1) Net income is calculated for a stated period of time, known as the taxable year. Usually this is a period of twelve months, although it does not have to be the calendar year. (2) The taxpayer must report his true net income and is required to maintain such records as will enable him to prepare a true and accurate return.[2]

The law does not attempt to prescribe a uniform method of accounting for all taxpayers, but it does expect the taxpayer to adopt such methods as will clearly reflect the income from personal and business activities. Generally, two basic approaches to income tax accounting are recognized, and the taxpayer must elect to use one or the other: (1) the cash receipts and disbursements approach (or the so-called "cash basis" method) and (2) the accrual method.

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[2] Prentice-Hall, *Federal Tax Course, 1950*, p. 2701; see also Paul D. Seghers, "Tax Accounting Compared with Recognized Accounting Principles," *National Tax Journal*, Vol. 1, December 1948, pp. 341-352.

The cash basis approach means that the taxpayer must include in his gross income all income received during the year in the form of money or money's worth. He is then permitted to deduct only those items allowed by law which he has in fact disbursed during the year in cash or its equivalent.[3] The great majority of private individuals not engaged in a business carrying inventories use this method.

The use of the accrual method means that income must be reported as part of the gross income when it is in fact earned (as soon as the legal right to receive it accrues), even though it has not been received in cash. On the expenditure side the costs are recognized as soon as they are incurred (as soon as the legal duty to pay occurs) whether they are paid or not at that time.[4]

In the income tax accounting and reporting process, the "refining" first takes place in relation to the major categories of gross income in the production of which costs are incurred. The refining in relation to "income from rent and royalties" takes place within Schedule F. There the gross from that source is reported, and all the cost deductions for depreciation, taxes, repairs, and other expenses are taken and a net income is determined. The same is done for "annuities and pensions," "profit from business or profession," and income from "other sources."

After this is accomplished, the "refining process" becomes one of making all the personal adjustments allowed by law in the form of personal deductions, exemptions, and credits and of finally applying the appropriate tax rates against the net taxable income.

Exclusions from Gross Income

THERE ARE CERTAIN TYPES of receipts flowing to the taxpayer which it is not the policy of the law to tax. They are not recognized as a part of gross income, and they need not be reported upon the income tax return. These *exclusions* can arise for several reasons: (1) there may be constitutional reasons why the receipt must be excluded; (2) the receipt may not come within the legal definition of "income"; or (3) the receipt may be excluded for social reasons by statute.[5] The main categories of exclusions should be examined carefully.

INTEREST ON GOVERNMENTAL BONDS

The federal government may not tax the interest on state and municipal bonds, and likewise the states may not tax the interest on federal bonds. This policy is based upon the implied constitutional principle that is rooted in Supreme Court decisions dating back to *McCulloch v.*

[3] Prentice-Hall, *Federal Tax Course, 1950, loc. cit.*
[4] *Ibid.*, p. 2704.
[5] *Ibid.*, p. 1201.

Maryland in 1819 and *Collector v. Day* in 1870. The Court recognized certain special problems that could arise between the federal government and the states in a "federal system" in which both had sovereign powers.[6] However, both the states and federal government may exempt the income of their own bonds from their own taxation. This the states and local governments do quite generally. Prior to March 1, 1941, many federal bonds were exempt as to all or part of the federal income tax. However, the interest on federal bonds issued since the latter date are subject to the federal tax.

LIFE INSURANCE PROCEEDS

Life insurance proceeds received upon the death of the insured are not taxable as income on the theory that they are in effect a recovery for a loss. If the insurance proceeds are received by the insured before his death, then only the amount of the premiums "paid in" on the given policy are excluded from income on the theory that they are a "return of capital." However, if there is any return over and above the premiums, then said return must be reported as part of the gross income. The latter situation arises especially in connection with endowment policies. If the proceeds of an insurance policy are paid out in the form of annuities, they are taxed as annuities under a method which each year takes into account previous premiums paid.

Dividends received by policyholders on life insurance, endowment, and annuity policies are looked upon as a reduction in the cost of the policy and are, therefore, excluded from income until the amount paid for the policy has been recovered.[7] Health, accident, and workmen's compensation benefits are compensation for losses and injuries and therefore are not included as income. Unemployment insurance benefits paid by a state and by the federal government to railroad workers under a special unemployment insurance act are not treated as taxable income.[8]

GIFTS, BEQUESTS, AND INHERITANCES

The amounts of property received as gifts, bequests, or inheritances need not be included as part of gross income because the present law does not define them as such. They are looked upon as *transfers of capital* and may be subject to estate and inheritance taxes. Income from said property is taxable, however.

DAMAGES RECOVERED FOR VARIOUS INJURIES

Awards of damages for personal injuries received as a result of wilful or negligent conduct of another are not included as income on the theory

[6] Intergovernmental tax immunity is discussed in Chapter 2.
[7] *Ibid.*, p. 1213.
[8] *Ibid.*, p. 1214.

that the award of damages merely puts the injured party back into the same position that he was in before the injury. Damages recovered for injury to certain other personal and family rights (such as damages for alienation of affection, breach of promise to marry, slander, and libel) are also excludable. Damages for injury to the "good will" of a taxpayer's business represent a return of capital and are not taxable.[9]

CERTAIN GOVERNMENTAL ALLOWANCES

Pensions and other allowances for personal injuries or illness acquired in the active service with the armed forces of any country are excluded from tax. Benefits paid to veterans under the G. I. Bill of Rights are excluded. Tuition payments (including books and subsistence allowances) are among the exclusions recognized. Bonus payments to veterans by the various states are not counted as income.

MISCELLANEOUS EXCLUSIONS

Many other individual exclusions are granted. Among these are: (1) social security benefits; (2) the rental value of a dwelling house furnished to a minister of the gospel; (3) awards of support money for minor children; (4) a housewife's allowance from the husband (but husband may not deduct); (5) income received by one as an agent for another; (6) receipt of a loan; (7) a minor's income when less than the amount of the exemption need not be included by the parent; (8) any kind of return of capital; (9) tax refunds (but not the interest thereon); (10) certain types of prizes where the purpose is to advance scholarship and learning and where the participants are more interested in prestige than the money prize (such as Nobel prize and essay contests in the public interest).

What Must Be Included in Gross Income?

GROSS INCOME is defined as the "gains, profits and income derived from salaries, wages or compensation for personal service—or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property —also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, and income derived from any source whatever unless exempt from tax by law." [10]

COMPENSATION FOR SERVICES

All compensation for personal services is included in gross income as long as there is no unconditional obligation to pay it back, regardless of

[9] *Ibid.*, pp. 1215-16.
[10] *Ibid.*, p. 1301.

the name by which it is designated or the manner in which it is computed. It must be reported as the amount "before" payroll deductions by the employer, savings bond purchases, employee contributions to annuities, and union dues.

Because an employer is under no legal obligation to pay the employee or the employee performs the service voluntarily, this does not mean that the amount received is not taxable. Under this ruling amounts paid to an employee while he is ill or on vacation are income. Most bonuses (such as Christmas bonuses) have been ruled to be income to the employee. If the employer takes the amount as a business deduction, then that is considered fair proof of income to the employee. If a taxpayer claims that an amount paid to him is a gift, the intent to make a gift must be established by competent evidence.

Awards and prizes. Prizes and awards are generally deemed taxable if it can be shown that the recipient put forth some effort in obtaining them. A woman is quietly working in her home when the telephone rings and a voice at the other end says, "This is the 'crock of gold' program; you have just won $1,000." The check is forwarded to her. Is the $1,000 income to this woman? In this case the woman did not have her radio on at the time and, therefore, was not even listening to the program. The courts held that this was a gift—not income. The general principle they apply in these cases is that of testing whether any consideration or benefit moved from the grantee to the grantor. If such benefit did pass, it will be looked upon as income to the grantee.

Compensation other than cash. Where compensation is received in some form other than cash (such as notes, securities, etc.), then the amount to be included in gross income is the "fair market value" of the item received. If it is impossible to determine the fair market value, then no income is reported at the time; but when the item is sold, the entire sales price must be included.

Board and lodging is included in gross income if the employee is free to live where he wants to and is not required to live in the quarters provided. However, if the employee is required to live in the furnished quarters or is "on call" during off-duty hours, then board and lodging is not included in gross income.

If stocks, bonds, and notes are purchased by a stockholder or an employee of a corporation at less than fair market value, then the difference between the amount paid and fair market value is deemed to be compensation and must be reported as such.

Compensation of children. Compensation received by a child is income to the child for income tax purposes and must be reported by him. It is not considered income to the parent. The child is responsible for filing a return as soon as his income exceeds the amount of the personal

exemption. At the same time the parent also loses the right to claim the child as a dependent.

MISCELLANEOUS TYPES OF INCOME

Interest received for the use of money (except as excluded or exempt) is reportable as income. All dividends in cash, in kind, or in the stock of another corporation are income to the stockholder when received. The taxation of stock dividends is treated in full in another chapter of this book.

Cancellation of a debt by a creditor can be classified in one of two general categories: income or gift. Forgiveness of debt will result in income if the cancellation is made because of services rendered to the creditor. If the taxpayer can prove that the cancelled debt was intended as a gift, then, of course, there is no income. When forgiveness of debt takes place under the National Bankruptcy Act it is not taxable as income.

Periodic alimony payments received by a divorcee are taxable income to her and deductible by the former husband. It does not make any difference where the payments originate, whether the husband sets up an annuity, or makes periodic payments directly. However, the amount included in a divorce decree for the support of minor children is not included in her gross income. Capital gains, gains from transactions entered into for a profit, and profits from the conduct of a trade, business, or profession are also income; these will be treated in greater technical detail elsewhere.

Deductions—Costs Incurred in Producing Income

THE AMERICAN CONCEPT of the income tax is a "net" concept. Therefore all reasonable and necessary costs incurred in the production of income are usually allowed as a "deduction" from gross income. However, it must be noted that all deductions are purely statutory. A taxpayer claiming a deduction must be able to point to some specific provision of the statute authorizing the deduction. The "deduction" is a very important instrument in "refining" gross income down to net income.

Business deductions can be classed in three general categories; these are: (1) payments made for liabilities incurred; (2) realized losses; (3) reductions in the value of property or interests in property.

Payments for liabilities. Some of the ordinary expenses that are deductible are as follows: expenditures for supplies, management and labor, rentals, traveling (under certain conditions), business entertainment, advertising, operation of automobile for business purposes (does not

include traveling to and from work), business insurance premiums, trade publications, fees, interest, and taxes.

Realized losses. The types of losses recognized under this heading are those evidenced by a closed and completed transaction fixed by an identifiable event. Among these are losses on sales and exchanges of property, losses incurred in a profession, trade, or business, and losses suffered in "transactions entered into for a profit" though not connected with a trade or business. Included also are various business casualty losses. Theft, embezzlement, and swindling losses may also be taken as a deduction if they can be proved. Bad debts are a deduction from gross income if: (1) they were bona fide debts before becoming worthless, and (2) they have not been previously deducted by a charge to an expense account or a credit to a reserve account. "Recovery of a bad debt" is a gross income item, however, if the taxpayer enjoyed a tax benefit at the time he took the bad debt as a deduction. Safety deposit box rentals, custodian fees for investment, and debt collection expenses are a few of the "non-trade" or "non-business" deductions.

Reductions in or impairment of capital. Under our system of enterprise we recognize both in accounting and for tax purposes that the owner has the right to maintain his capital intact. Capital is the source of income and the source must be maintained to continue producing income. Therefore, certain deductions are allowed annually for the prorated impairment of the capital. Those most commonly recognized are maintenance, depreciation, depletion, and obsolescence. The impairment that takes place in the capital and property each year is deductible as an annual expense.

Maintenance. Reasonable repairs and maintenance are allowed as a deduction from gross income on income-producing property. The line of demarcation between currently deductible repair expenses of business property and expenditures for improvements, recoverable through annual depreciation allowances, is often a narrow one. The Tax Court has said: "A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition; it does not add to the value of property, nor does it appreciably prolong its life." [11]

Depreciation. Depreciation is the amount a person is allowed to recover on his *capital asset* due to the estimated wear and tear that has taken place on it during the year. This amount is a proper deduction from gross income to arrive at adjusted gross income. The two most popular methods of computing depreciation are the straight-line method and the unit-production method. The straight-line method is the one most often used, and it is computed by dividing the cost of the asset by the estimated years of service-life. In other words, if the estimated service-life

[11] *Illinois Merchants Trust Co. Ex*, 4 BTA 103.

of an asset is ten years, then the annual rate of depreciation is one-tenth or 10 per cent of the cost of the asset. Under the unit-production method the cost of the asset is divided by the estimated number of units it will produce. For tax purposes the same method of computing depreciation must be followed each year unless a change is authorized by the tax commissioner. If depreciation is not deducted in a given year, the asset is still reduced in value as if depreciation had been taken. "Lost" depreciation may not be recovered in later years. Because of its rather fixed and permanent character, no depreciation is allowed on land.

Obsolescence. Obsolescence may be taken when it can be shown that the useful life of a capital asset is shorter than the actual physical life. This usually occurs when some new invention appears that is superior to the old asset. This may force the abandonment of the property at a future date—that is, prior to the end of its normal useful life. Thus, if an asset has an estimated "remaining" physical life of five years but the property will have to be abandoned in two years for a more up-to-date machine, then the remaining depreciation may be divided between those two years and taken as an obsolescence (or accelerated depreciation) deduction (after salvage value has been accounted for, however.)

Depletion. The income tax statutes also make allowance for a fourth form of impairment of capital—depletion. Whenever wasting assets such as oil, gas, minerals, or timber are removed from their natural state, the basic deposit is reduced by just that amount. This has the effect of selling the basic capital in the business segment by segment. At the end of the extraction period that capital will have completely disappeared. It would not be equitable to tax the total sales of such assets, so an allowance is made under the income tax for the disappearance of this capital. This allowance is known as depletion. One method of granting the deduction is to base it upon the cost of the wasting asset and to express it as a percentage thereof until 100 per cent of the "cost" has been depleted. Another approach—now used extensively under the federal income tax—is to grant the allowance as a fixed percentage of the gross extractions each year, regardless of the cost of original acquisition. For instance, the federal law allows a deduction of 27½ per cent of gross extractions of oil each year as long as anything is extracted. Some authorities have appraised the "percentage depletion" allowance as being quite generous to the owners of natural resources.

Personal Deductions

CERTAIN DEDUCTIONS are allowed to nearly all taxpayers regardless of whether or not they are engaged in a business. The general rule, of

course, is that the personal living expenses of the taxpayer are not deductible. However, it has been the policy under most income tax laws to grant to the individual taxpayer consideration for certain types of costs upon which it seems inequitable to require him to pay taxes. Among these are: (1) contributions to charitable purposes, (2) certain types of taxes, (3) interest paid, (4) medical expenses, (5) certain casualty losses, and (6) certain special miscellaneous deductions. If the long form of return is used, then these items are itemized on Page 3 of the return; if the short form is used, then they are automatically taken into account by use of the tax table and standard deduction. These items are deducted from "adjusted gross" income in arriving at net income.

The standard deduction. In the situation where the taxpayer files the long form but does not have very much in the way of actual personal deductions, he may with minor exceptions elect to take a standard deduction in lieu of "other deductions." The size of the taxpayer's standard deduction depends upon his "adjusted gross income." If the adjusted gross income is $5,000 or more, the amount of the standard deduction is as follows:

Single person or joint return	$1,000 or 10 per cent of adjusted gross income, whichever is less
Married person's separate return	$500

If the adjusted gross income is less than $5,000 and the taxpayer computes his tax from the table and the standard deduction (approximately 10 per cent of adjusted gross income) is automatically taken into account in the table. If husband and wife file separate returns, neither may use the standard deduction unless the other also does.

Personal Exemptions and Credits

ANOTHER MAJOR INSTRUMENT of subtraction in income tax accounting is the personal exemption and credit for dependents. The law recognizes that there is a minimum of income below which the imposition of the tax would cut into the basic cost of living. Exemptions can be taken only when prescribed by statute, and all statutory requirements must be completely satisfied. The taxpayer is entitled to the following exemptions against net income: (1) $600 for the taxpayer; (2) $600 for the spouse if a joint return is filed; (3) $600 additional for the taxpayer who is 65 or over and $600 additional if he has a spouse 65 or over; (4) $600 additional if he is blind and another $600 if he has a spouse who is blind; and (5) $600 for each "dependent" whose gross income is less than $500.[12]

[12] Prentice-Hall, *Federal Tax Course, 1950*, p. 1109.

The Application of Tax Rates and Calculation of Tax

THE ACTUAL CALCULATION of the tax is largely a matter of step-by-step arithmetic once the "adjusted gross income" has been ascertained. The adjusted gross income represents the gross income *minus* all business expenses and cost elements incurred in producing the income. In recent years it has been "item four" on the face of the federal return.

To make the long-form computation it is necessary (1) to start with the adjusted gross income, (2) subtract the itemized personal deductions or the standard deduction, (3) subtract the personal exemptions and credits; this should leave as a residue the net taxable income to which the tax rates are applied.

In the past the next step was merely that of applying the tax rates to the various brackets of income. Since 1946, however, special adjustments have had to be made before the final tax is computed. From 1946 through 1950 the so-called "tentative tax" had to be calculated first by the application of the "combined" normal and surtax rates which have been merged in one schedule. Once the tentative tax had been determined, it was reduced by certain percentage adjustments allowed by law according to the size of the tentative tax. In the early postwar years this was the means that Congress took to give the taxpayers a reduction in income taxes without readjusting the entire income tax rate schedule.

If the taxpayers are a married couple filing a joint return, the tax is calculated on only half of the net taxable income and then multiplied by two. This is permitted under the "split income" provision which keeps half of the income out of a higher level of rates.

INCOME TAX RATES 1945-50

During 1944 the personal income tax rates were the highest in our history. The combined normal and surtax ranged from 23 per cent on the first $2,000 of taxable net income to 94 per cent on the marginal part above $200,000.

However, in 1945 Congress reduced the combined normal and surtax rate range to 20 per cent and 91 per cent respectively. The scale so set up was called the "Tentative Tax Schedule." The tax calculated upon it was in effect a "tentative tax" because a "percentage reduction" of 5 per cent was allowed to all taxpayers on said tentative tax. This schedule of rates and 5 per cent reduction prevailed for several years after the close of World War II.

In 1948 Congress without changing the tentative tax rate schedule allowed even more generous percentage reductions on the tentative tax. The percentage reductions from tentative tax for 1948 and 1949 were:

if the tentative income tax is (a) not over $400, then reduce tentative tax by 17 per cent; (b) over $400 but not over $100,000, then reduce tax by $68 plus 12 per cent of the excess over $400; (c) over $100,000, reduce tax by $12,020 plus 9.75 per cent of excess over $100,000.

INCOME TAX RATES UNDER REVENUE ACT OF 1950

The *Revenue Act of 1950* in effect eliminated the 5 per cent tentative tax reduction of 1945 and the graduated percentage reductions adopted in 1948. The Act made no changes in the basic tentative tax rate schedule which still ranges from 20 per cent on the first $2,000 of taxable income to 91 per cent on the marginal part above $200,000. However, the new law provides that in no event shall the combined normal and surtax for the taxable year exceed 80 per cent of the total net income. The above system of rates is applicable to taxable years beginning after September 30, 1950. Taxpayers whose basis is the calendar year 1950, however, will receive percentage reductions from tentative tax equal to 75 per cent of those prevailing in 1949. For the calendar year 1951 no percentage reductions were granted. The 1950 Act does not change the system of splitting the income of husband and wife adopted in the *Revenue Act of 1948*.

Some representative rates in the new schedule are: 34 per cent at $10,000, 56 per cent at $20,000 and 89 per cent at $100,000. The rates in the early 1950's are bound to rise still more as the revenue needs of the federal government increase with expanded national defense expenditure. The reader should consult the rate schedule which accompanies the instructions on the federal income tax return (1040) for the taxable year in which he is interested.

Some Practical Income Tax Reporting Suggestions

THE TAXPAYER can minimize his difficulties with the tax administration authorities if he will follow certain basic rules in his income tax reporting. Some of these are: (1) fill in all necessary schedules and explanations in reasonable detail; (2) attach supplementary schedules and explanations on the more unusual items of deduction; (3) specify clearly all facts in those situations where difficulties can be anticipated; (4) preserve all records, receipts, letters, and other documents which are relevant to proving the taxpayer's position; (5) retain a copy of the return for future reference; (6) be consistent from year to year on depreciation and other continuous items; (7) be honest and fair in taking deductions, exemptions, and credits, and present the return in a legible, neat condition. By and large, the tax administrators are fair and reasonable provided the return indicates what the taxpayer is doing and why he is doing it.

SECTION II

Income Tax Administration [13]

Introduction

WHILE IT IS TRUE that efficient administration is necessary for the success of any tax, it is especially true of the income tax. The nature of the income tax—that of self-assessment by the taxpayer, plus the many complex features of the law itself—requires the highest degree of co-operation between the tax administrators and the taxpayers. Since the income tax structure is built on voluntary self-assessment, it is vital for taxpayers to feel that the administration is fair and equitable.

Naturally it is impossible to administer any tax law in such a manner as to satisfy everyone. Many conflicts are bound to occur. A number of these conflicts are a result of the law itself; others are due to judicial weaknesses; and some are caused by administrative faults. Much room for improvement remains in strengthening the two prongs of income tax *administration* and *compliance*. However, the fact remains that most people consider the income tax the fairest of any, and certainly much of the credit for this belongs to its administration.

The following pages survey income tax administration from the point of view of its functional tasks. Discussed in sequence are the problems of getting full taxpayer coverage and assessment, collecting the tax, the auditing, the ultimate enforcement of the tax, the provisions for judicial review, and various other aspects of tax administration.

GETTING FULL TAXPAYER COVERAGE AND ASSESSMENT

Essential to public morale and a large revenue yield is a complete reporting and full assessment of all citizens and business units having a tax liability to government. Particularly strategic in obtaining full coverage is the great reliance upon "self-reporting" and "self-assessment" by the taxpayers themselves. The taxpayer is the focal point in the whole income tax system. He is part of the process of tax administration and performs functions in that process. If he does his job well, the task of the administrator is greatly simplified.

Operation of self-reporting. Self-reporting makes the taxpayer responsible in the first instance for getting his name on the tax roll. This

[13] Excellent discussions of many aspects of Income Tax Administration may be found in *Income Tax Administration*, A Symposium Conducted by the Tax Institute. New York: Tax Institute Inc., Dec. 15-17, 1948; *Proceedings of National Tax Association*, Sacramento, Calif., 1948, pp. 40-144. Some of the ideas in Section II of this chapter were gleaned from Walter W. Heller, *State Income Tax Administration*, an unpublished Ph.D. dissertation, University of Wisconsin, 1941.

has enabled the inclusion on the tax rolls of millions of individuals and business entities whose inclusion otherwise would have been administratively costly and difficult.

For most income which is reported by the taxpayer there are other sources of objective information which can be checked by tax administrators. These include the exchange of information between governments, information at the source, audit of books, and so on. Even claims of donations can be checked through the requirement that the donee must be stated. For this reason, complete reliance upon the honesty of the taxpayer is not necessary. Nevertheless, as a practical matter much reliance is imperative, for there could not be sufficient administrative personnel to audit all the returns of the small income earners—laborers, small businessmen, farmers, and professional men.

In all except the lowest brackets of income under the personal income tax, the federal income tax laws require the individual to calculate his own tax, subject to ultimate assessment by tax administrators. In the process of self-assessment the taxpayer is aided by the use of a well-organized income tax return and a set of instructions. The income tax return has been of strategic value in the success of the income tax.

Taxpayer attitudes and compliance. The use of self-reporting and self-assessment presupposes high standards of public and private morality. It presupposes on the part of the taxpayer a reasonable knowledge of his tax-paying obligations. It presupposes that the taxpayer keeps good records and accounts in his business and economic affairs. All three of these are quite drastic assumptions.

The great majority of taxpayers are undoubtedly honest. Many, however, suffer from "taxpayer inertia." Some let the matter of working out the return go until the last minute; they have sort of a fear and aversion to it. Many who should file do not. Others never think about their income tax problems during the course of the year. Taxpayer's records, accounts, and memories are generally poor.

THE TASK OF COLLECTION

The goal for income tax collection is simplicity and a maximum of convenience. There must be no favoritism, delay, or carelessness. The exact amount due must be clear to the layman. The deadline for payment without penalty must be widely publicized. Dealing with the taxpayer concerning collections should be friendly and courteous, but firm. There should be no psychological burdens added to the economic. Outstanding features of federal income tax collection today are the pay-as-you-go provisions. These include both *collection at the source* (through a witholding tax on wages and salaries) and *quarterly installments* on estimated elements of personal income from other sources.

Collection at the source and pay-as-you-go. Prior to 1943, taxpayers paid their tax on each year's income on March 15th of the following year. The pay-as-you-go collection of taxes was instituted in that year. Under this plan the greater part of taxes on wages and salaries are withheld and sent to the Treasury by the employer rather than by the employee. This type of "collection at the source" had been used for many years in England, but it was adopted in the United States as a wartime measure. It is very likely that it will remain as a permanent procedure. The states still use the old annual collection technique.

Quarterly installments on other estimated income. The tax on elements of personal income other than wages and salaries is estimated by recipients during the first quarter of each taxable year and paid in quarterly installments.

On the 15th of March of the year following the payment of withheld taxes or quarterly installments, the taxpayer files his final return for the preceding year, which is in effect a reconciliation of the taxes withheld or paid as estimated. On the basis of this return the Bureau issues a refund, if necessary, or the taxpayer makes additional payment.

AUDITING AND ENFORCEMENT

The task of auditing returns, checking on the full and accurate reporting of income, and enforcing the income tax law is especially significant in view of the great reliance placed on the individual taxpayer in the administrative process. Tax coverage, assessment, and reporting must be "in full" and "on time." To overcome the influences of individual inertia and dishonesty, there must be widespread publicity of a definite enforcement procedure, re-enforced by civil and criminal penalties.

A number of specific procedures and techniques have been developed under the income tax to keep the individual alert and honest and to remedy any errors which may occur. These are the techniques of obtaining information at the source; the use of special investigations and tax informers; doomage power and net worth assessment; desk, correspondence, and field audits; the exchange of information between federal and state administrative bodies—and all these procedures are re-enforced by civil and criminal penalties. Administrative legal "remedies" include the use of distraint, suit, tax lien, and compromise settlement.

Information at the source. The technique of collecting information-at-the-source puts the burden on *payers* of income to supply the government with income data as a check upon the payees. All persons making payment of fixed or determinable income of $600 or more are required to prepare information returns if they do not file a return of tax withheld at the source. The returns include the name and address of the payee to whom the income is disbursed. They cover salaries, wages, fees, com-

missions, and bonuses, as well as fees paid to attorneys, public accountants, physicians, and members of other professions, interest, rent, royalties, annuities and other such income.[14] Where the information-at-the-source reports are filed with the individuals' returns, this technique has been useful to many states and the federal government. Frequently, however, it is not administratively possible to make full use of such information.

Investigation and tax informers. Special use is made by both state and federal governments of so-called "tax informers" who ferret out tax evasion information and pass it on to the administration for enforcement. In addition both units utilize special investigators of their own.

Doomage power and net worth assessment. Both the techniques of "doomage power" and "net worth assessment" give the government power to make arbitrary assessment where tax information has been destroyed, lost, or concealed. These techniques throw the burden upon the taxpayer to come forward and prove the correct amount. They are effective weapons of enforcement.

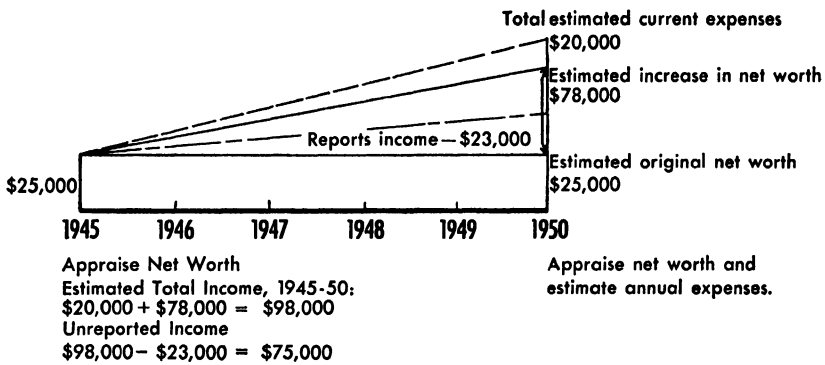


FIGURE 14. *Net Worth Assessment.*

"Doomage power" refers to the power of the administration to assess on the best information available if taxpayers are unco-operative. "Net worth assessment" is a special exercise of doomage power used against those individuals suspected of fraud over a period of time. Under this method the individual has his net worth appraised at two different points in time, separated by as long a period of time as it is felt he has been evading his full tax responsibilities. The increase in net worth between those two points of time plus the estimated current living expenses for that period afford the estimated total income for the period. The reported income is subtracted from the estimated total income to determine the unreported income upon which taxes and penalties are assessed. The technique requires thorough investigation and appraisal of books, records, bank

[14] Prentice-Hall, *Federal Tax Course, 1950*, pp. 3525-30.

accounts, safe deposit boxes, and other evidences of property ownership (as well as the spending habits of the individual). Figure 14 illustrates the procedure used.

Desk, correspondence, and field audits. As part of the collection procedure, a number of the returns are "audited"—that is, they are checked for accuracy and completeness. This may be done by a "desk" audit by using material available in the Internal Revenue Office or by calling the taxpayer into the office. It may be done by correspondence with those who can supply income information such as other governmental units and departments and the taxpayer himself, or by "field" audit, through special examination of taxpayers' books. Auditing the books of individuals and corporations is usually restricted for practical reasons to cases where the income is large or where there is reason to doubt the accuracy of the return.

Such auditing is especially useful in the case of professional and business income where information and collection at the source are not feasible. Federal regulations require that taxpayers keep books at their own peril, and these records must be always available to government field auditors.

Exchange of information. The federal government follows a policy of making its income tax returns and information available to state tax administrators for little or no charge. This practice has been conducive to better state administration because states receive less information at the source on incomes than does the federal government. This is especially true of incomes paid from without the state and interest coupons received from within the state. Exchange of information between departments of a single governmental unit has also been helpful in administering the income tax. More of such exchanges could be beneficially utilized.

Civil and criminal penalties. Substantial penalties are necessary in order to induce taxpayers to file their returns on time and to report their income and deductions fairly. The penalties are divided into two classes: (1) *ad valorem penalties*, which are added to and assessed as part of the tax; and (2) *specific penalties*, which are enforceable only by suit or prosecution.[15] The *ad valorem penalties* include an additional tax of 5 per cent per month up to 25 per cent, plus 6 per cent interest for failure to file on time and an additional tax of 50 per cent for any deficiency due to fraud with intent to evade the tax. *Specific penalties*, in which the intent to defraud is proved, allow the courts to assess fines up to $10,000 and/or imprisonment up to five years. Innocent understatement of income is rarely punished and usually only 6 per cent interest is assessed on the deficiency.

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[15] *Ibid.*, pp. 3612-13.

Legal remedies: lien, distraint, suit, and compromise settlement. When failure to comply with income tax laws is substantially proved, the government has certain remedies open to it whereby it can collect back taxes and enforce penalties. These remedies include the tax lien, distraint, the tax suit, and compromise settlement.

Unpaid taxes constitute a lien on the taxpayer's property, and the government may collect through the use of distraint—in which case the property is seized and sold for taxes within ten days after notice has been given—or the Bureau of Internal Revenue may turn the case over to the Tax Division of the Department of Justice. This Division prosecutes both collection suits and fraud charges. Taxpayers frequently seek to avoid prosecution on charges of tax fraud by voluntarily disclosing their defalcations or by asking for a compromise settlement. The government policy is fairly liberal with regard to voluntary disclosures, but unless it feels that nothing will be gained by prosecution, it will not compromise any suit.

Public Inspection. In most countries of the world *public inspection* of income tax returns is prohibited. In this country the data are usually kept confidential except for such restricted uses as the supplying of state income tax administrators with full use of federal income information. Wisconsin is the only American state which allows public inspection of income tax returns. There are many arguments both for and against such a procedure.

Conclusions and Evaluation

IT CAN HARDLY BE DOUBTED that good administration has contributed substantially to the success and popularity of the income tax on both federal and state levels. The federal government especially rates high on most measures of good administration.

Nevertheless, the nature of the income tax, with its complicated techniques and rules, presents many difficult problems. Numerous amendments to the law have been allowed to pile up, one on another, and the inevitable result has been complication and confusion. The Bureau works under the additional handicaps of the rapid expansion of the income tax and numerous changes in the statutes during recent years. This it has had to administer with an inadequate staff of employees.

The Bureau of Internal Revenue should develop a program of "preventive enforcement," including a special division for tax education and publicity. The "burden of proof" as to one's taxpaying liability should be put squarely on the shoulders of the taxpayer.

Tax research work should seek out in regular and systematic ways valuable suggestions from tax accountants, attorneys, and economists, as

well as from the taxpayers themselves. The strengthening of the income tax should not be entirely on the "tax gathering" side. Considerations of equity and justice must be given to the taxpayer to make the system function properly. Through these means the income tax can continue its role as the most rational and scientific revenue-raising instrument in a modern industrial economy.

II

The Taxation of Special Types of Income

WE BELIEVE *that capital gains often represent real increases in taxpaying ability, and capital losses, real decreases. The only question is whether the income tax is the proper place to take account of these changes in taxpaying ability.*

—TWENTIETH CENTURY FUND.[1]

Overview

TAXABLE INCOME does not always arise in simple, clear-cut ways. Income can accrue in literally thousands of different manners. One of the most common and difficult problems for the tax administrators, the legislatures, and the courts, is to define what accretions *are* and *are not* taxable income.

Some types of income have special characteristics and therefore require special treatment. Some types of income give rise to special problems of definition, time-period determination, irregularity, cost elements, and administration. In all these situations, the law must make the pragmatic adjustments that will collect the revenue due and yet be fair and equitable to those operating in special circumstances. Usually the legislatures and the courts indulge in a practical economic analysis of the characteristics of the particular type of accretion in determining how it should be treated for tax purposes.

Some of the types of income that give rise to special difficulties are capital gains and losses, stock dividends, rental income, farm income, insurance proceeds, and many others.

It is the purpose of this chapter to (1) analyze the economic characteristics of two of these types of accretions: capital gains and losses

[1] Twentieth Century Fund, *Facing the Tax Problem*, New York, 1937, p. 488; see also Harold M. Somers, "An Economic Analysis of the Capital Gains Tax," *National Tax Journal*, Vol. 1, September 1948, pp. 226-232.

and stock dividends; (2) determine whether they should be taxed as income; (3) review some of the problems in taxing them; and (4) comment upon *how* they should be taxed.

SECTION I

The Taxation of Capital Gains and Losses

THE TAXATION of capital gains and losses has caused considerable comment and controversy. Whether they should be included as income for tax purposes leads to some tenuous problems. Some of these problems arise from differences in definition and interpretation as to what is income and what are capital gains and losses. Should capital gains be included as income? Should capital losses be looked upon as negative income and so deducted? Or should they be considered "capital phenomena," not to be associated with income? If they are recognized as a species of income, how should they be taxed? Should they be given special treatment to conform to their economic characteristics?

WHAT ARE CAPITAL GAINS AND LOSSES?

In the broad economic sense. Before we can define capital gains and losses, we must be able to define the source from which the gain or loss is derived. In other words, we must first know what a *capital asset* is. In the broad economic sense, a capital asset is any asset or property held for the further production of wealth or as a source of income. The *capital gain* arises from the *sale* of the asset itself at a price higher than that which was paid for it. The gain or loss accrues from the *sale* of the "source of the income" rather than the flow of the income from the source. In fact, in the broad economic sense there would be a capital gain if the asset had increased in value from the time of purchase without there being any sale or exchange. The capital gain or loss is to be distinguished from the sale of "goods" in the ordinary course of trade. In the case of the company whose business it is to produce and sell hats, any gain made from the sale of the hats is ordinary income. But if the same company were to sell one of the machines which it uses to produce hats, this would be the sale of a capital asset, subject to a capital gain or loss depending upon the price received for the machine. The latter type of gain or loss is an unusual or irregular one—one that arises outside the regular method of producing the company's business income.

Capital gains and losses for tax purposes. The tax statutes usually describe capital gains and losses as gains and losses from the sale of certain

types of assets most of which conform to the economic concept. The federal "instruction sheet" defines capital assets as "all property" held by the taxpayer (whether or not connected with a trade or business), but it does not include (1) stock in trade held primarily for sale to customers in the ordinary course of trade or business, (2) real property "used" in the trade or business, (3) securities of governments in the United States issued upon a discount basis, and a number of other exclusions.

By far the more common types of capital assets are stocks and bonds; these serve as the basis for well over 80 per cent of the capital gains reported in an average year. The next most significant item is rental real estate and even private residences (on which the capital gain is recognized but the capital loss is not allowed).

It must be noted that for tax purposes the gain or loss must be "realized." Mere accretions in the value of capital assets without a sale or an exchange are not taxable income. The appreciation in value must be transformed by a *sale or exchange.* This requirement for taxability is a sound one. Capital values vary from year to year and to attempt to assess the increases and decreases in value each tax period would be a huge administrative task that could seriously injure income tax administration. Furthermore, under such an arrangement the gains exist on paper and do not supply any liquid ability to pay the added tax. Such a plan could also force owners to sell capital assets to meet the tax when there might be sound business and economic reasons for retaining the property.

A major loophole in capital gains taxation exists in the present law by virtue of only taxing gains upon realization. It is quite easy for wealthy holders of capital assets to control and delay realization. The owner who must sell his stocks, bonds, and other assets to live on in his old age is forced to pay taxes on the capital gain. The more wealthy owner has it in his power to hold the assets until death, and in his will he can then transfer the stocks and bonds (gain and all) without ever having to account for the gain under the income tax. This seems inequitable to those who must "sell and realize" and gives a substantial advantage to those who have superior ability to pay. It would not be illogical for Congress and the state legislatures to define "transfer at death" as realization and thus take account of the gains and losses for income tax purposes at that point.

ARE CAPITAL GAINS INCOME?

A paramount question which gives rise to a great deal of controversy is the question of whether or not capital gains are income. Some would contend that these gains are not income. Capital accretions probably do not represent an addition to the flow of goods and services for the individual taxpayer. Nor do they represent an increase in the consumer's satisfaction. However, when capital accretions are "realized" they can

"command" goods, services, and consumer's satisfaction just as effectively as can a pink paycheck received for rendering personal services.

When capital gains are tested against the concept of income as an accretion of economic power, there is little doubt but that they can be classified as income even before they are realized. When we combine economic power and realization, a very strong case can be made out for designating them as income for tax purposes. They clearly represent ability to pay taxes. It is difficult to see any serious differences in the taxable capacity between the young lawyer in private practice who earns $10,000 per year and one who cashes in on his stocks and bonds for a gain of $10,000. It is true that the latter is a more irregular income, but it is also an "easier" income. Our conclusion is that it is only logical and fair that capital gains when realized be dealt with as income.

THE CHARACTERISTICS OF CAPITAL GAINS AND LOSSES

There are a number of factors which distinguish capital gains and losses from other forms of income. These characteristics are relevant in formulating tax policy with respect to these gains and losses. Among these characteristics are: (1) Realized capital gains and losses do not have any set periodicity. They may accrue over many years. Therefore, when capital gains are realized in a given year, they have a tendency to throw the taxpayer up into higher brackets; his gains are taxed at much higher rates than if they had been realized regularly over the years. It is hard to deny that some inequity is present in this situation. (2) Capital gains and losses are not as regularly recurrent as other forms of income. Substantial capital gains may come on a very few occasions in a lifetime, and yet when they come, they can be taxed more heavily than if they came regularly averaged over the years. (3) With most recipients of substantial capital gains, they represent something over and above the basic income. They, therefore, seldom affect the standard of living of the recipient. The gains usually lead to a new investment larger than the one upon which the gain was made. (4) Capital gains and losses can be "administered" to the advantage of the taxpayer—another factor that should be considered in capital gains tax policy. Gains and losses can be taken when most advantageous to the taxpayer. (5) Capital gains and losses are affected by the course of prices and the business cycle: they fluctuate more widely. From the point of view of the revenue, some years are highly productive of capital gains taxes; in other years the losses more than wipe out the gains. (6) Capital gains have a tendency to be concentrated in the upper-income groups. The Treasury estimated that for 1938, those with net incomes of $5,000 or more enjoyed about 67 per cent of the short-term and 87 per cent of the long-term gains.[2]

[2] Testimony of Randolph Paul before House Committee on Ways and Means concerning *Revenue Revision of 1942*, Vol. 2, p. 1638.

THE TAX TREATMENT OF CAPITAL GAINS AND LOSSES

Because of the characteristics of capital gains and losses, many proposals have been made for their possible tax treatment. This raises the question as to how they should be treated for tax purposes. Several major alternative approaches present themselves for consideration.

Ignore completely. First, gains and losses could be ignored altogether and excluded from the tax base. It has been maintained that revenue from this source is of no great consequence, that gains and losses have some tendency to cancel out, and the nonfiscal effects far outweigh the yield. The English attitude (which has been akin to this one) has been used to support the argument. According to that view, taxable income is that which is earned regularly and recurrently. Gains and losses are classified as "casual income" and escape taxation.[3] But American experience has been different from that of the British. Capital gains over the years average 12 to 15 per cent of the taxable income. Many individuals, especially owners of stock, pick up capital gains quite regularly. In many years their capital gains represent a substantial increase in economic power and ability to pay taxes. In our day of heavy need for revenue it would be particularly difficult to defend a capital gains exemption policy.

Treat like other income. A viewpoint opposite the one above was incorporated in the *Revenue Act of 1913*. Gains were given no special consideration and were taxed as regular income. This proposal was opposed on the ground that it would place a damper on investment and risk-taking. It had the further disadvantage of forcing up into the higher brackets those who sell capital assets and thus of subjecting the capital gain to a high marginal rate. When this approach is accompanied by complete deductibility of capital losses against other income, it can seriously cut into the revenue flowing to government in years of rapidly declining prices. Some authorities favor treating capital gains like other income with parity of treatment for losses, but the advocates of this plan would accompany it with a system of "averaging" all incomes *and* the taxation of capital gains at death. It is claimed that such a method would make it possible to lower the general level of income tax rates. If a workable system of averaging could be put into operation, this point of view merits consideration.

Special treatment. Special treatment is essentially a compromise between other proposals. It involves recognizing the special characteristics

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[3] R. M. Haig made a study of conditions of gains taxation in England and came to the conclusion that the definition of casual income was much narrower than supposed, and that the operation of the income exemption was detrimental to the securities and real estate markets. R. M. Haig, "Taxation of Capital Gains," *Wall Street Journal*, April 13, 1935, p. 4.

of capital gains and losses and then treating them in a special manner outside the income tax or within the framework of the income tax. It involves classifying the gains and losses based upon the length of time the asset is held, recognizing varying percentages of gain or loss based upon the period held, and giving them differentiated treatment as to rates.

This compromise has been evolving since 1916 when the first cognizance was given to capital gains as such in the tax statutes. The first distinction between short- and long-term gains and losses was made in 1921. In that year, gains from assets held less than two years were defined as short-term and the full gain recognized. The *Revenue Act of 1934* recognized five time periods with valuation of from 30 per cent for ten years to 100 per cent for less than one year. The number of categories was reduced to three in 1938.

PRESENT FEDERAL TREATMENT OF CAPITAL GAINS AND LOSSES

Short-term capital gains and losses. The method of treatment was last revised in 1942 when the present practice was inaugurated. The structure was made somewhat simpler in that only two holding periods were provided. Short-term gains and losses arise from the sale of those capital assets which have been held for "not more than six months." Short-term gains and losses are included within the short-term schedule at their full amount (100 per cent of gain or loss). However, short-term losses may be offset against short-term gains.

Long-term capital gains and losses. Long-term capital losses arise from the sale of those capital assets which have been held for "more than six months." Long-term gains and losses are included within the long-term schedule at 50 per cent of the gain or loss. Again the long-term losses may be offset against the gains. The net short-term gains or losses are then combined with the net long-term to produce the net gains or losses.

Long-term gain rate limitation. If there are net long-term capital gains, they *cannot* be taxed at more than 50 per cent on one-half of the net long-term gain (or in effect not more than 25 per cent of the full net long-term gain). This is called the alternative tax for the calculation of which a special schedule is supplied. This procedure minimizes the injustice of applying high bracket rates to gains which have accrued over long periods of time. This is also calculated to reduce the tendency of wealthy men to retain investments which have increased in value.

Capital loss carry-over. If there are final net capital losses, they are deductible up to $1,000 per year against "other income." Any balance of capital loss over the $1,000 may be carried forward for five years to be deducted from future net capital gains and up to $1,000 per year from other future income.

Conclusions on special treatment. As long as there is no method for averaging income in general in use, then the better practice is to give

capital gains and losses special treatment as an adjunct of the income tax. This treatment can take into consideration the characteristics of capital gains and losses. Care must be taken, however, not to make the treatment too complex. A large number of holding periods should be avoided. Some would recommend a short-term period of one year rather than six months. This would make it a little more difficult to manipulate the gains and losses in favor of the taxpayer. The asset would have to be held for more than one year before the gain could be cut in half.

EFFECTS OF CAPITAL GAINS TAXATION

Those who oppose the taxation of capital gains maintain that such taxation has adverse effects not only upon individual investors but also upon the functioning of our economic system as well.

Intensifies booms and busts. It is maintained that the tax induces investors in prosperity to hold stocks and bonds which would ordinarily be sold, thus creating a false scarcity, forcing the price up, and aggravating the boom. The opposite situation applies in a depression and acts to depress an already degenerating market. This no doubt occurs in some measure. A reaction of this kind is more apt to occur in the situation where gains are taxed like other income and where the losses may be taken in full. It is not so apt to happen where long-term gains and losses are recognized at 50 per cent.

Capital gains taxation and business incentives. Capital gains taxation is sometimes indicted on the ground that it interferes with risk-taking and investment incentives. It is claimed that capital gains and dividends are the main returns for risk-taking. It is true that for the professional speculators, capital gains are looked upon as strategically important; but for the great majority who desire to make bona fide investments in enterprise, the annual rate of return is the primary reason for making the investment decision. The thought of an accretion to capital value is secondary and often remote—something to be welcomed and accepted if it comes—but it is not the motivating factor in "investment" decisions. Most investors look upon capital accretions as windfalls, especially when the annual return has been steady and good.

Capital gains illusory. In periods of rapidly rising prices, the market prices of capital assets also rise. Therefore, many of the gains subject to tax are illusory: they do not represent "real gains" at all. This results in taking something that isn't there. Likewise, however, during periods of falling prices capital losses allowed as deductions may not represent "real losses" either. Inequities arising here can be material. Their adjustment is not a simple matter. In the absence of a *capital assets price index number* which might be difficult to administer, the special treatment of capital gains and losses offers the best approach to minimize this inequity.

CONCLUSIONS ON TAXATION OF CAPITAL GAINS AND LOSSES

If it were possible to work out and administer a comprehensive method for averaging all types of income, then the ideal way to treat capital gains would be like other income. This should then include *parity* of treatment for losses. It should also be accompanied by viewing the transfer of capital assets at death as a "sale or exchange" so as to serve as the basis for the taxation of the accrued gains and the allowance of the accrued losses under the income tax. In the absence of a general averaging approach, the special treatment of capital gains and losses comparable to our present federal methods seems preferable. This should be accompanied by the taxation of the gains and the allowance of the losses under the income tax at death, however.

SECTION II

The Taxation of Stock Dividends

THE PROBLEM OF TAXING STOCK DIVIDENDS

Sharp controversy in the courts has attended the attempt by the federal government to make stock dividends taxable as current income. Present court trends to reduce the area of tax immunity of stock dividends has raised the insistent question as to whether such dividends are really best considered as current income and whether they should be made taxable as such. Answers to these questions depend upon the nature of stock dividends, their use in corporation finance, their importance as a tax avoidance device, their revenue importance, and the effects such taxation would have upon corporate policy and the economy as a whole.

THE NATURE OF STOCK DIVIDENDS

Definition. Stock dividends are a method of "evidencing" the accumulated earnings of a corporation to its stockholders without actually distributing the earnings. They consist of issues of *new shares of stock* to the stockholders in proportion to their prior holdings. As such, they are to be distinguished from cash dividends, dividends-in-stock, dividends in kind, and a stock split-up. Cash dividends are distributions of these earnings in cash; dividends-in-stock are distributions in the stock of "another" corporation; dividends in kind are distributions in the form of goods and services; and a stock split-up consists of increasing the number of shares of stock outstanding, but lowering proportionately the unit par value of the stock, usually without a previously accumulated surplus and without increasing the equity of existing stockholders.

Effect on firm's accounts. As a bookkeeping transaction, the declaration of a stock dividend is a "capitalization of an accumulated surplus" —that is, a transfer of the amount represented by the dividend from a surplus account to a legal capital account. There is no reduction in the total assets of the corporation as in the case of dividends in stock, cash, or kind.

Effect on value of stockholders' shares. Controversy exists as to the effect of a stock dividend on the total market value of the stockholders' shares in the corporation. Most authorities agree, however, that there should be no increase in the combined market value of the stockholders' shares as a result of the stock dividend. The value of the original shares would therefore fall proportionately. This is because the accumulated earnings in the form of surplus in the corporation may already have been capitalized in the market value of the original shares, and a stock dividend is merely an accounting device to recognize this increased capitalization.

Functions performed for firm. A recent survey has discovered a number of important motives behind the use of stock dividends by large corporations.[4] Most firms have found need for the device in times of peak earnings when the firm's own needs for internal capital have made the distribution of the cash to stockholders undesirable. The earned cash has usually been absorbed in expansion of plant and equipment, in increased investment in inventories and accounts receivable, and in cash reserves because of apprehension of economic conditions. While thus employing the earnings, the firms have used stock dividends to give stockholders some tangible evidence of at least a part of the retained earnings and thus have kept stockholders satisfied. Other motives for issuance include the desire to achieve a broader base of distribution of the stock when the existing shares are closely held; the expectation being that present shareholders will sell their stock dividends.

HOW ARE STOCK DIVIDENDS TAXED?

Stock dividends may be treated either as *current income* (and subject to the regular income tax rates) or as *capital gains* (and subject to the capital gains rates only when they are sold).

Early immunity from current income taxation. The Sixteenth Amendment gave Congress the power to tax all income from whatever source derived, and the *Revenue Act of 1916* evinced a purpose to tax stock dividends as current income. A leading test case, *Eisner v. Macomber*, however, held that stock dividends were not taxable as current income.[5]

[4] Robert E. Zang and George C. Thompson, "Why Stock Dividends Are Declared," *Taxes—The Tax Magazine*, October 1949, pp. 883-886. Study was made by questionnaire and interview of listed corporations of the N. Y. Stock and Curb Exchanges by the Columbia University Schools of Law and Business joint graduate seminar on the effects of taxation on business policy.

[5] *Eisner v. Macomber*, 252 U. S. 189 (1920).

The argument in the case was based upon four assertions. First, stock dividends are *not realized.* That is, they are not yet in spendable or consumable form. The concept of "realization" is, of course, a matter of degree. Second, the stockholder has *received nothing* from the corporation for his separate use and benefit that in effect he did not have before under the theory of the stockholder's equity. Although the shareholder may sell his new shares, to do so would result in a loss of voting power and a decrease in his capital holdings. However, it should be remembered that the market value of the original stock has probably increased before the distribution of the dividend as a result of the accumulated earnings.

Third, there is *no separation from corporate capital* of the stock dividend, as is the case with other types of dividends. All that occurs is a transfer of liabilities on the corporation books from surplus to capital account. The corporation retains its surplus and the stockholder merely gets an additional piece of paper. And fourth, there is *no change in the proportionate claims* of the individual upon the corporation since all stockholders participate in the exact proportion of their prior holdings. As a result of the *Eisner v. Macomber* decision, stock dividends were held not taxable as current income. This treatment prevailed throughout the 1920's and well into the 1930's.

Later narrowing of immunity. In 1936 the Supreme Court declared that stock dividends which changed the character of the rights and interests of the stockholders are taxable as current income.[6] The case involved the distribution of nonvoting preferred stock to common stockholders with preferred stock outstanding. The court reasoned that the common stockholders now had new rights that they did not possess before. Subsequent decisions have further extended the application of this principle to dividends of common stock to preferred stockholders with common stock outstanding.[7] Nor may the stockholder be given an option to take either cash or stock and still avoid taxation as current income.[8]

Present Treasury policy is to tax as current income those classes of stock dividends which change any of the stockholders' rights, such as a distribution in a different class of stock, different voting rights, or rights to liquidation.[9] Any further reductions of stock dividend immunity, however, will probably wait upon congressional legislation rather than upon further court interpretation.

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[6] *Koshland v. Helvering,* 298 U. S. 441 (1936).
[7] *Helvering v. Gowran,* 302 U. S. 238 (1937).
[8] *Southeastern Finance Co.,* T. C. 1069 (A).
[9] Zang and Thompson, *op. cit.,* p. 884.

ARE STOCK DIVIDENDS CURRENT INCOME?

Stock dividends live in that shadowland between "current income" and "capital gains." Despite the many criteria raised by the courts, the main distinction between these two appears to be one of "realization." Both represent an accretion to economic power.

All dividends except stock dividends are "separated from the capital" of the corporation, and are thus "realized" to a greater degree than stock dividends. The accumulation of corporate earnings without declaration of a stock dividend constitutes realization to a lesser degree. This is indisputably a capital gain in the broad economic sense. But to which side do stock dividends more closely adhere? As noted, the courts have been making stock dividends increasingly susceptible to current income taxation in those cases in which the stockholder receives "something different," new rights, and interests. As Mr. Justice Douglas dissented in the *Griffiths* case, "*Eisner v. Macomber* dies a slow death." [10] Nevertheless, since the distinction is one of degree, any drawing of a line between what is and what is not current income must be arbitrary.

HOW SHOULD STOCK DIVIDENDS BE TAXED?

Any decision to classify and tax stock dividends as current income should rest upon the possible social, economic, and ethical effects of such taxation. These effects include the importance of stock dividends as a tax avoidance device, as a possible revenue producer, and the possible effects on corporate policy and the economy as a whole.

Negligible importance as a tax avoidance device. Theoretically, stock dividends can be used for tax avoidance. This is because receivers can immediately sell their shares and be taxed only on the capital gains dating from the purchase of the original shares, rather than at full income tax rates on the market value of the dividend. In practice, however, their importance as a tax avoidance device is negligible. Not over 10-15 per cent of dividend shares are sold.[11] Shareholders tend to treat their stock dividends as capital rather than income.

Moderate importance as a revenue producer. Taxation of stock dividends would probably be only moderately significant to the revenue of the government. It is true that because of inflation and investment demands, stock dividends have tended to increase since World War II. However, as the temporary postwar conditions disappear, it is expected that the number of stock dividend distributions will correspondingly decline to former proportions. Of the billions of dollars in dividends of all kinds in 1936 and 1937, for example, stock dividends accounted

[10] *Helvering v. Griffiths*, 318 U. S. 371 (1943).
[11] Zang and Thompson, *op. cit.*, p. 885.

respectively for 4 and 2.3 per cent of the total. In 1936, 13.4 per cent of the stock dividends were declared taxable, and in 1937, 37 per cent.[12]

Moreover, the number of stock dividends could probably be expected to decrease if all were made taxable. Corporations would probably more frequently permit the accumulated surplus in the corporation to be reflected in the market value of outstanding shares. The need for "tangible evidence" to the shareholders could be satisfied by a properly interpreted corporate financial statement.

Probable tax effects on corporate policy and the economy. Since the psychological motive of informing stockholders of retained earnings could probably be performed by other "tax-free" devices, the further taxation of stock dividends would probably not seriously impair this function. Insofar as stock dividends are an incentive to "broadening the base of distribution" of shares through their sales, this function will be hindered slightly. But as noted previously, sales of stock dividends are usually slight.

Even though the effect upon corporate finance and the economy would probably not be serious as a result of the taxation of remaining tax-free stock dividends (mostly common on common), such taxation would nevertheless hamper a corporate device that has been used for legitimate purposes. It enables corporations to retain risk capital while apparently satisfying stockholders.

CONCLUSIONS ON STOCK DIVIDENDS

We have found that the revenue potentialities of stock dividends are not large. Similarly, their potentialities as a tax avoidance device are negligible. The assertion that the taxation of stock dividends would discourage corporate saving is questionable since other devices are available for informing stockholders of retained earnings. On the other hand, stock dividends do perform useful corporate functions, and their further taxation would create some financial inconvenience. Furthermore, the possibility of receiving a stock dividend can have some wholesome effects as an incentive to the risk-taking types of investment so badly needed in recent years.

For these reasons, the best policy would seem to be to exempt stock dividends of the most desirable kind—that is, common stock dividends to common stockholders. The exemption should be limited to current income taxation. Upon sale or transfer at death, the capital gains element should be taxed as a capital gain, and the stockholder should be required to account for the accretion above original investment in the long run.

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[12] Groves, *Postwar Taxation and Economic Progress*, p. 62.

Conclusions

THIS CHAPTER has attempted to deal with the taxation of two selected special types of income, namely, capital gains and losses and stock dividends. There are many others that could merit consideration. Among these are income from copyrights and patents, insurance proceeds and annuities, professional income, income from illegal operations, rental income, and farm income.

The significant observation to make is that special types of income often possess special economic characteristics; and that the tax laws and administration must make reasonable adjustments for those characteristics for the sake of fairness and equity. Making these adjustments often requires consummate legislative and administrative skill.

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Income Tax Problems and Reforms

THE SECRETARY *of the Treasury has given me a report of a preliminary study of income-tax returns for the calendar year 1936. This report reveals efforts at avoidance and evasion of tax liability so widespread and so amazing both in their boldness and their ingenuity that further action without delay seems imperative.*

—FRANKLIN D. ROOSEVELT.[1]

Overview

THE NET INCOME tax is no doubt the most scientific instrument yet conceived for raising revenue in a modern state. It is probably true, however, that we have not explored its full scientific possibilities. There remain at many points, opportunities for further refinement and improvement that will strengthen the effectiveness and the equity of the tax.

On the other hand, the income tax still presents many troublesome problems, some of which we have already considered in other connections. Among the more vital of the remaining problems to be now considered are: (1) the differentiation of income, (2) exemptions and graduation, (3) avoidance and evasion, (4) irregularity of income, and (5) problems applicable to the state income tax, including jurisdictional and multiple taxation problems. As each of the above problems is studied, the reader should turn his best thoughts to constructive adjustments that will overcome these problems and thus improve the scientific quality of the income tax.

Differentiation of Qualities of Income

THE APPLICATION of the progressive principle in taxation manifests itself largely in differentiating incomes according to amount. In addition to

[1] Franklin D. Roosevelt, *Hearings before the Joint Committee on Tax Evasion and Avoidance*, 75th Congress, 1st Session, 1937, p. 2.

distinguishing on the basis of quantity, a true application of ability-to-pay seems to require that some reasonable provision be made for differentiating income according to its quality and source. This thought is by no means a new one. It was appreciated and expressed by John Stuart Mill during the nineteenth century:

> The existing law treats all kinds of income exactly alike, taking its [five pence] in the pound as well from the person whose income dies with him, as from the landholder, stockholder, or mortgagee, who can transmit his fortune undiminished to his descendants. This is visible injustice.[2]

Quality classification of income can be made on a number of bases. The one suggested by Mill seems to present the strongest case for consideration. He distinguishes the kind of income flowing out of the rendition of "human services" from that arising out of the "ownership of property." The quality distinctions between the two are reasonably apparent. Income from personal services is far more vulnerable than that from property. Illness of the human worker immediately stops his service income, whereas the owner of property income can lie on the sunny sands of a beach and continue to draw his interest and dividend checks. Death completely destroys service income for those who were dependent upon the decedent, whereas the owner of stocks, bonds, and real estate can transmit the assets and its income to his heirs, and the assets can go on working for the heirs.

It would seem, therefore, that here is an area in which some adjustment for the greater vulnerability of service-income could be made under the income tax. In the period prior to World War II the federal law made an allowance for this vulnerability by granting what was known as a 10 per cent "earned income credit" on service-earned incomes. The amount of the credit was then deducted from the gross income for tax purposes. The re-establishment of such a credit in the federal return would be a contribution both to equity and true ability-to-pay.

Another differentiation which is valid to consider is that within the family of property income itself. It does not seem likely that we are going to remove the double taxation of corporately-earned income in the near future. There is ample evidence to show that most corporations are having difficulty getting risk-capital by the sale of stock.

The need for encouraging the flow of risk-capital from our individual citizens into our private enterprise economy may justify differentiating as between *risk-earned* income and *contract-property* income. The former involves greater risk than the latter. Perhaps then a "risk-earned credit" could be allowed all recipients of common stock income. A 25

[2] John Stuart Mill, *Principles of Political Economy*. New York: D. Appleton and Co., 1887, p. 544.

per cent credit might have some reasonable chance of being accepted by the voters and the legislatures. Such a procedure could contribute something to the flow of risk-capital into industry.

There exist other bases upon which to differentiate incomes, but most of them are too subjective in character to serve as the substance of income classifications and too intangible to be gauged and measured. The concepts of the "service-earned" and "risk-earned" income, however, deserve a hearing in our legislative halls.

Irregular Income and Averaging

THE PROBLEM OF IRREGULAR INCOME

Inequity arises from annual accounting approach. A special problem grows out of the fact that one calendar or fiscal year is taken as the period for determining taxable income. The problem is intensified by the fact that each person is taxed on his income base each year without regard to other years or to any period of years. Because of this "annual income" approach, the taxpayer with an income which fluctuates from year to year will pay more taxes on his total income over the years than the taxpayer with the same total income which is received in more uniform amounts. The fluctuating incomes are thrown into higher brackets in the good years. This is a recognized discrimination against irregular incomes.

Causes of fluctuating incomes. In a dynamic economy there are bound to be causes for irregular incomes, many of which are beyond the control of the individual taxpayer. For those who are risk-takers, speculators, and farmers the ups and downs of the business cycle contribute to the rise and fall of their incomes. This no doubt is the most general cause. Irregular transactions such as the realization of capital gains and losses are a major factor for those in the upper-income groups. Some of the irregularity originates from changes in the dividend payment policy of corporations. Some irregularity arises from business success or failure of individuals. Other causes are fortuitous—prizes, awards, and sweepstakes. Authors, lawyers, inventors and others are sometimes paid in lump sums for work done over several years. Many of the causes are personal: illness and incapacity, the rise and fall in the capacity of athletes, actors, singers and other entertainers. For many average citizens one of the main causes is unemployment. In many instances, especially to those involving personal misfortune and loss, the tax system seems bitterly unkind.

AVERAGING PERSONAL INCOMES

Previous experience with averaging. With the thought of minimizing the inequity of the income tax upon those having fluctuating incomes have come a number of proposals adjusting for losses and unused exemptions and for direct averaging of income over stated periods of time. On the whole, averaging schemes have not been too successful.

Beginning in 1927, Wisconsin inaugurated a system of basing its income tax on a "three year moving average." The taxpayer paid a tax each year based on his average income for the taxable year and the two previous years. On the downswing of the business cycle, the reaction of the taxpayers was quite unfriendly. The scheme then worked to their disadvantage because they were compelled to include the two previous higher incomes in striking the average; this meant that they were paying taxes on the income of the better years at a time when their ability to pay had in fact declined. The "moving average" seems to create a new inequity at a most disadvantageous time. For this reason and because of certain administrative difficulties, Wisconsin repealed the plan in 1934.

Recent proposals for averaging personal incomes. One recent proposal would overcome the weaknesses of the "moving average" by the use of a "retroactive average." [3] Under this plan the taxpayer would pay the yearly tax on his income as usual, but at the end of a five-year period he could claim a refund of taxes paid in "excess" of the total taxes which would have been levied had his average income been his actual income. In order to eliminate administrative costs from a large number of claims for small refunds, it is suggested that only in cases where actual taxes paid exceeded by 10 per cent the amount calculated on the "average income" would the refund be made. The better administrative procedure would probably be to require the taxpayer to file a special form in which he would "claim and prove" his right to the refund.

At present the federal income tax allows a form of limited averaging in several specific types of situations. Special consideration is granted to the taxpayers (often authors, inventors, lawyers) who work for long periods without pay and then receive all or a major part of the compensation upon completion of an undertaking. Where the services extend over a period of thirty-six months or more and not less than 80 per cent of the total compensation is received or accrued in the taxable year, the taxpayer is permitted to prorate this income over the earning period involved. A prorated adjustment is also allowed individuals who receive

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[3] Henry C. Simons, *Personal Income Taxation.* Chicago: University of Chicago Press, 1938, pp. 154-156. See also Harold M. Groves, *Postwar Taxation and Economic Progress.* New York: McGraw-Hill Book Co., 1946, pp. 223-236; Charles C. Holt, "Averaging Income for Tax Purposes: Equity and Fiscal Policy Considerations," *National Tax Journal,* 2: 349-361, December 1949.

"back pay" for work done in previous years in an amount in excess of 15 per cent of the gross income (including back pay) for the taxable year.[4]

Conclusions on averaging. The whole problem of averaging deserves attention on the grounds of equitable treatment of taxpayers; but it merits further consideration as a business and economic incentive. Often large, irregular incomes come as the result of the exercise of special economic courage and the assumption of heavy risk. When such income accrues in large lump-sum form, it should not be penalized. Averaging involves difficult administrative problems, but the hurdles are not insuperable if special "averaging refund forms" are scientifically constructed with the burden of proof upon the taxpayer-claimant. Clearly, the concept of improving the equitable quality of the income tax by averaging merits intelligent experimentation.

The Problem of Exemptions and Income Tax Base

PROBLEMS AND POLICIES ON EXEMPTION

It was quite natural for most Americans to hope that at the close of World War II reasonable upward adjustments in the personal exemptions under the federal income tax would be forthcoming. In 1939 these exemptions amounted to $2,500 per married couple and $1,000 per single person. During the War period they had been cut more than in half, so that at the close of the War they were $1,000 and $500 respectively. We have not been able to cut the federal budget to the $20 to $25 billion discussed near the close of the War. Instead the budget (1946-50) has ranged between $35 and $45 billion and has been tending upward. In the face of this situation, the adjustment of exemptions has been at a standstill.

The theory of personal exemptions. Income tax exemptions on low incomes rest soundly on the idea that providing public luxuries at the expense of private necessities is poor economics.[5] The attempt to make income taxation as socially digestible as possible necessitates that comparison be made of the "least justifiable" of public expenditures with the "most important" private wants sacrificed because of tax collections. It is within the framework of this type of policy that the purposes of personal exemptions under the income tax should be discussed. The more important of these purposes are as follows: (1) Exemptions allow a portion of the income untouched by taxes to serve as a subsistence standard of

[4] Prentice-Hall, Inc., *Federal Tax Course, 1950,* pp. 2714-16.

[5] Harold M. Groves, *Trouble Spots in Taxation.* Princeton: Princeton University Press, 1948, p. 54.

living. This is very difficult to challenge. It seems only humane that human beings be permitted to keep body and soul together before they are required to contribute to the body politic. It must be noted, however, that in our day the services of government clearly are an element necessary to human existence also. (2) Exemptions aid in preserving the market for consumers' goods. The marginal dollar preserved in the hands of the great majority of low-income people is likely to be spent for private consumers' goods. The maintenance of high levels of consumption and demand in a private enterprise economy is of strategic significance. (3) Exemptions aid in distinguishing taxpayers according to need. The man with several human beings dependent upon him for a living needs a larger minimum subsistence grant than does a man without dependents. Associated with this is the desire of the state to maintain and expand its population. (4) They make it unnecessary to extend the tax to larger numbers of small taxpayers who would yield up small revenue and incur high administrative costs per dollar collected. Our reduction of the exemptions to $500 per person in some measure refutes this claim. Better techniques of administration can be a deciding factor here.

Types of exemptions. Personal exemptions help to make the income tax one of the most rational and equitable tax tools at our disposal. Nevertheless, there is more that we need to learn about exemptions. Perhaps they can be better adjusted to reconcile the conflict between subsistence and the need for revenue.

The present personal exemptions of $600 per person and per dependent are granted to every income producer regardless of the size of his income. This type of exemption is called a continuing exemption. Because it reduces the amount of income subject to the progressive surtax, it in effect comes out of the taxpayer's highest bracket of income. As a result, the exemption is worth much more to the owner of a large income. The continuing exemption, then, is not in complete harmony with the concept of minimum subsistence, and it reduces the tax yield considerably.

The recent federal income tax law has extended the concept of the personal exemption to groups with special needs. Those persons who are blind are given an additional $600 exemption per year. The same consideration is also given to those who are over sixty-five years of age. These extensions can be justified both on the grounds of need and equity. In both instances the exemptions carry a social security connotation.

Probably more equitable and in greater harmony with the theory of personal exemptions would be a "disappearing exemption." Here the exemption is reduced or disappears as the taxable income goes above a selected figure. This concept is used in Sweden at the present time. The exemption disappears after the individual income reaches 11,000 kroner (about $525). Such a policy lays the basis for extracting more

revenue above the selected income level. It would also reserve the exemption to those who need it most.

Several states (Wisconsin, Arizona, Iowa, Kentucky, and Minnesota) have attempted to equalize the "dollar value" of the exemption to taxpayers by granting the exemption in "terms of taxes" rather than in the form of "so many dollars in income." This exemption is deducted from the final income "tax" liability. The exemption is calculated in terms of the tax in the lowest income bracket and therefore is the same for all income groups; thus the inequality of the continuing exemption noted above is avoided.

The conflict with the need for revenue. Desirable as most of the arguments in favor of granting personal exemptions are, they now enter into direct conflict with the need for very substantial revenues. If it were possible to reduce federal expenditures 20 to 25 per cent or if it were feasible to raise the level of the national income $40 to $50 billion in the near future, that conflict might subside. However, the outlook for the first of these possibilities is not particularly bright, especially in view of the $5.6 billion interest charge on the federal debt, the responsibilities to the veterans of World War I and II, our international economic responsibilities, the needs of national defense and other domestic needs.

The raising of exemptions in the face of such needs could seriously impair much needed revenue. This is true because every increase in exemptions cuts into the tax base—the very fund from which the revenues must come. This becomes dramatically more evident when it is realized that each hundred-dollar increase in exemptions is granted to 50 million income taxpayers plus at least another 60 to 65 million "dependents." This results in the loss of $10 to $12 billion in income tax base and ultimately several billion dollars in net revenue.

In the absence of substantial reductions in federal expenditures or material increases in the national income, we cannot look forward to very noticeable increases in income tax exemptions in the near future. Reasonable increases in exemptions should be made whenever feasible, however.

Problems of Income Tax Rate Structure

ALTHOUGH A PROGRESSIVE RATE structure is almost unanimously endorsed, the degree of progressivity, like the amount of exemptions, has long been a subject of controversy.

Significance of the first bracket rate. There are those who seem to think that all the necessary revenue can be procured by "soaking the rich." That may have been possible when the revenue needs of government were small. With the need for financing a 60 to 70 billion-dollar

federal budget, that is no longer even remotely feasible. When the need for revenue is great, it can be acquired only from large numbers of taxpayers. That is what makes the "standard" or first bracket rate so significant. Every taxpayer is in at least the first bracket. Each contributes from a few taxable dollars to $2,000 in income in it. There are now about 50 million taxpayers in the first income group. That means that a large fraction of all the revenue comes from that bracket. Several brackets above the first are also good revenue raisers.

This is borne out by the estimates of the Senate Committee on Finance. Those estimates show that in 1948 taxpayers earning $5,000 or less represented 95 per cent of all the taxpayers; they supplied 79 per cent of the taxable income and 51 per cent of the personal income tax revenue collected. On the other hand, all incomes of more than $5,000 per year accounted for 5 per cent of the taxpayers, 21 per cent of the taxable income, and 49 per cent of the revenue. The point is that our national income structure is a good deal like a cone: the bulk of the income is concentrated near the base. The first bracket portion is also the most stable element in the income structure.

Therefore the tax rate applied to the first bracket is particularly significant. The size of this rate is a strong determinant of the gross income tax collections. Furthermore, it is the "base rate" upon which the higher surtax rates are built. The reduction of this bracket rate by a few percentage points means very substantial losses in revenue. This rate was about 17 per cent under the 1948 Act. It is not very likely that we shall get the standard rate below this figure for some years to come, if ever in this generation.

The need for graduation. Important as the first bracket rate is, it does not and should not raise all the revenue. Since about a third of the taxable income lies above $2,000 and about 21 per cent is above $5,000, substantial ability-to-pay is present in those areas. However, all or a major part of the revenue could not be procured in the upper brackets even at confiscatory rates. The upper brackets should make their full contribution to the total revenues according to a scientifically-determined ability-to-pay. For the sake of equity and economic incentives, rates should not be carried to the point of confiscation. Furthermore, excessively high rates invite evasion and avoidance.

Problems of Evasion and Avoidance of Income Tax

THERE SEEMS TO BE a strong desire in most human beings to want to minimize their payments to government. The fact that there is no direct exchange transaction between the taxpayer and the government

at the time of payment and the fact that the taxpayer believes that he will get the service anyway strengthen that desire. Many citizens, therefore, strenuously seek methods by which to evade or avoid the payment of taxes. The two concepts are quite different and should be clearly distinguished in our tax thinking.

INCOME TAX EVASION AND AVOIDANCE [6]

Income tax evasion. Tax evasion is the outright breach of the law; it is the intentional omission to pay taxes legally due. In the income tax field it is accomplished by complete or partial failure to report income, by taking false deductions or exemptions, by keeping two sets of books to conceal income, and by other devious means. The Treasury Department has estimated that during World War II and the several years thereafter about $5 billion in federal income taxes have been evaded. Evasion occurs most extensively in connection with business incomes—the professions, small businesses, closely held corporations, those who pick up "extra money," illegal business activities, and miscellaneous others.

Tax evasion, if it becomes too extensive and if the citizens realize how general it is, can become a serious problem. It then affects the morale of taxpayers generally and stimulates tax laxity. It definitely makes more difficult the task of the administrators, and it can undermine the tax system as a whole.

Income tax avoidance. Tax avoidance is a favorite "indoor sport" for many Americans and their counsel. However, it does not bear the criminal stigma of tax evasion. Avoidance is usually practiced within the "letter" of the law, though rarely within its "spirit." It consists of a systematic searching-out of the weaknesses and loopholes in the tax statutes and then arranging one's income, business, and property affairs in such a manner as to be able to take advantage of the loopholes. It results in paying a minimum of tax. Its operations are perfectly legal; in fact, the courts have recognized it as such, and on occasion they have supported taxpayers in their tax avoidance efforts by maintaining that there is no duty to pay more than the law strictly requires. In a complex commercial and industrial society, it is physically impossible for the legislatures to draft tax laws in such a way as to foresee every possible contingency.

INCOME TAX AVOIDANCE TECHNIQUES

Tax avoidance is nothing new in American taxing experience. However, it seems to have gained substantial impetus in the mid-1930's. It came after Congress had strengthened certain ability-to-pay taxes (such as the personal income tax, the corporate income tax, the gift and estate

[6] See Randolph Paul, *Taxation for Prosperity*. Indianapolis: Bobbs-Merrill, 1947, Chapters 30 and 31.

taxes) by increasing the rates in the middle and upper brackets. The wave of evasion and avoidance became strongly evident by 1936 and 1937—so evident and serious that the Secretary of the Treasury was prompted to make a study and report on the problem. The President on the strength of this report delivered a special message to Congress recommending the plugging of the loopholes. In speaking of the report the President pointed out the boldness and widespread character of evasion and avoidance and urged immediate action by Congress. He spoke of "clever little schemes" as not admirable when they tend to undermine the foundations of society.[7]

Income tax avoidance over the years has taken many and varied forms. Sometimes the tax laws legally invite avoidance. This is true of tax exempt securities into which many wealthy persons place part of their savings. The failure to tax capital gains at death makes it possible to hand on substantial accretions in the value of capital assets. The reinvestment of corporate earnings accrue to the advantage of stockholders without a current tax liability.

Other techniques of income tax avoidance fall into several major patterns: (1) shunting income into expenditures or investments so that it is not realized to the taxpayer in the higher surtax brackets; (2) arranging one's property affairs so that the assets can be treated as capital assets and thus acquire favorable treatment for the realized income as a long-term capital gain; (3) breaking up high income-creating assets among a number of close relatives so as to sidestep the high bracket rates; and (4) setting up artificial deductions.[8] The *corporation*, the *trust*, and the *family partnership* have been the most efficient vehicles through which to achieve tax avoidance purposes.

Personal holding companies and income-shunting. One effective method of side-tracking income was that of interjecting a corporation between the high-bracket taxpayer and some of his sources of income. He would set up a corporation owned by himself and his immediate family (known in effect as a "personal holding company") to which the taxpayer conveyed his holdings of stocks, bonds, and income real estate. The holding company then received all his income from these sources. In this way the income did not come to him to be taxed in the higher brackets. Since he controlled the corporation he could take out such sums as he saw fit, or he could even borrow from the corporation with even less tax consequence. The Treasury Report showed that in 1936 one taxpayer saved $329,000 by this device, and another man and wife saved $791,000. In addition, over 64 "foreign" personal holding companies were set up

[7] *Hearings before the Joint Committee on Tax Evasion and Avoidance*, 75th Congress, 1st Sess. (1937), p. 2.

[8] William J. Shultz and C. Lowell Harriss, *American Public Finance* (5th ed.). New York: Prentice-Hall, Inc., 1949, p. 424.

in the Bahama Islands and a few in Newfoundland. Others went so far as to incorporate their talents, hobbies, country estates, yachts, and racing stables—very often transferring stocks and bonds to these corporations so that the income therefrom could be used to pay the costs and expenses of the yacht or country estate.

The personal-holding-company loophole has now been closed fairly well, and such companies are given special tax treatment. A personal holding company is defined as a corporation in which 50 per cent or more of the stock is owned directly or indirectly by not more than five persons and 80 per cent or more of its income is from investments. In such a case a special penalty surtax of 75 per cent is placed upon the company for the first $2,000 of the income which it fails to distribute and 85 per cent on all undistributed income above $2,000. The use of the personal holding company is still available as a tax avoidance device in the situation where the stock is not so closely held, however.

Multiple trusts and splitting income. Equally effective as a tax avoidance device has been the trust. The basic technique here is that of the high-bracket taxpayer's splitting up some of his income-producing property (stocks, bonds, and real estate) among the various members of his family. He can do this by outright gift or by "gift in trust." The latter method was and still is more advantageous for the taxpayer. Under this method the taxpayer can set up one or several trusts for each member. He is often able to retain some *control* over the property. Prior to 1937 each trust was looked upon as a separate person and was given a $1,000 exemption under the income tax. The transfer to the trust took a substantial portion of the donor's income out of the high surtax brackets and placed it in the lower brackets for each trust. It was possible to set up any number of trusts.

The Treasury reported in 1937 that "one thrifty taxpayer" set up 64 such trusts for four members of his family and saved about $485,000 in taxes in one year. In that year Congress, however, removed the $1,000 personal exemption for each trust and now an exemption of only $100 per trust is granted. Nevertheless, it is still possible to set up multiple trusts and get all the other advantages of income-splitting. At the time the Treasury recommended that all trusts having a common donor and beneficiary be treated as one trust for tax purposes, thus reducing the advantages of income-splitting. Some authorities would go further and treat all income from trusts created by a common donor for the benefit of immediate members of his family as his income to be taxed on his income tax return. However, Congress has not as yet seen fit to go that far, and multiple trusts still remain a potent avoidance device.

The family partnership and income-splitting. Another income-splitting device is found in the family partnership. The husband and father often takes his wife and children into the partnership business

with him. In many instances the other members make no contribution of labor or capital to the enterprise; they merely take their pro rata share of the partnership profits and spread them around in the lower brackets. In recent years the Treasury and the courts have been able to set aside many family partnerships if the "other members" failed to contribute either valuable services or capital to the partnership. The *Revenue Act of 1948* has, however, legalized splitting partnership income at least between husband and wife.

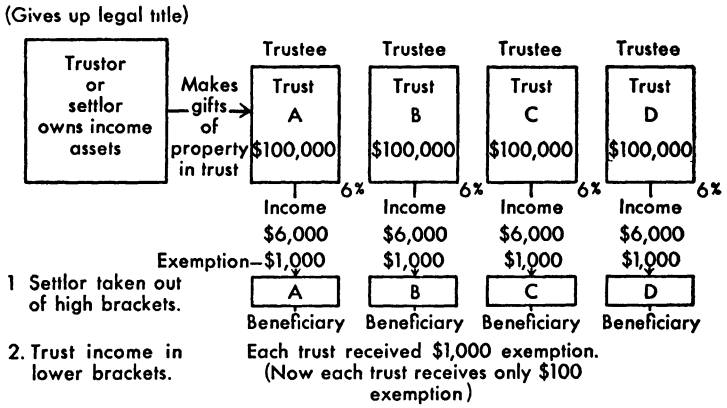


FIGURE 15. *The Use of Multiple Trusts for Income Tax Avoidance.*

Arranging income as a capital gain. Another tax avoidance device which has been available all along but which has come more strongly into the limelight in recent years is that of accumulating income within a business, property, or asset (failing to take it out and exposing it to the high personal surtax brackets) and then of selling the asset and having it interpreted as a "capital asset." Since long-term capital gains cannot be taxed at more than 25 per cent on the "full gain," substantial tax savings can be achieved.

General Dwight D. Eisenhower sold—lock, stock, and barrel—all the rights to his successful book, *Crusade in Europe*, rather than keeping the rights and receiving the royalty income from the book. Since the book was autobiographical in character and since the General was not a professional writer, the Bureau of Internal Revenue ruled that he was selling a long-term "capital asset"—the story of a life accumulated over the years. Taxes saved on the reported $1,000,000 sale price by application of the 25 per cent long-term capital gains rate amounted to well over half a million dollars.

Soon followed the sale of the Amos and Andy Program to the Columbia Broadcasting System for a reported $2,000,000 as a capital asset. Again this view was upheld. Here was a fictional story with certain well-defined characters which had been built up over the years by Freeman

P. Gosden and Charles J. Correll. The story and the characters existed separate from the personalities of Gosden and Correll. Furthermore, the program could go on after the death of the present actors merely by hiring others to play the parts.

Other radio entertainers have attempted to use the same approach—some of them with less success. Nevertheless, a problem and a serious loophole remains, for there are many situations where it is possible to work out a claim that what the taxpayer holds is a "capital asset" and therefore should be given special tax treatment and taxed at not more than 25 per cent.

However, this loophole was plugged by the *Revenue Act of 1950.* After September 23, 1950, all outright sales of copyrights and literary, musical, or artistic compositions of amateurs are to be treated as "ordinary income" rather than as long-term capital gains if held for more than six months. Inventions were not included in the above classification and so will continue to receive capital gains treatment. It is important to remember that authors, composers, and so forth still have the privilege of averaging their income from such works, if the work was produced over a period of thirty-six months or more.

The Hollywood collapsible corporation and capital gains. Another avoidance device is known as the Hollywood collapsible corporation. A corporation is organized for the purpose of producing a single moving picture. When the picture is completed the corporation is dissolved, and what the owners hold is a capital asset which when sold will be taxed as a long-term capital gain at the maximum 25 per cent rate.

The 1950 law, however, provides that in such cases the gain from the sale of the stock or the liquidation of the corporation shall be taxed to the stockholder as "ordinary income" instead of as a long-term capital gain.

Sale and lease-back. A new income tax avoidance mechanism which has raised its head conspicuously since 1945 is a kind of marriage between certain types of business and our tax-exempt, privately-endowed educational institutions. The technique is known as the "sale and lease-back." Many colleges and universities have found that their endowment funds have shrunk in income-producing power because of low rates of interest. Many of the large department stores have discovered that it is advantageous not to own their store buildings. Why not get together? The Treasury has been concerned about the problem since 1945 when Union College of Schenectady bought the buildings of Allied Stores, Inc. and leased them back to the company.

Recently a wholly-owned subsidiary of Yale University bought a new nine-story building from R. H. Macy and Company for $4,500,000 and leased it back for $240,000 a year. Under the arrangement the Macy Company got $4,500,000 in working capital that it can turn over more

profitably in merchandising than in real estate. But it still has the use of the building. Furthermore, the annual rental is an expense deductible under its income tax. The University gets a 5.3 per cent return on its investment—completely tax-exempt. So many stores and other businesses have sold their buildings to tax-exempt institutions that it is estimated that the Treasury is losing about $1 billion per year in income taxes.

An even more serious development is that in which the colleges are not only buying the buildings but the actual businesses as well. A recent survey of the American Council of Education found that about 160 colleges and universities have bought commercial enterprises out of endowment funds or with tax-exempt income. More and more business income is falling into the tax-exempt category. Fundamentally, it presents a serious problem of balancing the needs of endowed universities and the revenue needs of the federal government. This situation may involve more than straight loophole plugging.

The *Revenue Act of 1950* made provision for the closing of both of the above loopholes. The general purpose of the law is to deny the exemption from taxation if the tax-exempt organization is producing the income in a business activity not "substantially related" to the performance of the function for which the exemption is granted. Under this provision, tax-exempt organizations will have to pay taxes on part of the rents collected from long-term leases of the property they own, if the indebtedness incurred in acquiring the property is unpaid at the end of the year. In the situation where tax-exempt organizations own or get the income from unrelated businesses (such as manufacturing concerns), the so-called "feeder organization" will be denied tax exemption and the tax-exempt organization will be taxable on such income. Several other similar types of tax avoidance devices were removed by the 1950 Act.

MINIMIZING TAX AVOIDANCE

In an economic system as complex as ours, it would be absurd to believe that tax avoidance could ever be reduced to zero. However, every effort must be made to minimize this practice. Flagrant loopholes in the law must be closed as soon as they are discovered. All tax legislation must be carecarefully studied and tested by hearings in advance. Once the preliminary investigation work has been completed, the tax laws must be carefully drafted. Once passed, their operation must be continuously observed. The courts can be of great assistance in interpreting the statutes to carry out the intent of the legislature.

The purpose of tax-statute drafting should not be a one-way road—that of making the laws revenue-tight for government. Equally important is the task of creating tax laws which are workable and understandable from the point of view of the taxpayer. They should be made reasonable and realistic in their application to business and accounting methods as such

methods are in fact practiced. Hit and miss loophole-plugging will not be enough. Continuous recasting will be advisable. Periodically the Congress might do well to give the tax system a constructive rehabilitation.

Problems in State Income Taxation

ALLOCATING INCOME AMONG THE STATES FOR INCOME TAX PURPOSES

The problem of jurisdiction to tax. With about thirty-five states levying income taxes and with both individuals and corporations earning income in more than one state, a serious problem arises as to what income can and should be taxed by any given state. Wherein lies the difficulty of assigning the right to tax income. It lies in the matter (1) of defining income, and (2) of ascertaining a state's right to tax income in the light of constitutional and judicial limitations. In the determination of answers to these problems, the states have exercised their powers of self-government to the point where a confusing uncertainty with regard to taxing authority is the dominant feature of state tax structures.

Legally a state has the right to tax any subject matter which has a *legal situs* within the state. In the case of income that situs may arise in two ways: (1) the income may be produced within the state, or (2) the recipient of the income may reside within the state. In either case the basis is sufficient to confer upon the state the right to tax.

State practices in taxing personal income. Under the above theories it is possible for the states to use three approaches to the taxation of income: (1) each state may tax all persons (regardless of residence) upon all income produced within the state; (2) each state may tax only its own residents on their total incomes regardless of where produced; and (3) each state may tax all the income of its residents and in addition nonresidents' income produced within the state. Legally, it is permissible for the states to use the third approach, for in the one case the state has jurisdiction over the person and can tax him for benefits received and on his ability to pay; in the other, it has jurisdiction directly over the income.

In practice all these methods are used by the various states. Wisconsin and about five others operate on the "origin" basis—that is, they tax only such income as is created within the state. Delaware and a number of other states tax on a "domicile" basis—that is, they tax all of the income of the persons domiciled within the state regardless of where the income is produced. A serious problem of multiple taxation can arise here because the states are free to define domicile as they see fit.[9] A substantial number

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[9] George T. Altman, and Frank M. Keesling, *Allocation of Income in State Taxation.* Chicago: Commerce Clearing House, 1946, p. 41.

of states (including California and New York) apply *both* the "origin" and the "domicile" principle and thus tax their own residents on all income wherever earned and nonresidents on the income produced within the state. When this method is used an even more serious problem of multiple taxation arises.

The use of credits to minimize multiple taxation. The states themselves have recognized the character of this problem, and although they attempt to maximize their revenues, they have given some thought to minimizing multiple burdens. They have done this by means of credits—sometimes on a reciprocal basis only, however.

These credits take two basic forms.[10] The first provides a credit to be granted to nonresidents for that part of the income tax paid to the state of domicile on income produced within the state granting the credit. At present about 14 states grant credits to nonresidents for taxes paid to the state of domicile.

The second form of credit is granted to residents for income taxes paid to the state of origin. This approach is the more satisfactory and results in a situation where the taxing state in effect actually taxes only income produced within the state. This type of credit is reasonably easy to administer. Even where credits are provided, a certain amount of double taxation persists, for the credit allowances of the state of origin may not dovetail with those of the state of the domicile.

Then, too, it must be noted that the various credits are not allowed as unconditional grants. Quite often they are permitted only as a matter of reciprocity. They are granted only if other states grant comparable credits or do not have any income taxes. A few states attempt to avoid all possibility of double taxation by granting both types of credit.

All of these credits are noble efforts at minimizing multiple taxation, but as yet they are neither uniform nor universal enough to be generally effective. Every effort should be made to improve the quality of this reciprocal credit system.

Conclusions

THE PERSONAL INCOME TAX must necessarily serve as the backbone of modern tax systems. Since a heavy responsibility for raising revenue and for social purposes rests upon this tax, it should be perfected to the highest degree possible. Many problems are present under the tax, but most of them are not insoluble. The concept of the "earned income credit" as applied to service-earned income merits reconsideration. The disappearing exemption now used in Sweden should be examined for use in this

[10] William Vickrey, *Agenda for Progressive Taxation.* New York: The Ronald Press, 1947, pp. 313-314.

country. Since the nation is putting greater emphasis upon social security and since many individuals are providing a large measure of such security by private means, it might be fitting and proper to grant a *credit* for specified types of life insurance premiums paid. The credit could be limited to about $300 per year.

The outright evasion of the income tax must be minimized by effective administration and sterner enforcement. Tax avoidance can be reduced by careful drafting of tax laws in the first instance and by prompt and effective loophole-plugging. The concept of "averaging" irregular incomes to obtain greater equity should not be pigeonholed.

The states should make every effort to improve the quality of their income taxes. The rural and poorer states should make use of low, flat-rate income taxes to bolster their revenues. More cities should be given the right to levy the same type of income tax to equalize the burden of the property tax. The states should also extend and improve their reciprocity credits so as to mitigate the evils of multiple taxation.

Finally, our legislatures, state and national, should be continually on the search for every principle and technique that will improve the scientific, equitable, and ability-to-pay qualities of the personal income tax.

Part Four

THE TAXATION OF GIFTS AND INHERITANCES

XIII. THE ECONOMICS OF INHERITANCE TAXATION

XIV. INHERITANCE TAXATION IN AMERICAN JURISDICTIONS

XV. INHERITANCE TAX PROBLEMS AND REFORMS

13

The Economics of Inheritance Taxation [1]

> I AM ASTONISHED *that ancient and modern writers have not attributed to the laws relating to succession a greater influence in the march of human affairs.... They should be placed at the head of all political institutions, for they exercise an incredible influence upon the social conditions of people.*
>
> —DE TOCQUEVILLE.[2]

Overview

THE TAXATION of the transfer of property at death is by no means a new institution historically. Under a system of private property, the right "to bequeath" makes up a part of the idea of private property, but the right "to inherit" does not. However, the right to property is not a natural right; it is the product of the social and legal system.

The passing-on of property from one generation to another may take one of several forms. The first form is known as the *inter vivos* gift—that is, a gift of property from one living person to another. The second comes about by "operation of law"—that is, through the laws of inheritance (when there is no will). And the third occurs when the deceased estate-owner has specifically designated given persons or institutions as the object of his bounty by "will."

Two general types of death taxes have developed: the "inheritance" (or successions) tax based upon the right to receive given shares, and the "estate" tax based upon the transfer of the net estate before distribution to the heirs. More recently, the gift tax has been conceived to tax transfers from one living person to another.

This chapter considers: (1) the revenue importance of death taxes;

[1] A good deal of the material in this chapter is derived from an unpublished Ph.D. dissertation by the author, *Modernization of Federal Estate and Gift Taxation*, University of Wisconsin, 1945.

[2] De Tocqueville, *La Democratie en Amerique*, Vol. I, Chapter III, pp. 74-75.

(2) the economics of death taxation; (3) the arguments for and against death taxes; (4) the shifting and incidence of transfer taxes; and (5) the counter-cycle possibilities of death taxes.

The Fiscal Significance of Death Taxes

THE REVENUE returns from our federal death tax have been sadly disappointing. Though Congress has raised the rates, engaged in some loophole-plugging, and added a gift tax to strengthen the effectiveness of the estate tax, this tax has not been the revenue-raiser that it ought to be. Because of the rather substantial exemptions under the federal estate tax, less than 1 per cent of those who die in adulthood leave estates which are taxable under the present federal laws. As a result of the *Revenue Act of 1948*, probably less than ½ of 1 per cent of the estates are so taxable. Likewise, at the state level, death taxes make up a relatively small fraction of the total revenue.

FISCAL IMPORTANCE OF FEDERAL ESTATE TAXES

During the late '20's and early '30's, federal estate tax collections ranged between $35 million and $65 million per year. In the same period federal tobacco tax collections alone usually ranged from $400 to $450 million per year. Combined federal estate and gift taxes in 1938 reached $417 million, or about 7.9 per cent of the total federal tax collections. Collections for these two taxes did not go over the half-billion mark until 1944. However, in 1947, they amounted to about $779 million, or about 2 per cent of the total federal receipts. This figure went to about $900 million in 1948, it fell back to $797 million in 1949, and it receded even further to $657 million in 1950. Despite the secular increase in transfer tax revenue in terms of dollars, there has been a material decline in the relative importance of these taxes because of the expansion of several other types of revenue.

FISCAL IMPORTANCE OF STATE DEATH TAXES

On the state level, the picture is not much more encouraging. In 1940 the 47 states (Nevada has no inheritance tax) and the District of Columbia realized just under $143 million, which amounted to 2.4 per cent of the total state tax yields ($5.9 billion). A breakdown of this $143 million shows that three states, New York, Pennsylvania, and California, received over 41 per cent of the total realized by all the states through death tax receipts. To some of the states, transfer taxes were of slight importance. (Arizona, for instance, received less than $25,000 while New York received almost $25 million.) Twenty-eight states and the District of Columbia received less than $2 million each from such taxes in that year. The point

to be stressed here is that the fiscal significance of transfer taxes varies from state to state as well as from year to year, and that in most states transfer taxes make up a relatively small fraction of total tax receipts.

The Economics of Inheritance Taxation

THE TERM "inheritance" can be used in a number of different ways. In this study a broad interpretation is accepted. Inherited property must necessarily mean any property received "without cost" from another person during the latter's life or at his death, whether by gift, will, or operation of law. Economic considerations force the adoption of this definition because the economic consequences of gratuitous transfers of property are essentially the same, regardless of the *form* or the *time* of the transfer.

INHERITANCE: NATURAL VS. POLITICAL RIGHT

In earlier days many felt, and some still think, that inheritance is an absolute corollary of private property. The tendency in more recent times has been toward a realization that inheritance is not an inherent right of man but rather a product of our legal thought. William Blackstone, the commentator on the English common law, maintained that the right of inheritance is clearly a political establishment since the permanent right of property, vested in the ancestor, was no natural right but merely a civil right. Most American jurisdictions have recognized that inheritance is not a natural or absolute right but is governed by the law of the place where the property is located.[3]

THEORIES OF DEATH TAXATION

There has been no scarcity of theories on the subject of death taxes; consequently, the student encounters an abundant variety of opinions, pro and con, upon the advisability of levying such duties. During the nineteenth century the taxation of inherited wealth became a lively issue in England and on the Continent. In the United States, Max West stood out as the strongest advocate in the field.[4] By the close of the century, a number of theories of inheritance taxation had crystallized.

State partnership. Those who explain the inheritance and estate taxes as a just share accruing to the state point to the role the government has played in the creation of every great aggregation of wealth. The state contributes protection and a developed society that makes accumulation possible. Upon dissolution of the partnership by death, the state is entitled

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[3] *Wilson v. Stortz*, 117 Ark. 418, 175 S.W. 45 (1915).

[4] See Max West, *The Inheritance Tax*. New York: Columbia College, 1893, p. 114.

to a share in the assets of the partnership. Andrew Carnegie, in commenting upon fortune-building, is reported to have said, "Now who made that growth? The growth of the American public—that is where that wealth came from and that is the partner in every enterprise where money is made honorably; it is the people of the United States.... I say the community fails in its duty and our legislators fail in their duties if they do not exact a tremendous share, a progressive share." [5]

Back tax theories. The proponents of the "back-tax" theory of death taxation look upon such duties as a lump-sum payment upon death in lieu of taxes which have either been avoided, evaded, or not levied during the lifetime of the testator. The "back tax" view grew out of the fact that large amounts of personal property escape taxation during the lives of the owners. The inheritance tax has, therefore, been justified as a means of mopping up taxes which have been evaded during the lifetime of the decedent. In strict justice this view is not wholly sound, for the inheritance tax bears little relation to the amount of taxes evaded.[6] It has sometimes been criticized because it penalizes the heirs for the omissions of the decedent. An inheritance tax levied on this principle would have to be limited to personalty, because real property does not easily evade taxes.[7]

The lump-sum view as contrasted with the "back tax" argument represents a somewhat sounder approach to inheritance tax theory. It regards the tax as in lieu of taxes which have not been imposed. Since it accrues after the death of the estate owner, it comes at a time most convenient for him. It is maintained that such a tax is just another way of levying a portion of the property or income tax.[8]

Limitation of inheritance. The privilege of bequeathing wealth should be restricted, it has been argued, for the benefit of society as a whole. Jeremy Bentham argued that there was no sound reason for intestate succession among collateral heirs. He attacked the ethical grounds of inheritance and insisted that even heavy taxes upon inheritances were unburdensome. John Stuart Mill advocated a restriction upon the amount any one person might receive by will or inheritance. His argument went as follows:

> The inequalities of property which arise from unequal industry, frugality, perserverance, talents, and to 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

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[5] E. R. A. Seligman, *Studies in Public Finance.* New York: The Macmillan Co., 1925, p. 161.

[6] West, *op. cit.*, pp. 116-117.

[7] William J. Shultz, *Taxation of Inheritance.* Boston: Houghton Mifflin Co., 1926, pp. 183-184.

[8] West, *op. cit.*, pp. 117-118.

> in requiring that if he desires any further accession of fortune, he shall work for it.[9]

Another phase of the limitation of inheritance theory implied a desire for diffusion and an aversion to the concentration of wealth. None other than former President Herbert Hoover has voiced an opinion in that direction:

> I am convinced that one of the continuous and underlying problems of sustained democracy is the constant and wider diffusion of property ownership. Indeed, I should become fatalistic of the ultimate destruction of democracy itself, if I believed that the result of all our invention, all our discovery, all our increasing economic efficiency, and all our growing wealth would be toward further concentration of ownership. We are all fundamentally interested that our public and private policies should be so directed that with our increasing wealth, the tendencies of diffusion of ownership shall be greater than the tendencies of concentration.[10]

The Italian economist, Eugenio Rignano, proposed a unique plan as an effective limitation upon inheritance. He would divide one's estate at the time of death into two parts, the first being that portion acquired by an individual during his life by his own efforts, the second being that part of his estate which had been inherited. Two sets of rates would be employed with the lower schedule applying to that portion earned by one's own efforts. On the part of the estate which had been inherited, a heavier duty would be levied. Rignano felt that such a plan would serve as an economic incentive because wealth accumulated through one's own efforts would be taxed less severely than wealth that had been handed down.[11]

The benefits received theory. Still another theory of the inheritance tax maintains that the tax is nothing more than a fee or payment for benefits received.[12] This theory is supported by the cost-of-service and the value-of-service concepts.

When the tax approximated registration fees or charges just sufficient to cover the cost of drawing up and officially recording papers of transfer, the idea was that the sum charged was equivalent to the cost-of-service performed for the interested parties. Cost-of-service is the price of

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[9] John Stuart Mill, *Principles of Political Economy*. New York: Longmans, Green and Co., 1909, Book II, Chap. II, p. 232.

[10] Herbert Hoover in the *Proceedings* of the American Academy of Political Science for April, 1925. Quoted by A. Phillip Woolfson, "Inheritance Taxation and the Maladjustment of National Income," *Taxes, The Tax Magazine*, Vol. 15, August 1937, pp. 459-460.

[11] Eugenio Rigano, *The Social Significance of the Inheritance Tax*. New York: Alfred A. Knopf, 1924, pp. 22-23.

[12] West, *op. cit.*, pp. 115-116; Schultz, *op. cit.*, pp. 179-183.

government service in supervising the transfer according to the wishes of the testator. It is determined by the expense to the state. This theory does not seem adequate to support modern progressive death taxes.

A variation of this argument is the value-of-service concept. It contends that since the right of bequest and inheritance is a privilege bestowed by positive law, those who benefit from it should be willing to pay reasonable value for the services rendered by the state in aiding in the process of transmitting the property to the beneficiaries.

The ability-to-pay theory. The inheritance tax field has not been without its faculty or ability-to-pay theory. To the heir the receipt of an inheritance is the acquisition of property without service. It might be looked upon as fortuitous income which increases his tax-paying ability. This, of course, is not necessarily true in the case of dependent widows and minor children. The faculty doctrine is essentially one of personal taxation. In any analysis of ability-to-pay, several basic questions arise. First, whose ability to pay is relevant, that of the heir, the predecessor, or both? And second, how is this tax-paying ability to be reckoned; by the taxpayer's expenditures, his income or his accumulated wealth?

If it is the heir's ability that is relevant, then death taxes, as most often constituted, fall short of their purpose because they take no account of the economic status of the recipient at the time of inheritance. If it is the predecessor's ability that should be considered, then some may ask, "How does a dead man have the ability to pay taxes?" If both are relevant, others may ask, "How can it be both?"

When death taxes are levied upon the heirs under the typical "inheritance" or "successions" tax, the application of the ability-to-pay concept would seem to demand that the over-all financial status of the heir be considered in determining rates and exemptions. Norway, in 1895, made the minimum exemptions of the inheritance tax law conditional upon the general economic position of the heir, with an exemption being allowed only when the combined total of prior wealth plus inheritance was less than 400 kroner (about $400 in 1895; a good deal less now).

The reckoning of tax-paying ability in the death tax field is not without its problems. Most authorities agree that in the death tax field, accumulated wealth best represents ability to pay. One authority draws the following realistic conclusion:

> Any inheritance tax is paid out of the inheritance; even a pauper is able to pay millions of death taxes. Therefore, it is always the deceased person's estate which pays an inheritance tax and the so-called 'ability to pay' entirely depends on the deceased man's estate.[13]

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[13] Paul Haensel, "The Proper Sphere of Death Taxes," *Annals of the American Academy*, 183: 86-95, January 1936.

In the final analysis, it is the decedent's estate that must stand ready to pay both estate and inheritance taxes. It is very seldom that heirs pay the taxes out of their own prior holdings.

INHERITANCE VS. ESTATE TAXES

Theory of estate tax. Death taxes in the United States have taken two basic forms: the estate tax and the inheritance tax. From the legal point of view the former is a tax upon the transfer of the net estate at death. It is definitely an excise tax (not a property tax) levied upon the total "net" estate after due allowance for debts, costs of administration and exemptions granted by law. In its collection, very little consideration is given to the number of heirs, the degree of relationship, or the size of the bounty transmitted to the individual distributee. It is a levy based upon the estate as a whole before final distribution. This fiscal instrument is used by the United States Government as well as by a number of the states.

Theory of inheritance tax. What is popularly known as an inheritance tax is legally more accurately described as a "succession" tax. It is an excise tax upon the right of the beneficiary to succeed to an estate or a portion thereof. This tax is levied against each distributive share, usually according to a system of rates (proportional or progressive) adjusted to the size of each share and the degree of relationship between the decedent and the beneficiary. Many of the states have adopted this form of death tax.

Appraisal of estate tax approach. The estate tax is easier to understand, to calculate, and to administer. Since it falls upon the entire net estate, there are no problems of degree of relationship, size of the individual bequest, and systems of rates and exemptions adjusted to a number of classifications. It merely involves the application of a single system of rates to a single tax base. The estate tax method of handling death duties also avoids in large measure the complicated task of determining the value of the distributive shares where the transfers take the form of life estates, vested, and contingent remainders.

From the fiscal point of view, its most convincing advantage is its greater revenue-producing capacity. This is particularly true when progressive rates are applied. The use of a tax on the net estate results in a broader base and prevents a diminution of the revenue through skimming off that portion of the estate which is in the higher brackets.

The estate tax possesses effective capacity to deconcentrate wealth. Since it attacks the size of the estate as a whole, it trims off a portion before the process of distribution begins. It must be admitted that the estate tax has a strong leveling effect in the first instance.

Appraisal of inheritance tax approach. The advocates of the succession type of death duties are not without strong and valid arguments.

They maintain that the final resting-place of all death taxes is on the beneficiary. The creator of the estate is gone and wholly indifferent to taxes of any kind. It is the heir who finally pays the death tax, for his share is less by the amount of the government's tax collection. If the incidence is upon the recipient, then the death tax should be so arranged as to meet the principles of a tax justice from his point of view. Their conclusion is that a succession tax can be constructed so as to produce a larger measure of equity and justice to those who receive the wealth and bear the tax.

Along the same line it is argued that the inheritance tax gives special weight to the beneficiary's ability to pay taxes, based upon the bounty he has received. It fails, however, to measure his general ability to pay because it takes no account of either his present income or the size of his own private estate.

SHIFTING AND INCIDENCE OF DEATH TAXES

The significance of incidence. Another problem of both theoretical and practical significance is that of shifting and incidence. Is it possible to shift the burden of death taxes to others outside the scope of the inheritance? Where is the "final resting place" of these tax burdens? These questions are relevant and vital to an adequate understanding of the economics of inheritance taxation. A knowledge of the incidence of these taxes will aid in determining their economic effects.

The shifting of death taxes. It is generally agreed that practically no shifting of the tax burden takes place in the death tax field. These taxes are definitely not connected with any sale which gives the opportunity of passing the taxes on to others in the form of a higher price. It is conceivable that insofar as death taxes tend to deplete the supply of loanable funds (there is no convincing evidence that they have in American experience as yet), some shifting might take place in the form of higher interest rates for funds. The forces and factors involved in this process, however, are so remote and uncertain in their operation that little reliance can be placed upon them. Since there is no shifting outside the inheritance process, the issue does arise, however, as to who bears the death tax, the predecessor or the heir?

Incidence upon the predecessor. One view holds that the incidence of death taxes is upon the predecessor. Some authorities reach this conclusion by regarding a death tax as a capitalized income tax.[14] Others hold it to be an occasional property tax associated with death of the owner. They dismiss as irrelevant the fact that the testator is dead before

[14] J. Westlake, "The Theory of Taxation with Reference to Nationality, Residence and Property," *Economic Journal*, 9:372, September 1899.

the tax is levied.[15] The Colwyn Committee gave a qualified recognition to this view. It suggested that the estate duty in England does not establish uniformity of incidence upon predecessors, yet there is "good support for giving primary but not exclusive place to the notion that the incidence of the duty is on the predecessor."[16] The Committee maintained that the allocation of burden is based upon the predecessor's actions and state of mind as found in deliberate saving against death duties, by the curtailment of expenditures, and by greater effort. The testator during his life foregoes a little better standard of living, gives up some of his leisure time, and actually sacrifices economic enjoyments and values to meet the tax. By so doing, he bears at least part of the burden of the death tax during his lifetime. Even the late John Maynard Keynes lends some support to this analysis.[17]

Incidence on successors. Another point of view places the incidence of death taxes upon successors. Adam Smith was one of the first to give weight to this notion. He said that "taxes upon the transference of property from the dead to the living fall finally as well as immediately upon the person to whom the property is transferred."[18] Hugh Dalton, an English fiscal economist, seems to have no difficulty in placing the incidence directly on the successors. To him, dead men like all inanimate objects pay no taxes.[19] He also seems to imply that the burden of a tax must always come after its levy.

Incidence on both. Consideration of the first two possibilities will reveal to the reader a third prospect. If the decedent had recognized the inevitability of the death taxes and had attempted to save more to meet the obligation to the state but was unable to save the whole amount necessary to defray such taxes, the incidence would fall partly on the heir and partly on the decedent. The proportion would depend on just how successful the deceased had been in his efforts to save enough to meet the taxes and pass on specific sums to the heirs.

Type of death tax not too relevant. It is probably true that the form of a given death tax is not a matter which goes to the essence of the problem of incidence. Differences in estate or succession taxes as to name, description, taxpayer's responsibility, and rate graduation are all important from the administrative and legal point of view, but they do

[15] A. C. Pigou, *A Study in Public Finance.* London: Macmillan Co., 1929, p. 161; see also G. F. Shirras, *Science of Public Finance,* (3rd ed.). London: Macmillan Co., 1936, Vol. 2, p. 542.

[16] Committee on National Debt and Taxation, *Minutes of Evidence,* Vol. 1, 1927, p. 171.

[17] J. M. Keynes, "Colwyn Report on National Debt and Taxation," *Economic Journal,* 37:199, June 1927.

[18] Adam Smith, *Wealth of Nations* (4th ed.), Edwin Cannan, ed. London: Methuen, 1904, Vol. 2, p. 346.

[19] Hugh Dalton, *Principles of Public Finance* (9th ed.). London: Routledge, 1936, p. 53.

not exercise any controlling influence in the determination of burden situs.[20] The same corpus of wealth is the tax object, and in either instance the economic results for the inheritor are the same—that is, a diminution in the amount to be enjoyed.[21]

Conclusions on death tax shifting and incidence. There are a few conclusions concerning shifting and incidence in this tax area which may be safely drawn. Among these are: (1) On the whole, there is no sound evidence to prove that death taxes are shifted to parties outside the inheritance. (2) It is economically sound to maintain that the incidence of death taxes is basically the same, whether they are levied as estate taxes or succession taxes. (3) Economic considerations (rather than legislative intent) are determinative of burden location. (4) The mere fact that the testator does not tender the payment of the tax in person does not prevent some of the burden from falling upon him. To argue that he makes no tender only confuses incidence with payment. (5) The burden of a death tax may arise both prior to or subsequent to death. Sometimes the creator of an estate anticipates the ultimate burden and amortizes it during the later years of his life through the curtailment of living expenses, increased effort, and more intense saving. (6) It is difficult to say with any degree of certainty whether the incidence of death taxes falls on the predecessor, the successor, both, or neither. On this issue we have theories, but very little empirical data.[22]

An Analysis of the Economic Effects of Death Taxes

IN THE CONSIDERATION of a tax, it is vital to regard the tax not separately but as one part of the over-all tax structure. The relevant query is whether we would be better off with no death duties and with other taxes higher, or if the economy would benefit if we adopted higher death taxes and possibly lower income or sales taxes. In addition, it is necessary to discover the effects of transfer taxes upon investment, employment, savings, and consumption.

ARGUMENTS IN FAVOR OF DEATH TAXES

Inheritance is unearned income. What was capital to the testator may be fortuitous income to the heir.[23] For this he has seldom rendered

[20] J. K. Hall, "Incidence of Death Duties," *American Economic Review*, 30: 46-47, March 1940.

[21] *Ibid.*, p. 47.

[22] William J. Shultz and C. Lowell Harriss, *American Public Finance* (5th ed.). New York: Prentice-Hall, Inc., 1949, p. 504.

[23] T. S. Adams, "Effect of Income and Inheritance Taxes on the Distribution of Wealth," *American Economic Review, Supplement* 5: 240, March 1915.

an equivalent service to the predecessor or to society. To him the inheritance constitutes unearned income that he has acquired without cost. Since this is so, inheritance presents a fit object for taxation—a tax levy which, except as to those who are in fact dependent upon the decedent, is quite burdenless.

Inheritance is a measure of ability to pay. When an heir or other distributee receives a bounty at the hands of a testator, he has received a capacity to pay taxes which is greater than if he had produced an equivalent income himself. When such a bounty is bestowed upon a distant relative or a stranger, then in most instances the bounty represents even a greater ability to pay. Furthermore, the decedent's fortune represents the owner's ability to pay during his lifetime, and death presents a strategic time to tax that ability when property relations are to be reorganized, reappraised and the wealth redistributed.

Death taxes contribute to equality of opportunity. Death taxes, when properly levied and collected, can contribute to a large measure of equality of opportunity among citizens in a democracy. Implied in democratic institutions is the thought of "equality of opportunity"—the idea that each individual should have the chance to start with an "even break" and then advance as far and as rapidly as his qualities will take him.

Death taxes contribute to better distribution of wealth. A further justification of death taxes advanced by some is that they can contribute to a more equitable distribution of wealth. This comes about in several ways. First, effective death taxation has a levelling effect upon large aggregations of wealth. Second, death taxes of the "succession or inheritance" variety may encourage estate owners to distribute their estates more widely by "will." And third, government by the expenditure of the death tax revenues upon the types of public services enjoyed by the lower-income groups contributes to their welfare. There is little doubt but that in the long run by these various means, more equitable distribution of wealth and welfare can be achieved.

ARGUMENTS AGAINST DEATH TAXATION

Death taxes impair capital. Possibly the most persistent argument against death duties is that such taxes reduce the stock of capital. Perhaps the strongest recent champion of this indictment was Andrew W. Mellon, former Secretary of the Treasury. In speaking of the federal estate tax as it stood in 1924, he made the following comment:

> This excessively high taxation should be considered from two standpoints; first, its effect upon existing capital, or its static effect; and second, its effect on the production of future capital, or its dynamic effect. Death taxes are taxes on capital. It is obvious that if the government, to maintain itself, were to take 50% of every estate large or small and if, on the average, a man could not double his inheritance,

> there would be an actual depletion of capital within the country and ultimately there would be nothing left to tax.[24]

This is the same type of argument that the opponents of the inheritance tax since Adam Smith have asserted as one of the economically dangerous effects. This is an unwarranted claim if by "reduction of the stock of capital," the critics are referring to the present volume of producers' goods. The levying of a 20 per cent tax on an estate does not mean that the tax gatherer is going to take two of the ten drill presses or lathes in a shop. The capital itself is certainly not destroyed. The claims to ownership (stocks) might well change hands as a result of the tax, but the capital goods are not destroyed.

However, there is some truth to this argument, and an estate tax might actually affect the supply of capital goods; but if so, it will be the "future" formation of capital. Let us consider what happens when claims to property have to be sold in order to meet taxes. A second party, Smith, buys the title to the property, and with the cash obtained, the heirs are able to pay the government the taxes due. The state now has its taxes, the title to the capital goods has passed to Smith and no capital has been destroyed. Smith, however, may have purchased the claim to the property with money he had been saving to build a house. If no opportunity to purchase part of the estate had presented itself, he might have built his house, thus creating new capital. It is in this manner that the future stock of capital might be hindered in its growth by death taxes.

Just how our stock of capital goods will be affected by death taxes depends, also, on what the heirs would have done with the tax money paid to the government. Some who inherit great fortunes promptly proceed to devote the balance of their lives to riotous living and are little concerned with increasing the amount of capital goods in the nation. On the other hand, there are successors to wealth who adopt a more levelheaded course and make intelligent capital investments. In other words, no general statement or claim can be made as to how the tax reacts upon the stock of capital goods until all the possibilities are investigated.

Death taxes impair scale of production. One of the indictments leveled against inheritance taxation is that it forces the parceling of estates, land, and business properties in a manner which is destructive of economic efficiency. In the ownership of real estate it is true that some parceling has taken place—much of it from the natural desire to spread the bounty among a number of heirs. The social objective here is

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[24] Andrew W. Mellon, "Economic Aspects of Estate and Inheritance Taxation," *Trust Companies*, 39: 709, December 1924.

definitely in favor of the diffusion of land ownership. As far as land ownership is concerned, the evidence seems to indicate that the effect of inheritance and inheritance taxation has been wholesome. There is no sign as yet of extensive, minute subdivision to the point of undermining economic efficiency.

For large business properties the corporate form of ownership is the most common. At present there are very few large-scale production units which are owned by one individual or one family. Death taxes cannot seriously affect large corporations as production units. The death of a heavy stockholder may mean the transfer of the stock to other members of his family or the sale of part of it to others to meet death taxes. This may result in an increase in the number of stockholders, but it does not mean that the corporation as a productive unit will be broken up.

Death taxes impair incentive to labor. In testing the soundness of this claim, the economist is faced with several perplexing psychoeconomic questions which must be answered before any valid conclusions can be drawn as to the effects on the incentive to work. They are: (1) Is economic effort motivated only by monetary rewards? (2) Are inheritance taxes such a subtraction from the rewards of producers that they tend to diminish their work efforts during life?

The answer to the first question is that pecuniary compensation is not the only motivating force that draws forth economic effort. There are several others. It must be admitted that pecuniary reward is a primary stimulant to work. But after an individual has achieved a satisfactory standard of living, he may go on working just as effectively as ever for other reasons. William James has stated that nine-tenths of the world's work is done out of emulation; and there are those who stress the significance of the "creative impulse." Thorstein Veblen speaks of the "instinct of workmanship." Both Andrew Carnegie and Charles Schwab have pointed out that among many wealthy enterprisers, it is the love of power and activity that keeps them going long after they have ceased to desire money, death taxes to the contrary notwithstanding.

On the second question, there is strong authority to the effect that in the final analysis the economic motives for working are not seriously affected by a contingency that reduces an estate only at death, except in relation to those who are well-advanced in age. Max West was definitely of the opinion that "death is usually looked upon as a remote event and occupies no very prominent place in the minds of men."[25] John A. Hobson was largely of the same view. Speaking at a time when the federal estate tax was about 10 per cent in the higher brackets, he said:

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[25] West, *op. cit.*, p. 212.

> Putting the matter concretely, I do not believe that well-to-do people would accumulate and leave behind less than they do now, if the state were to take half or more of their estates.[26]

In the final analysis, the inheritance tax is associated with the facts of death. The real motivating and repressive forces in life are those tied up with the facts of life. The primary and most dynamic consideration in the whole field of economic incentives is that we keep open the channels of opportunity for producing, enjoying, and accumulating during the course of the life of the producer himself.

Death taxes impair the incentive to risk. In a modern capitalistic society, the assumption of the risks of entrepreneurship is basic to the full functioning of the economy. Any tax which seriously impairs the performance of this function tends to lower the level of production, employment, and income. There seems to be no strong proximate relation between death taxes and the assumption of risk. Death taxes are too remote to enter into the year-to-year calculations of the active individual enterpriser, except as he may purchase life insurance to aid in paying death taxes; they play no part in the decisions of business corporations; and they do not impinge upon annual income or annual savings. They may subtract from the volume of accumulated private savings at death, but that bears very little relation to propensity to risk during life. The purpose of all risk-taking is to gain income and profits. Death taxes do not noticeably bear upon either. There is some question, therefore, as to how such taxes can serve to dull the incentive to risk and invest, except among those in the upper age-brackets.

Death taxes impair propensity to save. It is sometimes maintained that death taxes tend to curtail the propensity to save. Among younger people this claim is practically of no force and effect. To all but morbid youth, death and its concomitant, death taxes, are far beyond the things that matter. All their acts and thoughts are associated with the facts of living—not dying. The conclusion is that inheritance taxation probably is not a material factor in the causation of non-saving among people in their twenties, thirties, and even forties.

It is quite conceivable that inheritance taxes may even result in increasing the savings of those whose desire it is to leave widows, sons, and daughters particular pieces of property or specified sums of money. To accomplish this objective, such men must lay aside an additional sum either by direct saving or through life insurance to meet the tax. The latter is not an uncommon practice among the large accumulators of wealth.

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[26] John A. Hobson, *Taxation in the New State.* New York: Harcourt, Brace & Howe, 1920, p. 117.

Death taxes impair continuance of family-held business. It is often maintained that death taxes tend to break up closely-held businesses, both corporate and non-corporate, and thereby also tend to foster large-unit business. That family-owned units are faced with special problems under state inheritance taxes and the federal estate tax is well-recognized. How many family businesses are confronted with such problems and adversely affected by them is difficult to say because there is no organized empirical evidence on the subject.[27]

In the typical case, a dynamic head of the family has built up a successful business by plowing back a large fraction of the earnings over the years. Unless there has been careful estate planning, on the death of the head of the family a considerable part of his wealth is tied up in the business. Death taxes must be paid in cash and within a relatively short period. This may mean that the business as a whole or a substantial interest therein may have to be sold to defray death taxes. The business may fall into the hands of a large competitor in the field and the family may lose control of the management of the business. In an economy such as ours there is a strong social interest in maintaining the vigor of many medium-sized business units. Clearly, death taxes should not militate against this interest.

However, the problem need not be as serious as it might seem if foresight is used in "estate planning." Among the devices available for minimizing the tax liability at death are: (1) planned gifts to the members of the family over a period of years prior to death; (2) the accumulation of life insurance to serve as a liquid element in the estate; (3) the accumulation of other types of liquid assets; (4) arrangements for the purchase of the business after death by other members of the family and reliable employees; (5) the transfer of some of the ownership rights in the business to a charitable trust free of death taxes (but with retention of control); and (6) extension of time for the payment of the tax, in which case the tax may be paid out of income at 4 per cent interest over a period up to 10 years.[28]

However, in the situation where the head of the family's business group dies suddenly in his forties or early fifties without having had time to plan his estate wisely, the basic problem of the break-up or the transfer of the business remains.

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[27] For a well-balanced discussion of this subject, see C. Lowell Harriss, "Estate Taxes and the Family-Owned Business," *California Law Review*, Vol. 38, March 1950, pp. 117-149.

[28] See C. Lowell Harriss, *op. cit.*, pp. 132-148.

Death and Gift Taxes and Fiscal Policy

BY AND LARGE death and gift taxes are not effective instruments of counter-cycle policy. Good death and gift tax policy requires that once rates and exemptions have been fixed they should remain relatively stable for a reasonable period of years. They are not repetitive taxes, but they are applied only once with respect to a given estate or inheritance. Raising and lowering rates for counter-cycle purposes could be unfair as to some estates depending upon the phase of the business cycle in which death occurred.

Furthermore, neither the transfer of property at death nor the taxation of such transfers bears any proximate relation to basic economic decisions of risk-taking, investing, working, or consuming and, therefore, cannot be applied as counter-cycle levers to affect investment and consumption.

It is true that because of their progressive character, death and gift taxes possess an element of built-in flexibility. The progressivity in the rates allows some counter-cyclical action to take place in the sense that more potential purchasing power is absorbed in prosperous times when estate asset values are high and less in depression. On the whole, neither death nor gift taxes are particularly adaptable to planned counter-cycle purposes. It might be good fiscal policy, however, to apply heavier gift tax rates in prosperity and wartime, when high income and profits tend to stimulate the making of generous gifts. Such a policy could be sustained both on revenue and distributional grounds.

Conclusions

A NUMBER of conclusions concerning the outlook for inheritance tax theory and policy in the American economy in the future can be drawn. Among these are:

1. Death taxes are here to stay; they have passed through the growing-pain stage. Many of the dire economic consequences that were trotted out in bogey-man style in opposition to them, have not materialized as yet on the American scene.

2. Death taxes have little material effect upon the scale of production; this is especially true as long as the corporation remains the main type of business organization for carrying on large scale business. However, steeply progressive death taxes can threaten the continued existence of closely-held, medium-sized production units.

3. By and large, inheritance taxes do not curtail noticeably the in-

centive to work. The essential requisite is that human beings have the use, enjoyment, and control over the fruits of their labor during life. There are many motives for continued work effort.

4. It is probably true that death taxes are too remote (except in the later years of life) to affect risk-taking in any serious degree. For most active men below 60 years of age, there is no functional relation between ultimate death taxes and current risk-taking.

5. Study and observation lead to the conclusion that inheritance taxes do not seriously curtail the "propensity" to save. The great majority of motives for saving are associated with the purposes of life. Except for the later years of existence, saving goes on without much concern over death taxes. Much saving is habitual, some is automatic, and some is even practiced to meet the burden of possible death taxes.

6. It is reasonably safe to conclude that death taxes have no strong tendency to curtail consumption because they do not fall upon those who have the greatest propensity to consume. It is true that some forbearance of present enjoyment does take place on the part of some estate-builders in anticipation of death taxes, but it does not bulk large as a total. On the other hand, among some older wealthy people, the prospect of death taxes has the tendency to increase consumption and enjoyment.

7. Realistically, there is a good deal more to be feared from the "intensive use" of highly progressive income taxes than from death taxes. Annual income taxes bear a closer functional relation to working, risk-taking, saving, and consuming; they are more apt to discourage the performance of these functions.

8. Death tax policy can have constructive effects upon the functioning of the economy in an indirect way. Though death and gift taxes are not flexible instruments of fiscal policy, yet more effective use of such taxes for revenue purposes might make it possible to ease the income tax at strategic points so as to reduce some barriers to active enterprise and so as to contribute to a larger volume of consumption.

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Inheritance Taxation in American Jurisdictions

DEATH TAXATION *has established itself as a permanent element of the federal tax system only during the past generation.... State death taxes have a history reaching back into colonial times. Until the twentieth century, however, their significance was social rather than fiscal—the revenue they produced was trifling.*

—SHULTZ AND HARRISS.[1]

Overview

THE TRANSFER of the property of a deceased person to his heirs or beneficiaries (whether by will, intestate operation of law, gifts *causa mortis*, gifts made in contemplation of death, or gifts to take effect at or after death) is taxable by the federal government and by all states except Nevada. Taxes upon the transfer of gifts between living persons (*inter vivos*) are levied by the federal government and twelve states.

This chapter is concerned with death and gift taxation as it exists at the state and federal levels in the United States. It will analyze: (1) state inheritance taxation, (2) federal estate taxation, and (3) federal and state gift taxation. In relation to each of these types of taxation, it will be necessary to consider: (1) the tax base, (2) exemptions, (3) rates, (4) deductions, (5) credits, (6) time of appraisal, (7) jurisdiction to tax, and (8) administration. In addition to the social and economic implications involved, many technical legal considerations arise and must be mastered. The latter considerations are deeply rooted in the common law and its numerous ways of transferring property both during life and at death.

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[1] William J. Shultz and C. Lowell Harriss, *American Public Finance.* New York: Prentice-Hall, Inc., 1949, pp. 484 and 486.

State Inheritance Taxation

HISTORY OF STATE INHERITANCE TAXATION [2]

The early attempts at state inheritance taxes were principally a combination of probate and collateral heir taxes, which often taxed only the transfer of personal property and produced little or no revenue. They were poorly administered and were rarely permitted to remain on the statute books for any appreciable period of time.

New York Act of 1885. In 1885, however, New York made some improvements in inheritance tax methods. It placed a "proportional" (5 per cent) tax on personal property transferred to "both" collateral beneficiaries and direct heirs. Real property was made part of the base in 1891. The administrative sections of the act were well-drafted and thus made possible fairly effective administration. The New York statute served as a model for other states for about twenty years.

Wisconsin Act of 1903. Wisconsin, in 1903, passed the first modern inheritance tax law, which served as a model for subsequent inheritance tax legislation. The principal feature was a rate schedule graduated according to the amount of the inheritance and the degree of relationship between the beneficiary and decedent. It included both real and personal property in the tax base even when applied to direct heirs. The administrative provisions were improved so that the inheritance tax became a reliable source of revenue.

Later expansion. The institution of the "federal credit" in 1924 and 1926 further encouraged state inheritance tax legislation. This provision allowed a portion of the federal estate tax liability to be paid with state death tax receipts, so that it was in the interest of the states to adjust their rate schedules accordingly. Most states adopted rates which took full advantage of the federal credit, whereas some abandoned the inheritance tax approach altogether and changed to estate taxes modeled on the federal law, with rate schedules adjusted to take advantage of the federal credit.

Current status of state inheritance taxes. At the present time, every state except Nevada levies some form of death tax. Seven utilize the "estate" tax approach, eight states make exclusive use of the "inheritance or successions" tax approach, whereas the remaining states use the "inheritance" tax approach, supplemented by an estate tax in order to take full advantage of the federal credit.[3] There is wide variation among the states concerning tax base, exemptions, and the progressivity of the rates.

[2] See Eugene Oakes, "Development of American State Death Taxes," *Iowa Law Review*, Vol. 26, March 1941, pp. 451-478.

[3] The seven states using the estate tax approach are: Alabama, Arizona, Arkansas, Florida, Georgia, Mississippi, and New York. Those using only the inheritance tax approach are: Idaho, Illinois, North Dakota, Oregon, South Dakota, Utah, West Virginia, and Wyoming.

INHERITANCE TAX BASE AND RATES

Tax base under inheritance tax. The tax base under the "inheritance" or "successions" tax approach is the fair market value of all the property going to each heir or distributee at the death of the decedent or transferred during life "in contemplation of death," or intended to take effect in possession or enjoyment at or after death. It attempts to include every interest in property which is in effect transferred at death or intended to be a "testamentary disposition."

Inheritance tax rates. Succession tax rates are graduated according to the degree of relationship between the heir and the decedent, and according to the amount of the inheritance received. Generally the rates are mildly progressive. Rates for direct heirs begin at 1 per cent and rise to varying limits of from 4 to 16 per cent. Collateral heirs and all others are usually taxed at higher rates, beginning at 2 and 4 per cent and rising to 6 and 40 per cent. Some states levy flat rates of 5 to 10 per cent on collateral heirs. Those who are strangers to the blood pay the highest rates. Wisconsin applies a 40 per cent rate on the marginal part of an inheritance over $400,000 going to those who are strangers to the blood and to corporations. However, the "effective rate" on the "entire share" of any one beneficiary is limited to 15 per cent. Table III, p. 261, presents the schedule of rates, exemptions, and classification by heirs and the size of the inheritance in that state.

INHERITANCE TAX EXEMPTIONS AND DEDUCTIONS

The inheritance tax is levied on the *net share* of the estate passing to each beneficiary, and it is computed after certain exemptions, deductions, and credits have been utilized.

Exemptions. The largest personal exemption is allowed surviving spouses and direct heirs; this concession is defended on the ground that such heirs are dependent upon the decedent for their support and have lost their provider. Kansas allows a $75,000 exemption for the widow, whereas Pennsylvania allows only $500. However, $15,000 to $25,000 exemptions for widows are not uncommon. Widowers and children are usually given smaller exemptions than widows. Exemptions of from $2,000 to $5,000 for the former are not uncommon.

The exemptions for other classes of heirs are lower, but no similar justification can be found for allowing the exemptions, because their shares in the estate come as a windfall. Usually for the heirs and distributees below the immediate ones, the exemptions range from $50 and $100 for strangers to the blood to $2,000 for collateral heirs.

Deductions. Bequests to charitable, educational, and religious organizations are generally deductible if they are located within the state. When the charitable bequest passes outside the state, it is commonly taxed at

the highest rate applicable to collateral heirs. Educational bequests to outside institutions are sometimes deducted on a reciprocal basis.

In computing the net estate, debts owed by the deceased are deducted (as are administration costs) before the individual shares of the estate are computed for tax purposes. Under the estate tax approach, some states include administration costs as part of the taxable estate on the theory that the tax is imposed on the net estate existing at the time of the owner's death and that these administration costs develop only after the owner's death.

Both the federal government and fourteen states provide a deduction to prevent rapid recurrence of death taxes upon the same property when the heir dies soon after his benefactor. A deduction is permitted for any part of a present decedent's estate on which a prior death or gift tax has been levied within a specified time. The federal government uses a five-year period, whereas state laws set varying periods from one to six years.

Table III

RATES AND EXEMPTIONS UNDER THE WISCONSIN INHERITANCE TAX–1948

Relationship of Beneficiary to Deceased	*Exemption*	$0 *to* $25,000	$25,000 *to* $50,000	$50,000 *to* $100,000	$100,000 *to* $400,000	$400,000 *to* $500,000
CLASS 1						
Wife	$15,000	2%	4%	6%	8%	10%
Husband	5,000	2	4	6	8	10
Each other member	2,000	2	4	6	8	10
CLASS 2						
Uncles, aunts, and their descendants	$250	6%	12%	18%	24%	30%
CLASS 3						
All persons not falling within any of first two classes, and corporations, bodies politic, etc.	$100	8%	16%	24%	32%	40%

Source: *Martindale-Hubbell Law Directory*, Volume III, 81st Annual Edition, Summit, New Jersey, 1949.

INHERITANCE TAX PROPERTY VALUATION

Time of valuation. Property is valued in the majority of states at its fair market value "as of" the date of the owner's death. A few states permit the choice of three time periods for valuation: first, the value at the time of transfer (death); second, the value at the date of appraisal; and third, the value of the property one year after death. This latter approach is a more equitable one for the heir because it takes into consideration rapid declines in property values between the date of death and the final payment of the taxes.

Property valuation. The taxable property is usually appraised at its *fair market value* "as of" the particular time required by the statute. To aid the tax authorities in the ascertainment of fair market value, the state laws usually require that the state tax commission (or more commonly the probate court in the given county) appoint several appraisers (usually three) to submit a complete inventory of all the taxable property within the estate. Then each property "interest" is valued by them at fair market value for inheritance tax purposes. On many items of property, especially those for which there is no quoted market price on a given day, the appraisers can exercise a considerable degree of valuation discretion. However, the approach to valuing property for death tax purposes—where the appraisers must produce a *complete inventory* and "appraise" each item—is more thorough and accurate than the looser valuation for property tax purposes.

When there is an active market for such property as certain types of real estate and "market listed" stocks and bonds, the valuation task is relatively simple. When that is not the case, the valuation process becomes one of judgment and discretion. Under state inheritance tax laws where each distributive share must be valued, the appraisal of special types of "interests" in property also becomes relevant. This is true because the testator can transfer interests other than full ownership of the property. Among the types of interests which he may convey are estates for years, life estates, vested remainders, contingent remainders, and others. Therefore, it becomes necessary to appraise each interest according to its economic characteristics.

1. *Valuation of estates for years.* In the case of an estate for years, the valuation task is one of determining the "present value" of the use of, or the income from the property for the term of the estate. The state statutes usually allow a fixed rate of return in determining the present value. If a given estate for ten years is calculated to produce $50,000 income over the ten-year period and the statute allows 4 per cent in determining "present value," then the heir will pay an inheritance tax on the "present value" of $50,000 computed at 4 per cent, or $50,000 discounted at 4 per cent over the ten-year period.

2. *Valuation of life estates.* In the valuation of a life estate the problem is somewhat similar in that the heir is taxed upon the "present value" of the *life estate.* The additional problem is that of determining the *term* of the life estate. There is no fixed term since it depends upon how long the heir continues to live. To estimate the term, reference must be made to "life expectancy" tables. Once the life expectancy is determined, the calculation of the "present value" is similar to an estate for years.

3. *Valuation of vested remainders.* In ascertaining the value of a *vested remainder* (*A* to *B* for life, remainder to *C*) additional problems enter. A vested remainder is a property interest where the heir (*C*) gets

technical legal title to a given piece of property at the moment of the decedent's death subject to the life estate of *B* in our case. *C*, however, does not get full use and enjoyment of the property until *B* dies and the life estate expires. To value such an interest the general practice is to take the fair market value of the property involved in the life estate-remainder and *diminish* it by the present value of the intervening life estate.

4. *Valuation of contingent remainders.* The problem of valuation becomes even more difficult in the case where the heir receives a contingent remainder. Such a remainder is one in which there may be an identified remainderman, but some event must occur before he can take the property. (*A* to *B* for life, remainder to *C* if he reaches the age of thirty-six.) In other words, a certain contingency must occur before he can take the property. At the time of the death of the testator, it cannot be determined whether *C* ever will take the property. Therefore, the question arises under state inheritance tax laws as how such a contingent interest should be valued. The several states use a number of different methods. Some states like California make no allowance for the contingency and the interest is valued at the highest possible valuation and taxed at the highest rate that could occur. Some states follow the "low contingency" basis and require only the minimum amount with a later payment by the estate if more is required according to the contingency.

INHERITANCE TAX JURISDICTION

Since 47 states have estate and inheritance taxes, the question often arises as to which state has the jurisdiction to tax the property in the given instance. As in the property tax field certain principles attempt to govern and establish the taxable situs of property. The two bases upon which such situs can be established are (1) the *domicile* of the testator at the time of his death, and (2) the permanent *location* of the property at death. Generally the state in which the decedent was domiciled at the time of his death has the right to administer the estate for transfer and tax purposes. That does not mean that such state can tax all property owned by him regardless of where it was located, however.

Jurisdiction to tax tangible property. The jurisdiction to tax by the state of the domicile depends in part upon the character of the property transferred. There is no question about that state's right to tax the transfer of all property, tangible and intangible, belonging to the decedent actually located within the state. Said state, however, cannot tax the transfer of real property located in another state; nor can it tax the transfer of tangible personal property permanently used and kept in another state. States in which such "other property" is located may have *ancillary administration* over that part of the estate found within their borders and may tax the inheritance of it according to their inheritance tax laws.

Jurisdiction to tax intangible property. The jurisdiction to tax the death transfer of "intangibles" is not so clear-cut. For a long time our courts have held that "intangibles follow the person" and that stocks, bonds, and intangibles could only be taxed in the state of the domicile of the owner, regardless of where they were safekept. That is no longer the case, for the courts have more recently held that their transfer may also be taxed in the state in which they are deposited and in the state of the "corporate domicile" of the corporation issuing the securities.

INHERITANCE TAX ADMINISTRATION

The character and quality of inheritance tax administration varies materially from state to state. A survey of inheritance tax administration in the states finds that very few of the major state taxes are as poorly administered as the death taxes.[4] That judgment is first substantiated on the principles of administrative organization. A large number of states now place the inheritance tax within a central state tax commission or department of taxation; in other states its administration is found under the control of the state treasurer, the state comptroller, the attorney general, or the state auditor; sometimes it is left entirely in the hands of the county probate courts. Most of these agencies were originally organized for other purposes and still have other functions to perform. It is clearly recognized that in too many states the provision for inheritance tax administration violates the basic canons of sound administrative organization.

Under well-integrated state inheritance tax and local probate administrations, the opportunities for evasion and avoidance after the death of the estate owner are not great. Executors, administrators, and appraisers are in effect "officers of the court" and operate under the control of the court —with the result that they are hesitant to violate the rules. Appraisers have the tendency to "go easy" in their appraisals, and executors sometimes close their eyes to the "hiding" of small, valuable pieces of personal property. But since a complete inventory must be filed and the valuation of each item stated—all of which are part of a public record—there is not much outright *evasion* during the process of administration. That is not to say, however, substantial *avoidance* and some *evasion* does not take place *prior* to the death of the testator.

Thus it becomes incumbent upon state inheritance tax administrators to make surveys into the "life background" of both testators and their estates. The lifetime dispositions of the deceased must be re-examined to see if there were any "concealed gifts" of a testamentary character, any gifts which were in fact in "contemplation of death" or "to take effect at death." All of the latter are usually included as subject to estate and inheritance tax laws.

[4] Walter W. Heller and C. Lowell Harriss, "The Administration of State Death Taxes," *Iowa Law Review*, Vol. 26, No. 3, March 1941, pp. 628-673.

Effective inheritance tax administration should be centralized under the strict supervision of state officials who are experts in tax administration. Administration should be under a hierarchical organization with unbroken lines of authority and fixed responsibilities, and it should have a reasonable balance between centralization of control and decentralization of services.

Federal Estate Taxation

DEATH TAXES ordinarily take two fundamental forms: estate taxes or inheritance taxes. The federal government employs the estate tax. Under the federal estate tax there is no consideration given to the degree of relationship between the transferees and the decedent, except the spouse under the marital deduction. Also, the federal estate tax is not a tax on the property but a tax on the "transfer" of property. The amount of the tax is measured by the value of the property "to the extent of the interest therein of the decedent at the time of his death."

THE PERMANENT FEDERAL ESTATE TAX

Although the federal government had some experience with death taxes as early as 1798 in the form of a probate stamp tax (and as emergency taxes during the Civil and Spanish American Wars), a permanent death tax did not arrive on the scene until 1916.

The Estate Tax of 1916. Congress was urged to adopt an "estate tax" to help raise needed revenues for national defense and as a means of balancing the systems of death taxation among various state governments. The measure adopted (an estate tax) was intended to be a temporary one, but it continued on as a permanent part of the national revenue system. The rates were graduated from 1 to 10 per cent on estates above $50,000, with the highest rate applicable to estates in excess of $5 million. Each estate was granted a $50,000 specific exemption.

Early estate tax changes. Several changes have been made in the federal estate tax in the face of intermittent moves to repeal it. As a partial compromise of the efforts to repeal the tax, the 1924 Revenue Act provided a 25 per cent credit against the federal estate tax for any state inheritance taxes paid. In effect, one-fourth of any federal estate taxes due could be paid with state inheritance tax receipts. In addition, the "credit" was designed to encourage states to adopt inheritance taxes.

Much confusion existed among the various states because of the different rates and exemptions applied by the states having inheritance taxes and because of the refusal of some states to adopt this form of tax. In 1926 Congress raised the federal estate tax credit to 80 per cent, reduced the top rates from 40 per cent to 20 per cent, and raised the exemption from $50,000 to $100,000. Congress refused to repeal the estate tax despite

much opposition from the President, the Secretary of the Treasury, and from various states.

By 1930 the movement to repeal the federal estate tax had died out, largely because of the great depression. The *Revenue Act of 1932* increased the tax rates, lowered exemptions, and imposed an "additional tax" on top of the 1926 Act. To this day the federal estate tax exists in two parts. The first part is the "basic" federal estate tax to which is applied the rates and exemptions as they existed under the 1926 Act. This part of the tax has the benefit of the 80 per cent federal credit. The second part consists of the "additional" estate tax with its own system of rates and exemptions. It does not receive the benefit of the federal credit.

Recent estate tax changes. Substantial changes were introduced into the federal estate tax by the *Revenue Act of 1942*. An over-all specific exemption was set at $60,000 per estate, and the $40,000 special exemption for life insurance was removed. Some limitations were put upon powers of appointment for estate tax purposes, and thus a serious loophole was partially plugged. The Act removed the advantage that husbands and wives in "community property" states had under the tax. (Generally speaking, community property means that property accumulated during the marriage.) Under it the wife is automatically given a one-half interest in that property, though it has been produced entirely by the husband. In such states prior to 1942, it was held that upon the death of the husband, one-half of the community property was already in the ownership of the wife and that, in effect, *only* one-half of the community property passed to her on his death. Therefore, only one-half of the property was taxed under the federal estate tax.

In the 1942 Act Congress sought to remove this advantage held by husbands and wives in community property states. It provided for the taxation of "community property" passing from the spouse to whom it was *attributable* in an economic sense. In other words, if the husband had produced the wealth by his efforts during the marriage, then it would be taxable on his death under the estate tax. However, if the surviving spouse could prove that part of the community property had actually arisen out of his or her efforts alone prior to or during marriage, said part would not be taxable. Despite the administrative and theoretical difficulties of tracing and identifying the "economic source" of part or all of an estate, the Act was sustained by the courts.[5]

The 1948 Revenue Act completely changed these provisions of the 1942 Act by extending to husbands and wives in "all states" the advantages previously enjoyed only in the community property states. Now with the so-called "marital deduction," proportions up to 50 per cent of the adjusted gross estate are exempt if they are left to a surviving wife or

[5] *Fernandez v. Wiener*, 326 U. S. 340; 66 S. Ct. 178 (1945).

husband where the decedent died on or after January 1, 1948. However, if the decedent leaves the surviving spouse less than 50 per cent of the adjusted gross, the marital deduction cannot be greater than the value of the surviving spouse's share of the estate. This is generally recognized as being quite a generous treatment. In effect it also means that as between husband and wife the estate must have net assets of over $120,000 before any estate tax is due whatsoever. Prior to the 1948 Act a tax liability accrued as soon as the net estate exceeded $60,000.

ANALYSIS OF ESTATE TAX STRUCTURE

The estate tax base. The executor or administrator having actual or constructive possession of the decedent's property must file an estate tax return (Treasury Department Form 706) within fifteen months after death of decedent.

The basic requirements for the federal estate tax are contained in Chapter 3 of the Internal Revenue Code. For a citizen or resident of the United States a return must be filed if the *gross estate* exceeds $60,000 at the death of decedent. The value of the estate *at the time of death* determines whether or not a return must be filed.

The various classes of property which must be reported as part of the gross estate include real estate, stocks and bonds, mortgages, notes, cash, and insurance on decedent's life if he paid the premiums or retained certain incidents of ownership in the insurance policies. All such property is included to the "extent of the decedent's interest therein." Though the income from state and local bonds may not be taxed under the federal income tax, these "state instrumentalities" (the bonds) must be included as *assets* in the gross estate for estate tax purposes. The courts have permitted this inclusion on the theory that the taxation of the transfer of these bonds at death would not interfere with the performance of a governmental function, whereas the taxation of the "interest" on these bonds could affect state and local borrowing.

It must be noted that estate taxes are paid on the "net estate" after certain exemptions and deductions have been allowed. One of the primary problems is that of determining what must be included as part of the gross estate. The definition of the gross estate is becoming broader and more inclusive with every effort to plug the loopholes. The recent tendencies have been to include any transfers made during the decedent's life which he may draw back to himself or exercise control over during his life. The same has been held with respect to transfers which by certain contingencies might *revert* to him before his death, even though that possibility is quite remote.[6] The inequity of including in the estate the full fair market value of the property subject to the *possibility of reverter* was

[6] *Fidelity-Philadelphia Trust Co. v. Rothensies*, 324 U.S. 108 (1945).

recognized by Congress in the *Technical Changes Act of 1949*. Under that act, if the *right to the possibility of reverter* (created by the testator) is worth not more than 5 per cent of total property subject to the reverter, then neither the "right" nor the "property" subject to the right shall be included in the decedent's estate at death. If the value of the right exceeds the 5 per cent quantum, then the value of the property in its entirety shall be taxed to the decedent's estate. If, however, the reverter right flows to testator solely by *operation of state law*, the property will not be taxed under any circumstances at death.

Exemptions and deductions. In the case of citizens or residents of the United States, a specific exemption of $100,000 is allowed for purposes of the "basic estate tax" which is calculated according to the rates and exemptions of the 1926 Act. To calculate the "additional tax" imposed on top of the basic estate tax, a specific exemption of $60,000 is allowed.

In addition to the above specific exemptions certain "deductions" are allowable. Expenses connected with the decedent's funeral, liabilities and debts, administration expenses in handling the estate, and contributions made to religious, scientific, educational, or charitable organizations are deductible. In addition, any property the decedent received as a gift or inheritance within five years of his death and on which federal estate or gift taxes were paid is deductible from the estate. This provision is designed to prevent an entire estate from being taxed away where a quick succession of deaths occurs in a family. The property received with respect to which such deduction is sought must be capable of identification as having been received by the decedent from such prior decedent by gift or inheritance. A further limitation arises under the "marital deduction" of the *Revenue Act of 1948*. If the property passing from the decedent within five years came from the decedent's spouse, then this property will not be subject to the special deduction. The purpose here seems to be to avoid giving such property the advantage of both the "marital deduction" and the deduction for property "previously taxed" within five years.

A further deduction (known as the "marital deduction") allowed under the 1948 Act is now also granted with some qualifications. This, as was previously pointed out, makes it possible as between husband and wife practically to split the wealth and deduct up to one-half from the gross estate. Under the *Revenue Act of 1950* reasonable support for the decedent's dependents during settlement of the estate is no longer allowed as a deduction.

The "net taxable estate" is therefore determined by subtracting from the gross estate all the various exemptions and deductions allowed by law.

Tax rates. In the 1926 Act the rates increase gradually from 1 per cent of the first $10,000 of the net taxable estate to 20 per cent of such net

taxable amount in excess of $10,000,000. These rates still apply under the "basic tax." On top of the "basic tax" an "additional tax" is levied. At the present time the rates imposed by the "additional tax" in the *Revenue Act of 1942* progress from 3 per cent of the first $5,000 net taxable estate (after the $60,000 exemption) to 77 per cent of the net taxable estate of $10,000,000 or more.

Credits. At the present time the federal estate tax code allows a credit of 80 per cent of the tax due for state inheritance taxes paid under the *rates and exemptions* of the 1926 Act. This applies only to the "basic estate tax" where inheritance taxes are in fact paid to the states. There are no credits allowed on the "additional estate tax."

The use of a credit on federal estate taxes for state inheritance or estate taxes paid was designed to bring uniformity into the death tax picture throughout the country. The present 80 per cent credit does not possess the "levelling" effect it once had because the credit does not extend to the "additional tax." In fact, to increase the rates Congress chose to use the "additional tax" method rather than disturb the 1926 tax and credit. Many have urged the reduction of the 80 per cent credit; it has been retained, however, partly on the ground that it stimulates the states to take advantage of its existence. Undesirable competition among the states for wealthy residents might result if the federal government abandoned the field of death taxation or discontinued the credit.

Time of appraisal. Unless the executor elects to do otherwise all property included in the gross estate must be *valued* on the basis of the fair market value "as of the date of death of the decedent." Section 811 (j) of the Internal Revenue Code, however, provides for "optional valuation" at the discretion of the executor *as of* one year from the date of death. The purpose of this section is to relieve estates of serious hardship in those situations where a period of deflation follows the decedent's death and the value of the assets of the estate drops drastically before the taxes can be paid. Optional valuation will then permit taxation on the lower valuation. If the privilege of optional valuation is exercised, all property sold or distributed within the year is valued as of the date of such sale or distribution. Any property not sold is valued *as of* one year after decedent's death.

FEDERAL ESTATE TAX ADMINISTRATION

The task of administering the federal estate tax is one of the responsibilities of the Bureau of Internal Revenue. A special agency, the Federal Estate Tax Division, has been set up for that purpose. The Division maintains internal revenue agents in thirty-eight large cities throughout the United States. It is generally recognized that the Estate Tax Division operates quite effectively. Every estate tax return is checked by an official of the Division. This compares very favorably with the auditing

Table IV

FEDERAL ESTATE TAXES

On Net Estates of Decedents Dying After October 21, 1942

Net Estate Before Deducting Exemption	ADDITIONAL TAX REVENUE ACT OF 1942		TAX UNDER REVENUE ACT OF 1926		*Maximum Credit Allowed on Payment of State Inheritance Tax (80% of 1926 Tax Only)*	TOTAL FEDERAL ESTATE TAX *Effective 10/22/42*
	Rate of Tax On Block	*Amount of Tax*	*Rate of Tax On Block*	*Amount of Tax*		
$ 60,000	—	$ —	—	$ —	$ —	$ —
100,000	18%	4,800	—	—	—	4,800
300,000	30%	62,700	3%	4,500	3,600	59,100
500,000	32%	126,500	4%	12,500	10,000	116,500
1,060,000	37%	325,700	7%	45,700	36,560	289,140
2,060,000	45%	753,200	9%	129,900	103,920	649,280
3,060,000	53%	1,263,200	11%	234,100	187,280	1,075,920
5,060,000	63%	2,468,200	14%	497,900	398,320	2,069,880
7,060,000	70%	3,838,200	16%	807,100	645,680	3,192,520
10,060,000	76%	6,088,200	19%	1,345,900	1,076,720	5,011,480
20,060,000	77%	13,788,200	20%	3,345,500	2,676,400	11,111,800
50,060,000	77%	36,888,200	20%	9,345,500	7,476,400	29,411,800
All over this amt.	77%	—	20%	—	—	—

coverage of the federal income tax, which represents but a small percentage of the returns filed.

All estate tax returns are referred to internal revenue agents in charge in the thirty-eight division cities for investigation and determination of the tax, and later these returns receive a post-audit review in the Bureau at Washington.

In some respects estate taxes are easier to administer than inheritance taxes. This is true because under the latter tax each interest transferred to heirs must be identified and valued. The types of interests which heirs may receive are numerous, and many of them are contingent and therefore are not determinable until other heirs die.

Many problems of a comparable character appear in connection with the *estate tax* as well. One of the big problems for the revenue agent auditing and investigating the return is that of being sure that all of the decedent's property has been reported on the return. Decedents also may hold a large variety of interests in property at death which must be discovered and valued. In order to detect these interests the agent must make investigations in the field and outside the estate tax return. Some of these interests are: (1) property jointly owned, (2) reversionary interests, (3) interests in insurance on the life of another, (4) accounts receivable, (5) pension rights, and (6) unregistered bonds. In addition, many items with large value in a small bulk (objects which can be easily concealed and transferred) must be checked carefully. Jewelry, heirlooms, furs, currency, stamp collections, art objects, and other items are of this character. Gifts made during the last few years of life must be checked to determine whether or not gifts have been made in contemplation of death.

The complex structure of our federal estate tax adds problems to both administration and compliance. The division of the tax into the "basic tax" and the "additional tax," each with its own system of rates and exemptions, is clearly in point. The 80 per cent credit provided only under the basic tax creates further problems.[7]

Federal Gift Taxation

A TRUE GIFT TAX is a tax upon the transfer of property from one living person to another. Such a gift is known as an *inter vivos* gift. To provide a true *inter vivos* gift, the donor should not have testamentary purposes in mind—he should not contemplate death, nor should he intend that the gift shall not take effect until death. He should intend that it

[7] For a recent discussion of federal estate tax administration see C. Lowell Harriss, "Federal Estate Tax Administration," *Taxes, The Tax Magazine*, Vol. 28, April 1950, pp. 341-357 and 376.

shall be an outright gift during his life. Prior to the passage of the federal gift tax, many estate owners gave away large parts of their estates prior to death without any kind of tax liability in order to avoid the federal estate tax.

The federal gift tax was passed to tax transfers made during life, to serve as a "backstop" for the federal estate tax, and to offset some of the loss of income tax revenues which results from "splitting up by gift" income-producing estates.

HISTORY OF FEDERAL GIFT TAX

The 1924 Gift Tax Act. The first federal gift tax was imposed by Congress in 1924. It had as its objective to reduce the outright avoidance of the federal estate tax by *inter vivos* gifts. Although the tax was quite generous in its provisions, strong opposition to it from certain quarters resulted in its repeal in 1926.

The Gift Tax of 1932. From 1926 to 1932 there was no gift tax at the federal level, so that it was again possible to give away a large part of one's estate during life and thus avoid the federal estate tax at death. By 1932 the attitude on gift taxation had changed as a result of the depression and the strong need for revenue. In that year Congress re-enacted a gift tax which was intended to be an even stronger "back-stop" for the federal estate tax and to some extent for the income tax. The rate pattern was set at a level about three-quarters as high as that of the estate tax. The rates, exemptions, and other features of the gift tax have been changed a number of times since 1932, usually to correspond with changes in the estate tax. It now appears that the gift tax has become a permanent part of the federal tax structure.

ANALYSIS OF GIFT TAX STRUCTURE

The gift tax base. Under the Internal Revenue Code the term "gift" has a broad meaning. Every transfer of money or property, whether made as a sale or otherwise, from one person to another "without full and adequate consideration" in money or money's worth is in whole or in part a gift within the meaning of the tax law. The gift tax is not a tax on property as such, but it is an excise on the transfer of property to others in the form of a gift.

It is not the intent and purpose of the gift tax act to tax "support money" given to dependents or "token gifts" on birthdays and Christmas. The true purpose is to get at substantial transfers of property from one person or generation to another. The value of the gift is determined *as of* the time of the gift. The substance of all taxable gifts must be reported by the "donor" each year on March 15th on special gift tax returns supplied by the Collectors of Internal Revenue. The tax is paid by the *donor* and the amount of the tax paid is not counted as part of the

tax base. A lien attaches upon all gifts made during the year, and if the tax is not paid when due, the *donee* of any gift becomes personally liable for the tax to the extent of the value of his gift.

Exemptions, deductions, and exclusions. The gift tax is levied on the net value of the gifts made after certain allowances granted by law. Each *donor* is allowed a "blanket exemption" of $30,000, which he may use as he sees fit over his lifetime. That is, he may make tax-free gifts of this amount in any one year or he may spread the exemption over a number of years. This exemption is not an annual allowance, so that once it is exhausted it cannot be utilized again. Also, each donor is allowed a tax-free gift of $3,000 to each of any number of donees within any one year. This allowance is known as the "annual exclusion."

As a result of the 1948 Act, in addition to the above exemptions and exclusions, the "married donor" is allowed the so-called "marital deduction" as under the estate tax. This gives such donor the right to deduct one-half the value of any gift given by said donor to his wife or her husband. If a husband gives his wife $8,000, he is allowed an annual exclusion of $3,000. He is also allowed a marital deduction of one-half the gift, or $4,000. The result is that only $1,000 of the gift is subject to tax.

The 1948 Act also increased the advantages of a married donor in the case where the gift is made to a "third person." If a husband makes a gift of $10,000 to his eldest son, it will be presumed that the gift is made by "both" husband and wife—$5,000 by each. But since each has an annual exclusion of $3,000, each would file a return and pay a gift tax on $2,000. In other words, gift taxes would be paid on $4,000 out of the $10,000 gift. Under the "old rule" a tax would have been paid on $7,000. The new act has clearly enhanced the possibilities of gift tax avoidance by wealthy married couples.

Gift tax rates. The gift tax rates are approximately three-fourths as high as the federal estate tax rates. The rates start at 2¼ per cent of the first $5,000 net gift, and they gradually increase to 57¾ per cent of net gifts in excess of $10,000,000. However, over the years these rates are applied to a "cumulative base," so that it is not possible for the donor to give his estate away a little at a time at first- and second-bracket rates. Each year's gifts (after exemptions and exclusions) are added to all previous ones by the same donor for the purpose of applying the proper bracket rate. If an unmarried person were to make net gifts of $10,000 per year for two years, he would pay 2¾ per cent on the first $5,000 and 5¼ per cent on the second $5,000 the first year. In the second year the second $10,000 would be added to the first and he would pay 8¼ per cent on it. If at the end of ten years he had given away $100,000 in taxable gifts and then decided to give away an additional $10,000, it would cost him 22½ per cent on the marginal gift.

Federal gift tax yield. The yield of the federal gift tax has never been very large. The collections during the first year of the 1932 Act amounted to about $4.6 million. Collections reached $77 million for 1948, but fell to $48.7 million in 1950. The effect of the "marital deduction" of the 1948 Act will probably be to reduce quite substantially the yield for several years.

The federal gift tax is significant for reasons other than its own direct yield. It reduces a much heavier avoidance of the estate tax; it probably reduces the volume of *inter vivos* gifts somewhat and thus preserves the base for later estate taxation. Finally, it probably reduces the splitting up of income-property by gift and thus aids in preserving the income tax base.

State Gift Taxation

HISTORY OF STATE GIFT TAXATION

Though many states had inheritance taxes prior to the federal adoption of the estate tax in 1916, no state adopted a gift tax until the federal government enacted its gift tax in 1932. The following year Wisconsin passed such a tax. Since then eleven other states have added this tax to their state tax structures. Most states, however, have no gift tax supplements to their inheritance taxes, and it is still generally possible to avoid state inheritance taxes by carefully planned annual gifts during life.

ANALYSIS OF STATE GIFT TAX STRUCTURES

Most of the gift tax states levy the tax upon the donor after the pattern of the federal gift levy. Wisconsin, however, levies it upon the donee. The latter method results in some tax delinquency due to negligence or ignorance on the part of donees. This is true in spite of the fact that the Wisconsin Department of Taxation asks all donors and donees (on their state income tax returns) whether they have given or received any gift over $1,000 during the taxable year.

State gift tax base and exemptions. Most gift tax states require that all *inter vivos* transfers of property or any interest therein without full consideration must be reported as taxable gifts, if they are larger than a given amount.

The method of granting exemptions under state gift taxes is not uniform. Some states follow the federal pattern of allowing the donor an "annual exemption or exclusion" for "each donee." Oklahoma grants a $3,000 exemption for each donee each calendar year. North Carolina does the same but limits it to $1,000. Colorado uses the same approach but graduates the "annual exemption" according to the degree of relationship of the donee to the donor.

Another approach is to grant a specific exemption on the "total gifts"

made by the donor during his lifetime. Some states make this a single lump-sum to all donees as a group. Oregon allows a $10,000 exemption for this purpose. But it also allows a lump-sum exemption for each calendar year—$5,000 per year for the closely related group and $1,000 for all other donees as a group.

A more common type of lump-sum exemption is used in California, Louisiana, Minnesota, Virginia, and Washington, where the exemption is graduated according to the degree of relationship and usually is the same as under the state inheritance tax for each category.

State gift tax rates. Like the inheritance tax rates, the gift tax rates are graduated not only according to the size of the gift but also according to the degree of relationship between the donor and donee. Oregon is the only exception. It has one rate scale (ranging from 1½ per cent to 12 per cent) for all gifts based upon the size of the bounty, but with no regard to the degree of relationship. California graduates its rates according to both criteria, and the rate schedules are the same as those for the state inheritance tax. It must be noted also that there is no federal credit granted for state gift taxes paid. If such a credit were granted, it is quite likely that more states would levy gift taxes.

Conclusions

ESTATE AND INHERITANCE TAXES are now definitely a permanent part of our state and federal tax structures. However, a number of problems remain in the field. There ought to be better co-ordination between the two death tax systems. The federal estate tax credit ought to be adjusted and brought up to date. Certain inequities ought to be eliminated. Death tax avoidance should be minimized. At the federal level some authorities strongly advocate the integration of estate and gift taxes. Perhaps a federal credit ought to be granted for state "gift taxes" paid. These and a number of other problems are the basis for analysis and discussion in the following chapter.

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Inheritance Tax Problems and Reforms

THE DEATH TAX *field needs a thorough overhauling.... If the job is done thoroughly, death taxes can be made to assume a place of prominence in the tax system commensurate with their inherent merits.*
—COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS.[1]

Overview

AT NO TIME since the passage of the federal estate tax in 1916 and the gift tax in 1932 has federal death taxation had a thorough overhauling. There has been some touching up of rates, trimming down of exemptions, and sporadic "loophole plugging." Much of the same can be said for our state inheritance taxation. Until recently the revenue yield has been sadly disappointing at both the state and federal levels. Death and gift taxes have failed to carry their proportion of the load in our tax system.

Many special problems arise in death tax practice, among which are: (1) the inequity of taxing estates in rapid succession; (2) valuation of different types of property and different types of estates in property; and (3) problems of double and triple taxation of certain kinds of transfers.

The outstanding weakness of our gift and death tax structure is the fact that it is perforated with loopholes. Tax avoidance has been wholesale, and the impact of these taxes has been capricious. Too many transfers avoid the progressive rates of the upper brackets. This is bound to result in unfairness to many taxpayers who are in no position to take advantage of the loopholes.

It is with these various types of problems that this chapter is concerned. In addition, it discusses constructive reforms in the death and gift tax field and explores the possibilities of the "integration" of death and gift taxes under one tax base, one set of exemptions, and a single set of rates.

[1] Committee on Intergovernmental Fiscal Relations, *Federal, State and Local Government Fiscal Relations*, U. S. Treasury Department, Senate Document No. 69, 78th Congress, 1st Session 1943, p. 16.

The Problem of Taxing Estates in Rapid Succession

IF ESTATE and inheritance taxes should be levied on an estate two or three times within a few hours, or even a few years, most people would proclaim the resulting burden to be execptionally harsh and unjust. This could conceivably be the case where a rapid succession of transfers results from successive deaths of the owners, perhaps as the result of fatal accidents. The property could pass from father to mother to son, for example, within a short period of time.

Recognizing the inequity, some states and the federal government have "rapid succession" statutes. Usually they provide for exemption from taxation of transfers of the "same property" occurring within five years of a previous transfer. If there is no statute, however, courts have held that a second transfer even a few hours later is taxable.[2]

Many tax students consider the present successive transfer statutes inadequate. Various remedies have been suggested. Some authorities advocate that since inherited wealth is usually treated as a life estate by the recipient, graduation of the death tax should be according to the life expectancy of the heir.[3] This, however, could still create inequities in cases of premature or accidental death. Other fiscal experts advocate adjusting the tax according to the age differential between the decedent and the heir.[4]

Perhaps the most prevalent proposals involve adjusting the tax according to the time elapsing between transfers. Under this technique, for example, a successive transfer of the "same property" within five years might be given 80 per cent exemption, between five and ten years, 40 per cent exemption, and after ten years no exemption from death taxes because of rapid succession. Whatever the method used, a strong case can be presented for a well-conceived system of taking into account the "time dimension" in death tax administration.

Special Problems in Valuation

THE PROPER VALUATION of property for death tax purposes is not mere convenience; it is of the highest strategic importance. This importance multiplies as the rates become increasingly high. Yet many valuation problems remain unsolved. Among these is the fact that our present valuation methods cast definite unfairnesses and inequities upon estate

[2] *People v. Strom's Estate*, 363 Ill. 241 (1936).

[3] William J. Shultz, *The Taxation of Inheritance*. Boston: Houghton Mifflin Company, 1926, pp. 221 ff.

[4] For a thoroughgoing attempt at solving this and other death tax problems through a new tax technique, see discussion of the "Bequeathing Power Succession Tax" in William Vickrey, *Agenda for Progressive Taxation*. New York: The Ronald Press, 1947, pp. 224 ff.

owners. It is to avoid these undesirable results that proper valuation of estates and inheritances is essential.

VALUATION OF CLOSELY-HELD STOCK

Some of the special valuation problems arise in connection with the valuation of stock. The appraisal of closely-held stock, of large blocks of stock, and of stock in a declining market presents some of the more common issues in death tax valuation. For inactive, unlisted stock, often concentrated in the hands of a few family members (such as that of the Ford Motor Company), there are no market quotations available upon which to make an appraisal. This makes it necessary to measure the substantive values within the corporation back of the stock and from these values to attempt the construction of a fair market value. Indicators of this value are the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock.[5] There must be a weighing and balancing of a myriad of factors entering into the valuation according to the particular circumstances of the case. Under such circumstances there are bound to be striking differences of opinion between the government and the taxpayer as to the true value. As a result many problems arise and many appeals are taken to the courts.

VALUATION OF LARGE BLOCKS OF STOCK

Occasionally a decedent's estate contains such a large block of stock that its liquidation within a short period of time would seriously depress the market value for that stock and bring great losses to the estate. For this reason the "blockage rule" has been developed. According to this rule the appraisal of the value would take into consideration the size of the block of stock, the time it would take to liquidate it, and the conditions of the market.[6] The rule is used with caution, however. Sometimes the stock may not have to be liquidated, or ownership of a large block of stock may give *extra* value because of the greater control over company policies. In such cases the use of "blockage" would not be justified.

VALUATION OF STOCK IN A DECLINING MARKET

Stock and other property sometimes declines greatly in value after the appraisal for death tax purposes, largely as a result of changes in general economic conditions. This was tragically borne out during the stock market collapse of 1929 and depression of the 1930's. The result has sometimes been that the market value of the stock has left little after taxes for the heirs. It is mainly for this reason that the federal government has provided for *optional valuation.* Under this arrangement the executor

[5] *Regulations 105,* Sec. 81.10C (1942).
[6] *Helvering v. Safe Deposit and Trust Co. of Baltimore,* 95 F. 2d 806 (1936).

of the decedent's estate has the option of selecting as the *valuation date* either the day of death or one year from the day of death. He will exercise his option to protect the estate if property values drop materially after the day of death. This will avoid the inequity of having to pay high death taxes on shrunken values.

ECONOMIC CONSEQUENCES OF VALUATION METHODS

Consequences. The dangers of rapidly declining market values for stock after valuation and the loss of value due to liquidating large blocks of stock has brought forth a strong movement for avoiding these consequences by "estate planning." It is charged that present valuation procedures have forced older investors to remove their capital from the more risky illiquid investments to those which are more secure and more easily transformed into cash without loss.[7] This practice, it is claimed, can be a serious blow to the functioning of our economy because it can remove one of the major sources of badly-needed risk capital. There is some evidence that such funds are already flowing into the overcrowded channels of safe, low-return, liquid investment. The argument is plausible, although the extent to which this has occurred is not clear.[8]

Present remedies. "Optional valuation" and the "blockage rule" help to alleviate the dangers of decline in property values. Further remedy is found in provisions that estates are permitted to pay taxes on the installment plan over a period up to ten years. The basic difficulty lies, however, not in the conditions of the market or the size of the block of stock but rather in the method of valuation as of a particular day. Until this is remedied, the inequities and harmful economic consequences will still linger.

Recommendations.[9] To remove the hindrance to risk investment, it has been suggested that the estate be valued at "fair market value" *at time of sale or distribution*, with up to a period of three years allowable for the liquidation to take place. This procedure would represent an attempt to value the property "received" by the beneficiary rather than that "left" by the testator—that is, the value actually transferred from the decedent to the beneficiary.

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[7] There are many other objectives of estate planning besides that of providing liquid, secure investments in contemplation of death. Estate planning embraces the whole field of best providing for the future welfare of the family, as well as the avoidance of tax burden through gifts, trusts, and other devices. For various guides to estate planning see E. N. Polisher, *Estate Planning and Estate Tax Savings.* Philadelphia: G. T. Bisel Company, 1948. Also M. A. Shattuck, *An Estate Planners Handbook.* Boston: Little, Brown & Company, 1948.

[8] For a thorough discussion of this problem see Harold M. Groves, *Postwar Taxation and Economic Progress.* New York: McGraw-Hill Book Co., 1946, pp. 250-59.

[9] Recommendations adapted from Groves, *op. cit.*, pp. 258-259 and from William H. Anderson, *Modernization of Federal Estate and Gift Taxation,* an unpublished Ph.D. dissertation, University of Wisconsin, 1945, pp. 91-95.

Problems of Multiple Taxation

JURISDICTION TO TAX death transfers of the same property is often claimed by two or more states. This arises out of the fact that it is possible to claim jurisdiction (1) on the basis of the location of the property or (2) on the basis of the domicile of the owner. Serious injustices and harm have resulted from such multiple burdens. The problem has been further complicated by the fact that in recent years Supreme Court opinion has increased the "possibilities" of territorial multiple taxation under state inheritance tax laws.

The degree of overlapping claims to jurisdiction depends upon the kind of property involved. The problem is most acute in relation to the transfer of "intangible" personal property. Stocks and bonds, for example, create more opportunities for multiple taxation than most other kinds.

INTANGIBLE PERSONALTY

Intangible personalty presents the greatest number of opportunities for multiple death taxation as among the states. Here the Supreme Court readjustment of opinion has been most evident. Current legal theory makes it possible to establish jurisdiction to tax on several bases: the location of the intangibles, the domicile of the owner, and the corporate domicile of the entity issuing the stocks and bonds.

Early trend. During the early part of the twentieth century and before state inheritance taxation became common, the Supreme Court took no positive stand on multiple taxation in the death tax field. The matter was more or less left up to the states; and if inheritance taxes had been common, multiple taxation would have been possible. In the late '20's the Court seemed to establish a trend against multiple taxation. In relation to intangibles it began to put emphasis upon *mobilia sequuntur personam.*[10]

The keystone case in this trend, however, was that of the *First National Bank of Boston v. Maine* in 1932.[11] In this instance a deceased resident of Massachusetts left stock of a corporation chartered in Maine. Most of the property of the corporation was also located in Maine. Both Massachusetts and Maine taxed the transfer of this stock. The Supreme Court outlawed the Maine levy, asserting that the state of the domicile of the owner of the stock was the only state that could tax. It so held on the theory that "movables follow the person." The Court in effect held that multiple state death taxation was incompatible with "the due process of law" clause of the Fourteenth Amendment.

Shift in doctrine. This decision seemed to stabilize the problem of multiple death taxation for a number of years. The state of the domicile of the owner of the intangibles was the only state that had the right to

[10] *Blodgett v. Silberman*, 277 U. S. 1 (1928).
[11] 284 U. S. 312 (1932).

tax. However, this was not for long. *Curry v. McCanless* in 1939 held that the Fourteenth Amendment is no bar to double taxation and that taxation of intangibles is permissible in more than one state when the estate owner takes advantage of the benefit and protection of the laws of several states. It was here asserted that the domicile of the trustor-owner as well as the location of the intangibles in trust could serve as the basis for the taxation of a revocable trust.[12] *Utah v. Aldridge* in 1942[13] put another nail in the new doctrine by proclaiming that both the *state of domicile of the decedent-owner* and the *state of the domicile of the corporation* in which the decedent held stock may tax the death transfer of the stock. The Federal Supreme Court further asserted that it was not the province of the Court to provide a system which would avoid double taxation, for that was up to the federal and state legislatures.

Present doctrine. It now appears that intangible property may be taxable by the state of *domicile of the decedent-owner* (or trustor of a revocable trust), by the state of *location of the intangibles*, and by the *state of incorporation* for corporate stocks and bonds. With the recent emphasis upon the "benefit" and "power" doctrines, still further multiple taxation of intangibles at death may be found legal.[14]

THE PROBLEM OF DOUBLE DOMICILE

Multiple taxation in the death tax field is further increased by conflicting state requirements as to residence and domicile for taxation, and by conflicting state claims of jurisdiction based upon residence or domicile.

Distinction between residence and domicile. Residence and domicile have different meanings. "Domicile" always includes the *intention* of making a place ones' home. It is one's regular place of abode. "Residence" generally refers only to the physical fact of living in a place. Some states tax according to domicile. Most states tax according to residence, which includes domicile in many state definitions. This in itself raises the possibility of double taxation. In addition, despite the long-established principle that an individual can have only one domicile, courts in different states might each find a person's domicile to be in that state, without violating any constitutional principle. For tax purposes, under our federal system, therefore, an individual may be held domiciled or resident in more than one state.

Principles of domicile. The principles of domicile established by the courts are fairly clear. At common law it was thought that a person

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[12] 307 U. S. 357 (1939). This doctrine was reasserted by companion case, *Graves v. Elliot*, 307 U. S. 383 (1939).

[13] 316 U. S. 174 (1942).

[14] A more recent decision, for example, *Greenough v. Tax Assessors*, 331 U. S. 486 (1947) granted the power of the state of residence of a trustee (Rhode Island) to tax the value of a trust apportioned to him, even though the trust was administered in another state (New York). This was permitted on the ground that the Rhode Island courts are open for suits by or against resident trustees.

could have only one domicile. It is usually his place of birth unless he subsequently changed his place of abode. Except in rare instances it requires "specific intent" to establish domicile in a given place[15] and the doing of some "overt act" toward establishing such domicile. But a person is not obliged to reside at such a domicile in order to keep it.[16] Once established, a domicile continues until it is actually abandoned or until a new one is acquired.

The problem of double domicile is at once usually a problem of both tax avoidance and of double taxation, for usually the taxpayer attempts to migrate away from a high death-tax state to a lower one, and then he may "get caught" in both. This occurs because he does not want to sever his connections with the old home state and yet he does make substantial new connections in the new state.

Leading case. One of the most noted of inheritance tax domicile cases was that of millionaire Dr. John T. Dorrance, sole owner of Campbell Soup Company's stock.[17] Before he died Dorrance moved from Camden, New Jersey, to Philadelphia, but he kept homes and various evidences of interest in both states. Both states claimed domicile and therefore the right to tax his intangibles in full.

The Pennsylvania Supreme Court asserted that "A man's home is where he makes it, not where he would like to have it," whereas 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." Both states taxed and collected. The U. S. Supreme Court refused to decide the issue and thus implied that the definition of domicile was for each state to determine. Except in rare instances, the Supreme Court in all of such domicile cases has steadfastly refused to take jurisdiction.[18] Multiple death taxation through multiple domicile is a strong possibility for the unwary.

CONCLUSIONS AND RECOMMENDATIONS

Since the federal courts feel constitutionally unjustified in denying reasonable claims for tax jurisdiction, the solution of interstate multiple burdens appears to reside largely in legislative chambers.

[15] In the case of the city of Washington, D. C., however, because of its unique characteristics, it was held that *lack of intent* to establish domicile elsewhere was sufficient to establish domicile in Washington. *District of Columbia v. Murphy*, 314 U. S. 441 (1941).

[16] *Gould v. Gould*, 235 N. Y. 14 (1923).

[17] *Dorrance v. Pa.*, 287 U. S. 660 (1932).

[18] In one case the Supreme Court did take jurisdiction because so many states made claims upon the property that if they all prevailed, there would not have been sufficient assets in the entire estate to pay all of the separate taxes. *Texas v. Florida*, 306 U. S. 398 (1939). However, in *Worcester County Trust Co. v. Riley*, 302 U. S. 292 (1937), it was asserted that "The Constitution does not forestall the possibility of conflict of decisions of the courts of the . . . states."

Already the states have taken some action, though limited in extent, by means of "reciprocal legislation." Many state death tax statutes have reciprocity clauses[19] in which one state agrees to refrain from taxing the transfer of property of residents of another state, if the other state returns the favor. Unfortunately, however, most states have more to gain from not letting their reciprocity agreements cut heavily into their tax bases. As recommended earlier, states can adopt "uniform residence" requirements. There has been suggested a federal constitutional amendment defining jurisdiction to tax.

The courts also still have remedial action within their power. By developing a "substantial benefit" theory of taxation under which states could claim tax jurisdiction only if the benefits received by the property were "substantial," many of the flimsy excuses for taxation would fall away. Court interpretation could determine what classes of benefits satisfy the test.

Problems of Evasion and Avoidance

THE DESIRE to escape death taxes has increased as the rates have steadily risen over the years. Both evasion by illegal methods and avoidance by slipping through the legal loopholes have riddled the state and federal death taxes into a sieve-like state. Only the unfortunate, the unwary, and the honest are caught by the remaining fabric, all to the detriment of fairness, morale, and revenue production. The never-ending race to plug up the areas of escape faster than others are found has left the revenue administrators still far behind.

CONCEALED TRANSFER PRIOR TO DEATH

The crudest method of escape from the death tax is to conceal the transfer of property from death tax administrators. Many types of personal property (such as cash, jewelry, family heirlooms, many other items of non-income-earning personal property, and unregistered bonds) may be transferred secretly. Good administration can and does find many techniques for checking such evasion.[20] The proportion of loss through this method is probably minor.

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[19] Shultz and Harriss, *American Public Finance*, p. 731.

[20] These techniques include access to income-tax records from which can be detected income-earning property transfers, access to safety deposit boxes after the renter's death, power of the administrator to place the executor of the estate or the relatives of the deceased under oath and to take testimony, and ability to require notice from insurance companies of all insurance payments. See Groves, *Financing Government*, p. 240.

TAX AVOIDANCE THROUGH VARIOUS TYPES OF GIFTS

Our federal estate tax was conceived primarily as a death tax—a tax upon the transfer of property from the dead to the living. In the original 1916 Act no attempt was made to tax gifts between living persons. With the overwhelming desire to escape death taxes, the solution looked simple: in anticipation of death, give away property either directly or in the form of trusts. In this manner the decedent's estate could be substantially reduced before death.

To meet this threat the federal legislature and courts not only applied a permanent gift tax in 1932, but they also developed a four-fold classification of gifts for purposes of distinguishing between those legally liable for the substantially lower gift tax rates and those which are essentially transfers at death and taxable as such.

Three types of gifts (in addition to transfers at death) are now taxable under the death tax. These are gifts made *in contemplation of death*, gifts *to take effect at death*, and gifts *causa mortis* (made from the death bed). Gifts *inter vivos* (between living persons) are subject only to the gift tax. The greatest administrative and judicial problems arise in connection with what gifts are actually made "in contemplation of death" or "to take effect in possession and enjoyment at or after death."

			Death	
Gifts inter vivos	Gifts in contemplation of death	Gifts to take effect at or after death	Gifts causa mortis	Transfers at death by will or inheritance
Subject to gift tax only	Subject to death taxes if estate cannot prove noncontemplation where gift was made within two years of death.	Subject to death taxes if proved to take effect at or after death	Clearly subject to death taxes	Clearly subject to death taxes.

FIGURE 16. *Types of Gifts and Transfers—Tax Consequences.*

Gifts in contemplation of death. It is quite natural for the elderly wealthy person, realizing his days are nearing an end, to attempt to distribute a large bulk of his estate before it becomes subject to the severe death tax rates. Foreseeing this method of escape (based upon previous state experience), the federal estate tax law in 1916 contained a provision taxing transfers made "in contemplation of death." Defining what constitutes "contemplation of death" has absorbed the ingenuity of the courts ever since.

Essentially there are a few basic criteria. A transfer made in contemplation of death is one prompted by the thought that the donor has

not long to live and one made in lieu of a testamentary disposition. It is more than just the general expectancy of death which is held by most people. The thought of death must be "the impelling force that causes the transfer." [21] Illness and pertinent remarks to friends give the strongest indications of this impelling force.

To avoid the death tax it is sufficient to prove that the motive for giving is essentially associated with life rather than death—for example, to see children enjoy property while the donor lives, to save income or personal property taxes, to make dependents financially independent, and the like. In one case, the policy of giving children stocks, bonds, and securities to help them learn to handle money was sufficient reason to disprove contemplation of death.[22]

"Conclusive" vs. "prima facie" presumption of contemplation. To prove contemplation of death is not an easy matter. Some states and the federal government at one time legislated *conclusive presumption* statutes. These laws stated that if property were given away by a donor within a specified number of years of his death,[23] there would be established a "conclusive" presumption that the gifts were made in contemplation of death and therefore would be taxable as death transfers. These statutes were challenged as being in violation of the "due process" clause of the Fourteenth Amendment on the theory that under a "conclusive presumption," the estate is given no opportunity to prove that the gift was in fact a legitimate lifetime transfer.

When the courts outlawed conclusive presumption statutes,[24] the state and federal governments turned to *prima facie presumption laws.* These statutes differed from the former in that they permitted recourse to the courts by the representatives of the decedent's estate to overthrow the legal "presumption" of contemplation of death at the time of the gift. In the great majority of cases at the federal level the representatives have been successful in defeating the Treasury's claims when they have challenged them. Most *prima facie presumption* statutes specify a period of one to three years before death within which the presumption applies. For federal estate tax purposes the *Revenue Act of 1950* provided a three-year period. The effect is that the presumption places the burden upon the estate of the decedent to prove non-contemplation. This is of some assistance to the taxing government.

Gifts to take effect at death. Each of the federal estate tax laws since 1916 and many state laws contain a provision taxing transfers "intended to take effect in possession or enjoyment at or after death." [25] These

[21] *United States v. Wells,* 283 U. S. 102 (1931).

[22] *United States v. Wells,* supra.

[23] Six years under a Wisconsin statute, two years for the federal government.

[24] *Schlesinger v. Wisconsin,* 270 U. S. 230 (1926). *Heiner v. Donnan,* 285 U. S. 312 (1932).

[25] *Internal Revenue Code,* Sec. 811 (c); cf. 1916 Act Sec. 202 (b).

provisions were made for the purpose of combating the use of *inter vivos* trusts as a means of avoiding estate and inheritance taxes.

A gift in trust is a device whereby a third party or "trustee" (corporate or individual) is vested with title to certain property which he manages for the benefit of a second party, the "beneficiary." The "settlor" or "trustor" is the person who creates the trust by donating the property. In an *inter vivos* trust the settlor surrenders legal title to the property during his lifetime.

By means of the gift in trust an estate owner can often "eat his cake and have it too." He can convey away legal title to his property during life; but instead of giving up all control over the property, he can reserve to himself certain rights and enjoyments which will not be cut off until his death. Under technical property law (since legal title to such property had already passed during life), nothing is transferred at death that would be subject to an estate tax.

After a period of judicial fluctuation, the courts and the federal and state legislatures greatly reduced death tax avoidance through this means. It is now usually held that if an estate owner clings to some "incidents of ownership," even if the legal title has already passed, the trust corpus is still taxable at his death. These incidents of ownership include the right of the settlor to revoke the trust, the ability to change the beneficiary either alone or in conjunction with others,[26] the reservation of the right to "general" income or benefit of the property,[27] or the possibility of reversion of the property to the settlor.[28] If gifts with the reservation of different types of incidents of ownership were not taxed under the estate tax, the effectiveness of that tax would be seriously impaired.

THE LIFE-ESTATE-REMAINDER AND TAX AVOIDANCE

Another death tax avoidance device which makes it possible to skip death taxes on some transfers after death is the life-estate-remainder sequence. Usually at death the testator grants a life estate to one person and a remainder interest to another. This can be represented by *A* to *B* for life, remainder to *C*.

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[26] Provided for by the 1926 federal act, tested and defined by *Reinecke v. Northern Trust Co.*, 278 U. S. 339 (1929); *Helvering v. City Bank Farmers Trust Co.*, 296 U. S. 85 (1935).

[27] *Joint Resolution of Congress*, March 3, 1931, and *Revenue Act of 1932*, Sec. 803(a); *Helvering v. Bullard*, 303 U. S. 297 (1938).

[28] After some vacillation on the part of the Supreme Court in the 1930's, the Supreme Court without legislative action plugged the reversionary interest. *Helvering v. Hallock*, 309 U. S. 106 (1940); *Fidelity-Philadelphia Trust Co. v. Rothensies*, 324 U. S. 108 (1945). The courts have held that the entire grant must be included in the estate for tax purposes, no matter how remote the possibility of the reversion. To some this seems a bit harsh. As previously indicated, this harshness has been alleviated by Congress under the *Technical Changes Act of 1949*.

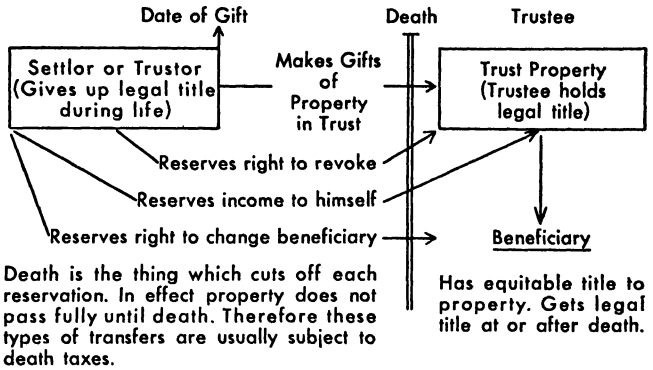


FIGURE 17. *Gifts in Trust to Take Effect at or after Death.*

Under this arrangement *B* has the use, enjoyment and income from the property during his life only. On *B*'s death the property passes in use and enjoyment to C who has had the legal right to it since *A*'s death. The legal theory is that this is all "one transfer" that took place at *A*'s death. Therefore only one death tax is due—that is, at *A*'s death. When the property passes to C no inheritance tax need be paid. This is true under both the federal estate tax and state inheritance taxes.

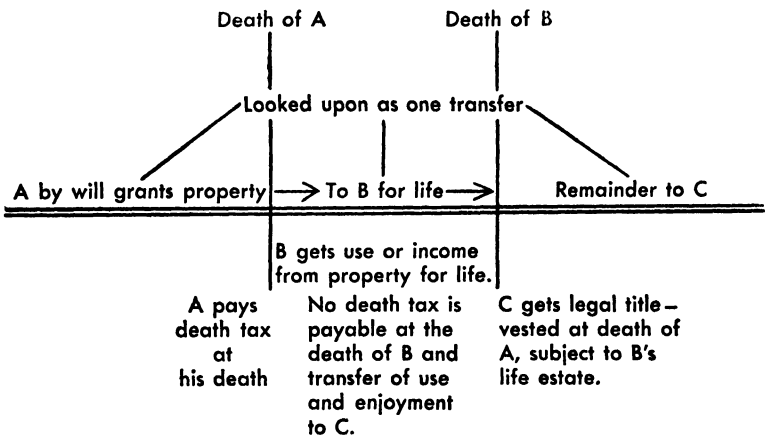


FIGURE 18. *Tax Avoidance by Life-Estate-Remainder Sequence.*

The life-estate-remainder sequence can be made to skip several death taxes by the interposition of several life estates, such as from husband to wife for life, to a son for life, remainder to a grandchild. Under both state and federal statutes there are limitations as to how far this may be carried. They usually require that the title to the property must "vest" within lives in being, plus twenty-one years, plus a period of gestation. Nevertheless, the life-estate-remainder is an efficient tax

avoidance instrument that is used almost universally by all large estate owners. In England the transfer from the life tenant to the remainderman has been taxed for some time.

POWERS OF APPOINTMENT AND TAX AVOIDANCE

The life-estate remainder becomes an even more efficient tax avoidance instrument when combined with the power of appointment. Under a power of appointment the life tenant is given the power by the decedent to designate who shall take the property after the cessation of the life-estate. It can be expressed as from *A* to *B* for life with power to appoint who shall take at *B*'s death. Some powers are general powers of appointment. This means that the life tenant can pass the property on to anyone of his own choosing. Some are special powers. This means that the property can be designated only to a particular "class" specified by the original testator. The general theory here is that the *donee of the power* (usually the life tenant) is really carrying out the will of the original decedent and that, therefore, there was but one transfer. General powers have usually been taxable, whereas special ones have not.

The power of appointment can be made more effective by granting the power to "delegate" the power to appoint once or even several times; thus several transfers beyond the first life tenant may avoid taxation.

Federal and some state laws have limited the use of powers of appointment, however. Since 1942 the federal government has provided for the taxation of property passing under all general and special powers of appointment, except where the holder of the power has no beneficial interest in the property subject to the power, or where the power to appoint is limited to a restricted class (usually close relatives). This class still includes a large fraction of those for whose benefit powers are normally granted. Since 1942 if the power to appoint is exercised by the creation of another power to appoint, the first exercised power does not qualify as one of the powers exempted from taxation.[29]

The result is that under federal law it is no longer possible to "delegate" a power without being subjected to taxation.

CHARITABLE TRUSTS AND FOUNDATIONS

Congress and most state legislatures have granted complete exemption from death taxes for all grants to charitable, educational, scientific, and religious institutions. This is justified on the theory that if these services are not rendered by privately-endowed agencies, they will have to be performed and paid for by government. In practice such donations

[29] *Internal Revenue Code*, Sec. 811 (f).

(by avoiding the high death tax rates) frequently cost the government much more in revenue than they cost the individual. (In effect it is the government that is making the donation. That in itself may be laudable and desirable where the true intent of the exemption is carried out.)

However, what happens in the case of many large estates is that the decedent makes provision in his will for setting up large charitable trusts or foundations in his own name and memory. Very often a large fraction of the total estate is devoted to such purposes entirely free of death taxes. Then large and beautiful office buildings are set up to house the foundation and honor the memory of the donor. Very often the costs of the administration of these trusts run quite high in proportion to the exempt service rendered. In addition, the dead hand of the testator, his family, his attorneys, and friends are permitted to "control" large bodies of wealth without regard for tax responsibilities for generations into the future. The element of "control" in modern economic life is often of greater strategic value than bare legal title. In effect a closely-held trust results in the transmission of property from the dead to the living. There is some question as to whether the intervening entity of the trust alters this basic effect.

The conclusion to be drawn from all this is that the whole question of tax exemption to charitable trusts and foundations should be reexamined. Where serious abuse exists, it should be corrected. Where legitimate performance of social service exists, it should be encouraged. Since "control" is highly significant, it may be suggested that the full charitable exemption be granted only where the charitable donation is made to an independent exempt agency free from the control of the decedent's family. Another approach would be to place some reasonable limitation upon the proportion of large estates which may be exempt from taxation as charitable distributions. Some readjustments are clearly in order so that we might promote more effectively the true intent of the charitable exemption.

Miscellaneous Death Tax Problems

THE COMPLEX CHARACTER OF DEATH TAXES

A number of other problems present themselves in the death tax field. One of them is the complex character of this form of taxation. Part of this complexity is due to the character of the subject matter involved. There has come down to us from the common law a whole array of property interests and modes of conveyancing. Under the estate tax it is significant to determine what types of interest the decedent "held" at death, and under succession taxes what types of interest the heir or

distributee "received." Depending upon the interest held or received, the death tax liability will vary. Some simplification of these property interests would reduce materially the complex character of death taxes.

Some of the complexities, on the other hand, arise out of the structure of the federal estate tax. At present that tax is divided into two parts: the "basic estate tax" and the "additional estate tax." Each has its separate system of rates and exemptions. The 80 per cent federal credit is allowed under the basic tax, but not under the additional tax. Here a unified, single-structure estate tax (with the federal credit adjusted to that structure) would add to simplification and remove the need for "double calculation" in estate tax reporting. Further to complicate the matter is the federal gift tax with its conflict and possible overlapping in relation to the estate tax. Again, the concept of integration to be discussed in a later section will contribute to greater simplicity. At the state level the structures of the "inheritance" taxes present comparable complexities.

INTERNATIONAL MULTIPLE TAXATION

Another set of death tax problems arises at the international level. Many American citizens live, accumulate property, and die in foreign countries. The citizens of foreign countries have the same experience in the United States. This set of circumstances gives rise to problems of jurisdiction to tax and the possibilities of heavy multiple taxation. In recent years the United States has entered into tax conventions (treaties) with Great Britain, Canada, and several other countries for the purpose of working out reciprocal arrangements to minimize this form of multiple taxation.[30]

The Need for the Integration of Gift and Death Taxes

WITH THE POSSIBLE EXCEPTION of the property tax on intangibles, no tax in our entire tax system has been so effectively avoided as the federal estate tax. At present the major defect in taxing transfers of wealth lies in the use of two separate taxes, and the estate owner is free to use either or both according to his particular advantage. The tax base is thus divided. It is possible for him to make use of the exemptions and lower bracket rates of both, thereby escaping the upper brackets of either. Inequities arise under this system because not all estate owners have the same chance to capitalize on avoidance techniques. A good deal depends upon the competence of legal advice, the current need

[30] Max Wasserman, "International Co-operation in Taxation Advances," *Foreign Commerce Weekly*, Vol. 34, March 28, 1949, pp. 7-9, 41-42.

for investment capital, sudden and unexpected death, and other factors.

Congress and our state legislatures must come to the realization there is not anything basically different between gifts *inter vivos* and grants at death. It is largely a matter of form and timing. The economic consequences are much the same for the decedent's estate as well as for the gift or inheritance recipient. Once the basic similarity between the two types of transfers is recognized, it must necessarily follow that they ought to be treated the same for tax purposes.

INTEGRATION OF GIFT AND DEATH TAXES

To overcome the various shortcomings of the present dual system and to make the incidence of transfer taxes more equitable as to various taxpayers, it has been recommended that gift and estate taxes be integrated into a single transfer tax system.[31] Such a system can be generalized as follows: (1) the integrated tax base would be a single, unified tax base made up of all lifetime and death transfers, cumulated over the life of the donor; (2) it would utilize a single set of exemptions for both types of grants; and (3) it would operate under one structure of rates adjusted progressively to the "cumulated tax base" as successive gifts were granted and the death transfers made. Each additional transfer would be taxed at the rate for the bracket in the cumulated base into which the transfer fell.

ADVANTAGES OF INTEGRATION

Integration would involve a fundamental reorganization of estate and gift taxes on a more scientific basis. Such an overhauling would give a basic unity of philosophy and treatment to both types of transfers. It would materially close the gaping loopholes associated with gifts in contemplation of death and gifts to take effect at or after death. It would do away with the problem of determining whether the transfer should be taxed as a gift or a death transfer. It would make more uniform and equitable the taxation of many transfers, regardless of legal advice, or suddenness of death. It would make for greater certainty of tax consequences, and the task of passing on property would become more straightforward. Finally, of course, the volume of revenue from these taxes would increase substantially and thus in some measure forestall the use of less equitable and economically less desirable forms of taxation.

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[31] George T. Altman, "Integration of Estate and Gift Taxes," *Law and Contemporary Problems*, Duke University, Vol. 7, Spring 1940; Groves, *Postwar Taxation and Economic Progress*, pp. 278-280; C. Lowell Harriss, *Gift Taxation in the United States*, American Council on Public Affairs, Washington, D. C., 1940; and Advisory Committee to the U. S. Treasury, *Federal Estate and Gift Taxes: A Proposal for Integration and for Consolidation with the Income Tax*, Washington, D. C., 1947.

Conclusions

THE PROBLEMS in inheritance and gift taxation are numerous and often technical. The leading problem at both state and federal levels is that of tax avoidance. At both levels administration could be improved. Problems of valuation loom quite significant. Those of fairness and equity are not absent. Many others are present.

A number of suggestions for reform may be reviewed and a few additional ones stated.

1. At the state level it would be well if more states would supplement their inheritance taxes with gift taxes. At present less than a third of the states have such taxes. Perhaps the extension of a "federal credit" for state gift taxes paid would encourage such a trend.

2. In order to improve the workability of death taxes as between the federal government and the states, the "federal credit" for state inheritance taxes paid should be granted as a fair percentage of "current" federal estate tax liabilities rather than based upon the 1926 law.

3. It is fundamentally urgent that the estate and gift taxes be "integrated" into one unified tax operated under a single tax base, one set of exemptions, and one schedule of rates. Once these taxes have been reorganized and integrated, the exemptions and rates should be stabilized at the adopted levels for a reasonable period into the future.

4. Specific effort must be made to plug those notorious loopholes that are associated with the "casuistries" of the fine art of property conveyancing—namely, those based upon the use of life-estate-remainders, trusts, and powers of appointment. Every transfer of the beneficial enjoyment of property from life tenant to life tenant and ultimately to remainder-man (whether directly, by the use of a trust, or the exercise of a power of appointment) should be subject to the integrated tax.

5. Some reasonable limit should be put upon the proportion of the large estates which may be donated to various recognized charitable purposes free of transfer taxes.

6. The possibility of including "time" between successive transfers of the "same property" in estates as one of the dimensions in the administration of the integrated tax should be explored and a scientific adjustment adopted.

7. Federal gift and estate taxes should be made just as equitable in their impact and operation as is reasonably possible. This applies to means of payment, the period over which payment may be made, the recognition of the life-partnership, and the treatment of the estates of those killed in the service of their country.

Part Five

THE TAXATION OF BUSINESS

XVI. THE ECONOMICS OF BUSINESS TAXATION

XVII. THE TAXATION OF BUSINESS GENERALLY

XVIII. THE TAXATION OF CORPORATIONS

XIX. THE TAXATION OF SPECIAL BUSINESS

• *1. Public Utilities, 2. Airlines, 3. Cooperatives*

XX. THE TAXATION OF SPECIAL BUSINESS

• *4. Banks, 5. Insurance Companies, 6. Chain Stores*

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The Economics of Business Taxation

OUR SO-CALLED *business taxes are levied in confusion with one pretext or another and with vague references to ability to pay and to benefits. We have no clear-cut conception of what business is or why and how it should be taxed.*

—ALFRED G. BUEHLER.[1]

Overview

THE TAXATION OF BUSINESS and business privilege by the state governments had its beginnings in the early 1800's. But business taxation as a source of federal peacetime revenue began with the federal corporation excise tax of 1909. During World War I the federal government relied heavily on business taxation and has done so in good measure ever since. In recent years the heaviest business tax burdens have been imposed by the federal government.

Business activity and business privilege are a favored basis for taxation for a number of reasons. Business taxes have the support of people and the approval of the courts. They are general, indirect taxes and their incidence is not very clear. Furthermore, business does derive a good deal of benefit from government, and business—especially big business—makes it necessary to incur costs for control and regulatory purposes. Finally, business taxes are easy to collect and are highly productive of revenue.

In the United States neither the federal government nor any of the states have found it advisable to develop an all-inclusive business tax—a tax applying to all incorporated and unincorporated enterprise. The result has been that in our country business taxes as such apply very largely to incorporated business. This chapter investigates a number of topics:

[1] Alfred G. Buehler, "The Taxation of Business," *The Bulletin*, National Tax Association, Vol. 30, December 1944, p. 85.

(1) The revenue importance of business taxation. (2) The nature of business taxation or what is business taxation? (3) The theory of business taxation or why should business be taxed? (4) The forms of business taxation or how should business be taxed? (5) The shifting and incidence of business taxes or does business as such really pay the tax? (6) Business taxation and fiscal policy.

The Fiscal Significance of Business Taxation

TAXES HAVE BEEN IMPOSED on business primarily because of fiscal and social expediency. Business as such has the ability to meet tax bills, and it is a readily accessible source of revenue. The fact that many of the taxes levied on business are shifted to the consumer is not very widely recognized, and it is felt that business can and must share in the over-all tax burden. The result has been a very marked expansion of business taxation since about 1910.

Revenue importance of federal business taxes. Business taxes now comprise a substantial percentage of total tax receipts both on the state and federal levels. In 1948, of the $44 billion in federal taxes collected, the general corporation, payroll and special business taxes amounted to $12.4 billion, or somewhat more than 28 per cent of total federal revenues. The absolute amount of federal business taxes as well as the proportion in 1945 was substantially larger. In that fiscal year about $16.5 billion out of $44 billion came from the corporate net income, excess profits, and capital stock taxes—in other words, well over a third of all federal taxes were derived from recognized business tax sources. With the recent increase in corporate net income and excess profits taxes both the volume and proportions of federal business taxes will be upward during the 1950's.

Revenue importance of state business taxes. The states also tap substantial revenues from business as such. The business tax revenue at this level comes largely from corporation income taxes, bank, chain store, franchise, license, stock transfer, insurance company, and utility taxes. In 1947 about $1.68 billion was derived from the above types of state business taxes. This represented about 23 per cent of total state revenues. If certain other types of taxes (many of which are shifted to consumers) on other business acts or transactions (excise, payroll, sales, gasoline, etc.) were included in the above figures, the proportion of business taxes to total tax collections would be substantially larger.

The conclusion to be drawn is that a larger proportion of both federal and state taxes are being drawn from business tax sources than formerly. At the federal level that proportion has run from a quarter to a third,

whereas at the state levels it has been somewhat less than a third during recent years. Among local governments business taxes are usually relatively minor in amount. Even here, as the city governments have become hard-pressed for revenue, they also have placed more emphasis upon license, franchise, and occupation taxes.

The Nature of Business Taxation

SOME AUTHORITIES claim that there are four legs to the tax stool (four major bases upon which taxes can be levied): (1) property, (2) income, (3) consumption, and (4) business. It could be argued that all taxes are *business* taxes in that all taxes must ultimately be paid out of the proceeds of economic activity (business) of some kind. However, in fiscal science as well as in common parlance business taxation has come to have a more restricted meaning—the taxation of "business as such." It is with this interpretation of business taxation that the next five chapters deal.

Nevertheless, the problem of the definition of business taxation is not solved by the use of the mere phrase "business as such." The problem is really a two-fold one: first, of defining "business," and second, of determining what taxes are business taxes.

WHAT IS A BUSINESS?

A multiplicity of definitions of business are available, and these range from the dictionary definition of "mercantile pursuits or transactions" to the legal interpretation of the Supreme Court of the United States and its statement that "business embraces everything about which a person can be employed, or that which occupies the time, attention and labor of men for the purpose of a livelihood or profits." Neither of these definitions will serve for the practical purposes of taxation.

Several characteristics of modern business stand out. Business usually involves the use of "several factors" of production (as distinguished from the mere rendition of personal services for an agreed compensation). It generally entails the use of a substantial element of capital. Business is usually done under some form of economic structure or entity. Other distinguishing characteristics are risk-taking, the uncertainty of the return, and the profit-seeking motive. Even with these characteristics in mind, it is not easy to identify business as such for tax purposes.

WHAT IS BUSINESS TAXATION?

The controversial question is raised as to just what constitutes business taxation? The above analysis would imply that business taxes are those taxes imposed upon and paid by various types of *profit-seeking* enter-

prises. Two problems complicate the case. First, in addition to its profit-seeking characteristic, a modern business is also a social unit as well as a legal entity under the law. As an impersonal entity, business is obliged to bear general taxes along with other social units: it pays property taxes on the property it owns, and it must pay general sales taxes when it consumes taxable commodities. These taxes and their variants are often confused with business taxes and thus obscure the essence of business taxes as such. Second, certain taxes are imposed upon business enterprise which are shifted forward to the consumers or backward to the factors of production. These sales taxes are still generally classified as business taxes, although it would be more logical to call them consumption taxes. Business pays many taxes along with other taxpayers.

In our discussion of business taxation we shall be concerned with those taxes which are peculiar to business as such. These taxes are usually levied upon business *entities*, *acts*, *privileges*, or *profits*. They usually take the form of "special taxes" on "business in general," such as business income taxes, capital stock taxes, excess profits taxes, franchise taxes, and occupation taxes. They also include "special taxes" on "special types of businesses" such as chain store, insurance company, bank, public utility, and co-operative taxes.

The Theory of Business Taxation

WHY SHOULD BUSINESS BE TAXED?

Modern business enterprise to a large extent is no longer the personal venture of the individual producer and inseparable from his personality; it is a complex organization or group venture having an organic unity and collective personality of its own. Nearly all production is carried on through the instrumentality of business enterprises which are the basic productive units of the modern capitalistic economy, and their operation is impossible without the active co-operation of the government.[2]

The imposition of taxes on business enterprises as such—that is, separately from the taxes levied on property, personal income, and consumption—can be justified on one or several of the following grounds: (1) the over-all services the state renders to all business; (2) the special privileges and services the state renders to many businesses; (3) the social costs accruing from some business operations; (4) the impersonal taxpaying capacity held by business entities; (5) social expediency; and (6) the possibility of social control of the abuses of business by taxation.

[2] Paul Studenski, "Toward a Theory of Business Taxation," *Journal of Political Economy*, Vol. 48, October 1940, p. 621.

GENERAL BENEFIT THEORY

The oldest theory used to justify business taxation is the general benefit or protection theory. It states that the government maintains law and order and provides such services as maintaining a stable currency, constructing and maintaining highways, providing a public educational system, and in general creating a favorable milieu for business. Critics of this theory argue that government does not exist primarily for the benefit of business, but for the benefit of all society; they maintain that it is nearly impossible to allocate the burden of general government expenditure. An extension of this theory is sometimes called the state-partnership theory.[3] This theory was initiated by Thomas Adams in 1917, and it has been elaborated upon by his modern supporter, Professor Paul Studenski. Thomas Adams asserted:

> The State and the community stand as silent partners in every business enterprise. From political and moral standpoints the justification for this class of tax is plain. A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment. New business creates new tasks, entails further public expenditures. In the long run, the more business the greater will be certain fundamental costs of government. From this point of view, all services rendered by government are looked upon as factors of production.[4]

SPECIAL BENEFIT THEORY

The special benefit theory holds that government confers special benefits to certain businesses and that the latter should pay for them in proportion to the benefit received through special taxation. These special privileges or benefits include: (1) the privilege of conducting business under the corporate form; (2) the privilege granted to public utilities to operate on public domain; (3) the privilege of conducting special types of business in which the public possesses a special concern for quality of performance; and (4) special protection of various sorts.[5]

The critics of this theory state that many of these privileges such as that of incorporation are open to all. They maintain that fees are charged for the privilege of incorporation, and the franchise to operate on the public domain as a monopoly is frequently paid for.

SPECIAL AND SOCIAL COST THEORIES

The cost approach as a justification of business taxation is divided into two kinds of costs: special and social costs. Some businesses demand public services which directly increase public expenditures. These can

[3] *Ibid.*

[4] *Proceedings*, National Taxation Association, 1917, p. 187.

[5] Philip Taylor, *The Economics of Public Finance.* New York: The Macmillan Co., 1948, p. 524.

be labeled "special costs." They can be used to compute the benefit received because: (1) they are easily ascertainable, and (2) they are based on the principle of transaction.

The social cost approach maintains that society is adversely affected by business activity in different ways (such as damage caused by air and water pollution, casualties of industrial accidents, waste of natural resources which includes the waste of human resources through technological or cyclical unemployment). These costs often indirectly affect public expenditure, but the contribution of this approach is that it opens a new line from the social point of view and subsequently widens the field of the benefit theory.

ABILITY-TO-PAY THEORY

The ability-to-pay justification for business taxation states that business enterprise, like individuals, should contribute to the government its share based on its faculty or ability to pay taxes. It maintains that the business entity exists and functions more than as an artificial person; it functions as an economic entity which possesses an ability to pay taxes separate from that of the owners. The controversy over this theory is centered in two main questions: (1) Does the business entity as such possess an independent ability-to-pay? (2) How can the ability be measured when the different profit levels, different amounts of capital invested, and different degrees of risk involved in various businesses are considered?

Critics of the theory believe that the faculty theory is applicable only to individuals. The owners of the businesses have an ultimate right to the assets and earnings. The business entity exists only in contemplation of the law. The entity exists only on paper under a charter. Things do not pay taxes. Since taxes must ultimately be paid by persons, it is more logical to levy taxes on persons directly than indirectly through businesses.

In answer to the second question, they maintain that taxing two firms with the same net income under a progressive tax can result in gross inequities depending upon *how the ownership of the stock* is distributed and *how much capital* is invested in each business unit.

SOCIAL EXPEDIENCY THEORY

Another practical argument in favor of business taxes is that they can be made to yield substantial revenue. This was demonstrated near the end of World War II when the federal government raised about one-third of its total revenues from business tax sources. From the administrative point of view it is easier to deal with a relatively small number of business firms than with millions of individual taxpayers. Furthermore, the unit costs of collecting the corporate net income tax, for

instance, run lower than gleaning a similar volume of revenue from natural persons. Business taxes work satisfactorily and bring in revenue in good volume.

CONTROL OR REGULATION THEORY

It has been argued that taxation should be utilized as an effective weapon to restrict the concentration and abuse of economic power. Some economists feel that taxation can serve as an auxiliary to direct controls in dealing with monopoly. Taxation draws off some of the funds that could be used for the extension of monopoly power, the stifling of competition, and legislative lobbying. Among other types of restrictive regulation that can be affected by taxation are the reduction of bigness, the limitation of profits, and the restriction of competition. But not all of the regulatory purposes of taxation are restrictive in character. Many nonfiscal purposes are stimulative and promotional. They can be used to encourage new and small business, to stimulate competition, to influence innovation, to encourage risk-taking and to promote co-operatives.

The opponents of the control theory of business taxation argue that taxation is a rather blunt and uncertain instrument of control that might do more harm than good by cutting into efficiency profits, by interfering with the incentives to risk and invest, and by affecting the ability of small and new firms to grow and expand.

The above are some of the major theories upon which the taxation of business as such can be based. All of these theories appear from time to time both in the fiscal literature and in legislative halls as arguments in favor of business taxation.

The Various Methods of Business Taxation

THE CONFUSION IN BUSINESS TAXATION

Business taxation in this country (especially at the state level) is a hodgepodge of hit-and-miss taxes levied on a large number of different bases under all kinds of rate schedules. These taxes are grossly lacking in scientific qualities and therefore are arbitrary and often inequitable. They exist in large numbers and lack co-ordination.[6] Some of them are relatively poor revenue raisers, and often their cost of collection and cost of compliance run high. Many of them are nuisances that add to the cost of doing business, and many business taxes are ultimately

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[6] Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy*. New York: W. W. Norton & Co., 1944, pp. 44-45.

either shifted forward to the consumers or backward to the factors of production. In some instances there is no valid tax theory back of them, except that they bring in some needed revenue.

A REVIEW OF BUSINESS TAX METHODS

Federal business tax bases. The business tax structure of the federal government has always been relatively simple. It began with the corporate excise tax (measured by net income) in 1909 and carried on as a corporate net income tax after 1913. For a short period (1936-39) a full-fledged undistributed profits tax was levied. The federal business tax structure probably reached the height of its complexity during World War II when it consisted of the corporate net income tax, an excess profits tax, and a capital-stock, declared-value excess profits tax. From 1946 to 1950 the mainstays in the federal business tax system have been the corporate net income tax and the payroll taxes; the excess profits and capital stock tax were repealed as of December 31, 1945. The Korean War, however, prompted Congress to re-introduce an excess profits tax into the federal tax structure.

A few minor business taxes supplement the corporate net income tax. Among these are the personal holding company tax, the tax on the undue accumulation of corporate profits, the tax on intercorporate dividends, and a special tax on consolidated returns by members of holding company groups. At the federal level, then, the more important business *tax bases* have been (1) corporate net income, (2) corporate excess profits, (3) capital stock, (4) undistributed profits, and (5) payrolls. These tax bases were taxed largely to the corporate form of doing business. It should be mentioned that certain schedules of the personal income tax apply to individual and partnership business income.

State business tax bases. Far more heterogeneous and complex are the business tax structures of the various states. Among the types of things which have served as tax bases for the states are corporate net income, unincorporated business net income, gross income, capital stock, franchises, privileges, occupations, and special types of business. Under franchise, privilege, and occupational taxes there have been worked out many different bases and measures for their application. Often these taxes are unscientific and arbitrary in their make-up. Some of them are based upon some rough measure of the volume of business done, but most of them are adjusted to no reasonable tax or economic principle at all.[7] It must be noted that at the state level some of the privilege, license, and occupational taxes apply to both incorporated and unincorporated business.

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[7] Roscoe Arant, "Business Taxation in the South," *Taxes, The Tax Magazine,* Vol. 16, July 1938, p. 463.

Shifting and Incidence in Business Taxation

THE SIGNIFICANCE OF INCIDENCE

The question of tax incidence is of particular significance in business taxation, because unless the tax remains where it is intended, it fails as a business tax. If it is shifted forward, it becomes a tax on consumers; if it is shifted backward, it becomes one on the factors of production. Furthermore, the social and economic effects of the tax become different from the effects intended. In any analysis of the shifting of business taxes, it is necessary to distinguish between those upon net income and gross income as well as those which are looked upon as a cost of doing business.

THE NEOCLASSICAL THEORY OF BUSINESS TAX SHIFTING

Incidence of gross income and cost taxes. Taxes upon gross receipts or income are in effect taxes of a certain sum per unit of output. They will be an addition to average variable cost and to marginal cost and will thereby occasion a change in output to the point where the new marginal cost (including tax) and marginal revenue are again equal. Clearly under monopoly such taxes will be shifted. Under conditions of pure competition gross income taxes will also be shifted, because they are universal and uniform in their impact—that is, they strike all producers, including the marginal ones. Under traditional theory in the long run *marginal producers* will drop out, *supply* will decrease, and the *remaining producers* can raise the price.

Another group of taxes (some of them such lump-sum taxes as license, privilege, and franchise taxes) is usually looked upon as additions to cost of production. They are an addition to fixed costs in that they remain constant regardless of the volume of output. In other words, they do not affect variable or marginal costs. Under monopoly such taxes will be absorbed by the monopolist (if he is already charging the full monopoly price). Under conditions of pure competition (where the individual producer cannot adjust output and price to suit himself) these lump-sum taxes affect the average total unit costs of all producers—low cost and marginal producers alike. Again according to traditional theory such taxes, if they are substantial enough, would be shifted in the long run through higher prices for a reduced supply.

Incidence of business net income taxes. More significant and relevant in the business tax picture is the incidence of the corporate net income tax. This is true because it is used by the federal government and a goodly number of the states; the revenues collected under it are sub-

stantial, and the corporation is the leading form of business structure in our economy.

Under the traditional theory it has been held that a corporate net income tax is not easily shifted either by competitive business or monopoly. Under competition a net income tax does not affect marginal producers (nor the marginal capacity of the low-cost producers). They have no net profits and therefore are not subject to the tax. Their costs are not affected nor are they forced out of business by such a tax. The conclusion is drawn that the incidence of the tax falls upon the stockholders of the firms which show a net profit.[8]

In the monopoly situation neo-classical shifting analysis maintained that a corporate net income tax could not be shifted either, but for different reasons. It assumed, of course, that the monopolist had already set his output and price at the point which would yield the maximum total net revenue. There is no other point that will yield as large a net revenue. It is, therefore, to his advantage to pay the income tax on that revenue, for he will still come out (after tax) better off than under any other set of conditions. The tax will be borne by the owners of the business rather than affect the price paid by the consumers.

The above views were sustained in an empirical way by a study made by the National Industrial Conference Board in the late 1920's. That report concluded that the nature of the tax, the theory of market prices, an analysis of corporate costs and profits, together with the opinions and practices of businessmen indicated that the corporate net income tax is not shifted, except in special circumstances.[9] An investigation of a similar character in England at about the same time drew similar inferences about the British income tax.[10]

RECENT BUSINESS INCOME TAX SHIFTING THEORY

Old theory reappraised. Since the 1930's the old prevailing theory has been subjected to reappraisal—even as it applied to the corporate net income tax. The old theory, it is argued, presents an oversimplified interpretation of the method by which prices are determined. It placed too much emphasis upon the significance of the costs of the marginal firm.[11] Even Alfred Marshall in the first quarter of the twentieth century recognized the strategic importance of the costs of the "rep-

[8] Edwin R. A. Seligman, *The Shifting and Incidence of Taxation* (5th ed.). New York: The Macmillan Co., 1927, pp. 358-363.

[9] National Industrial Conference Board, *The Shifting and Effects of the Federal Corporation Income Tax*, Vol. 1, 1928, p. 157.

[10] *Report of the Commitee on National Debt and Taxation*, "Incidence of the Income Tax," memorandum by W. H. Coates, H. M. Stationery Office, London, 1927, App. 11.

[11] Lewis H. Kimmel, *Taxes and Economic Incentives*. Washington, D. C.: Brookings Institution, 1950, p. 21.

resentative firm" in price determination. Another criticism is directed against the traditional theory. It is that the assumption of pure competition is unrealistic as applied to present markets. Many segments of the economy are dominated by various degrees of monopoly and monopolistic competition, and many prices are controlled and administered.

New theory set forth. Since the 1930's some students of the subject maintain that a corporate net income tax can be reflected in price and thus passed on to consumers. They hold that in some manufacturing industries prices are administered. Prices are determined in advance and are adhered to for sustained periods, depending upon changes in costs, demand, and competition.[12] In setting the prices to be charged, all costs at varying levels of output and estimates of probable demand are considered. One of the basic costs to which corporate management gives due consideration is a fair return on the equity capital employed in the business. The managers know that they have a responsibility to the stockholders, and they also keep in mind the need for equity capital in the future. This equity capital they may have to procure from the market. In order to produce such a return, the income taxes applicable to the profits of the firm must be considered. The fair rate of return sought must be "after taxes." If the management of a given concern considers 6 per cent after all costs and taxes as reasonable, and if a 30 per cent corporate net income tax is imposed, the management in making its profit plans would have to set the rate of profits "before taxes" high enough to cover the taxes and still leave the desired return. In the given case the rate "before taxes" would have to be set at 8.9 per cent.[13]

The proponents of this theory do not claim that a corporate income tax can always be shifted. They recognize that a number of factors enter into the feasibility of raising prices in order to retain a given rate of return "after taxes." As is to be expected, the character of the demand for the company's products is a relevant factor (the more elastic that demand, the greater the resistance to shifting).

Another relevant factor is the ratio of sales to taxable income. The more rapid the turnover of the equity capital used, the smaller the price increase necessary to cover the tax.[14] If the demand is highly elastic, then this ratio becomes meaningful because the higher the ratio of sales to taxable income, the smaller the price increase necessary to cover the tax and the greater the possibility of shifting.[15]

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

[13] The rate is derived by dividing 6 by 0.7 (1-0.30). For a realistic treatment of this new shifting theory see Lewis H. Kimmel, *op. cit.*, pp. 23-31.

[14] Carl Shoup, "Incidence of the Corporation Income Tax: Capital Structure and Turnover Rates," *National Tax Journal*, Vol. 1, March, 1948, p. 15.

[15] Kimmel, *op. cit.*, p. 25.

The character of the company's capital structure also has some bearing on whether the corporate income tax is recouped by a price increase. Generally, the higher the ratio of preferred stock dividends to profits, the greater is the need to attempt to shift a given tax increase.[16] This is because the obligation to pay dividends on preferred stock is a quasi-fixed obligation which must be met first. Any increase in taxes, therefore, will be paid out of funds available for common stockholders. This in turn will reduce the rate of return on equity capital. If a given rate of return is desired, prices may have to be increased to maintain such a rate.

Business opinion on shifting. Corporate managers today admit with greater frequency that the corporate income tax influences their pricing policies. In the first Industrial Conference Board survey on the subject, 22 per cent of the corporations answering the questionnaire believed that the tax was registered in prices to some degree.[17]

A second survey conducted in the latter part of 1941 showed some increase in the percentage of companies which believed the corporate income tax consciously affected price policy. Of the 220 corporations returning answers, 26 per cent held in the affirmative.[18]

A more recent study by the Brookings Institution in 1948 produced more conclusive evidence that the corporate income tax does influence pricing policies. Of the 209 firms responding, 125 or about 60 per cent replied in the affirmative.[19] This was at a time when the rate was relatively high—38 per cent, and during a period which could be characterized as a sellers' market.

CONCLUSIONS ON CORPORATE INCOME TAX SHIFTING

The theory of corporate income tax shifting is now quite unsettled. The traditional theory still has some validity and support, whereas the newer theory has not been firmly proved or established. The newer theory seems more realistic and is being strengthened by recent experience. Whether or not the corporate net income tax is shifted depends upon whether a firm is already maximizing its profits, whether it can and does "administer" its prices under conditions of monopoly or monopolistic competition, and whether it is in the market for new equity capital. Since 1940 tax and price experience seems to indicate that a larger proportion of the total corporate income taxes has been recaptured through higher prices than in the "roaring twenties" or the "depressed thirties." Very little business income tax shifting takes place in the

[16] *Ibid.*

[17] National Industrial Conference Board, *The Shifting and Effects of the Corporation Income Tax*, New York, 1928, Vol. 1, p. 237.

[18] Paul W. Ellis, *Effects of Taxes Upon Corporate Policy*. New York: National Industrial Conference Board, 1943, pp. 57, 82.

[19] Kimmel, *op. cit.*, pp. 27-31.

short run under either the old or new theory, except possibly in a strong sellers' market. That which does take place must occur in the long run. Any effort to measure even roughly the extent to which the corporate income tax increases prices in the various industries in any period would be difficult indeed.[20] However, it is no longer accurate to say that corporate net income taxes are seldom shifted.

THE EFFECTS OF CORPORATE INCOME TAX

Whether or not the corporate net income tax affects prices in the market, there is little doubt but that it has material effects in other areas of our business and economic lives. To the degree that shifting and price rises do not take place, the volume of profits after taxes is reduced. This will result in a drop in the "rate" of profits. In corporate finance this will mean one of several things: (1) a decrease in dividends, or (2) a curtailment of the undistributed profits, or (3) a cut in both. Which of these conditions will prevail will depend upon the short- and long-run capital needs of the corporation and the relative effectiveness of the managers and the stockholders in affecting the decision of the board of directors on dividend policy.[21] The more ultimate effects of the above possibilities will be explored point by point.

Dividend distribution and consumption. Assuming that the corporate net income tax results in a reduction of dividends, will that noticeably affect the volume of private consumption? On the theory that not a very large proportion of the total corporate stock is held by the people with the highest marginal propensity to consume, it is probably true that the tax has no material effect on consumption. However, if corporate income taxes were shifted in higher prices, the tax would then have some tendency to curtail consumption. On the other hand, if it could be demonstrated that dividend-recipients spend a material part of their dividends for living purposes, then the corporate net income tax could be said to affect the volume of consumption of goods and services.

Dividend distribution and flow of venture capital. Again if the corporate income tax reduces rates of dividend return, will this affect the flow of new venture capital into corporations in the future? Naturally, lower rates of return on risk investment will have the tendency to curb the flow of funds into corporate stock. This is especially true when dividend disbursements have been about as low as the fixed returns on more safe forms of investment. In the 1930's and well into the 1940's that was the experience of many companies. The interest of the American public in "equities" in this period has not been enthusiastic. There

[20] Kimmel, *op. cit.*, pp. 26-27, 30-31.

[21] Harold M. Somers, *Public Finance and National Income.* Philadelphia: The Blakiston Co., 1949, p. 226.

have been, however, other reasons besides taxation for this attitude. In the same period, interest rates on fixed obligations have also fallen. Recently American investors have discovered that many existing common stocks have been paying dividends after corporate taxes high enough to yield a return substantially better than the interest paid on both corporate and government bonds. Interest in equities and the stock market has thus improved materially in recent years. That interest would be even greater if part of the $8 to $9 billion per year (which the federal government alone collects under the corporate income tax) were available for dividend distribution.

Corporate income tax and expansion. The drainage of the corporate income tax away from business firms may affect expansion in several ways. First, to the extent that it results in lower dividend rates, it may retard the flow of new risk-capital into the business and thus hold back expansion. Second, to the extent that it cuts into undistributed profits, it subtracts from the internal funds available for expansion. Third, substantial corporate income taxes may affect the propensity to invest in new plant and equipment (1) because of the adverse effect on business psychology and (2) because the marginal return on the new investment (after taxes) may not warrant the trouble and risk involved in making it.

Again, the Brookings Institution, in an effort to discover whether the federal corporate income tax has affected managerial decisions to expand plant and equipment, polled 1,000 manufacturing concerns. Two hundred and eleven corporations replied, and 117 or 55 per cent granted that the tax had influenced their decisions on expansion. The study indicated that 55 per cent may have been an understatement.[22]

Corporate income tax and form of business structure. It is sometimes claimed that the corporate income tax when combined with the personal income tax on dividends discriminates against the corporate form of business organization. There is little doubt but that this double taxation of corporately-earned income gives individual proprietorships and partnerships substantial advantages taxwise when the business earnings are paid out to the owners. Whether or not this has affected materially the over-all business structure of the American economy is difficult to say. During World War II when the federal government levied excess profits taxes and capital stock taxes in addition to corporate net income taxes, there was some evidence of "de-incorporation"—a changing back to the partnership form. How extensive this was has never been determined. It was definitely limited to the smaller, family corporations. For corporations with large numbers of stockholders it is physically impossible to change to the partnership form. There is some evidence,

[22] Kimmel, *op. cit.*, pp. 34-36.

however, that the corporate income tax may have been a factor in causing a few large companies to change to the co-operative form.[23]

Even in the case of the smaller corporations the advantages of the corporate form tended to overbalance any tax differential even under recent peacetime rates and when no excess profits tax was involved. Stockholders in these companies stress the economic advantages of limited liability and raising capital through stock and bond issues. Furthermore, in closely-held corporations it is not uncommon for the major stockholders to be on the payroll at good salaries which are not subject to the corporate net income tax. It must be observed that the corporate form is not always at a disadvantage taxwise.[24] A great deal depends on how much of the net profits are retained in the business and other factors.

Corporate income tax and capital structures. One of the indictments brought against the corporate net income tax is that it fosters unbalanced capital structures and heavier emphasis upon bonds or debt capital. This arises from the fact that interest on bonds is looked upon as a contractual cost payment which may be deducted in determining corporate net income. Dividend payments to stockholders, however, are not given that treatment.

It is therefore advantageous for certain types of corporations to acquire a substantial part of their capital from bond sources, because this procedure reduces the amount of corporate net income taxes that must be paid and thereby increases the returns to the stockholders in the years in which dividends can be paid. A limited study in 1941 produced some evidence of the effect of the corporate net income tax on stock and bond financing.[25] The investigation showed that bond financing for the retail companies produced savings ranging from zero to 56.6 per cent.[26] For most of the concerns the tax saving from the use of bonds was less than 20 per cent.

A recent study attempted to discover how extensively methods of financing were affected by the corporate income tax. Of the 186 companies that replied on that issue, 76 or 41 per cent admitted that the tax had influenced their methods of financing.[27]

The bad feature from the point of view of the individual firm is that heavy emphasis upon bond financing loads the company with "fixed charges" on the bonds which must be met in good times and bad. Businesses which have marked fluctuations in their profits can be thrown

[23] Kimmel, *op. cit.*, fn. p. 32.

[24] Richard Goode, *Postwar Corporation Tax Structure*, Treasury Department, Division of Tax Research, Washington, D. C., 1946, p. 14.

[25] J. Keith Butters, *Federal Taxation of Corporate Profits*, doctoral dissertation, Harvard University, Cambridge, 1941.

[26] *Ibid.*, pp. 190-192.

[27] Kimmel, *op. cit.*, p. 42.

into receivership and bankruptcy in low-profit periods by their inability to meet interest charges. If too many companies become harnessed with heavy fixed charges, this weakness can have its adverse effects upon the economy as a whole.[28]

Business Taxation and Fiscal Policy

MINOR BUSINESS TAXES AND FISCAL POLICY

By and large most of the business taxes except those of the net income and payroll character are of little value in over-all fiscal policy. Many of them are relatively minor as revenue raisers. Those which are shifted to consumers in the form of higher prices may have a negative effect upon private consumption and in part for that reason should be avoided. However, those which are borne by stockholders may affect the propensity to invest. Most of these taxes (capital stock, franchise, license, and so forth) are of little value as positive instruments of fiscal policy. Some of them are useful, however, in the regulation of business at the state and local levels. Furthermore, these taxes have practically no efficacy for fiscal policy because they have little direct bearing upon or relation to the levels of national income. They cannot be manipulated in any effective manner to affect that income or the components thereof—investment and consumption.

CORPORATE INCOME TAXES AND FISCAL POLICY

The business taxes of the income tax group are of much greater utility in fiscal policy. This is true of corporate net income, excess profits, payroll, and possibly in some measure, gross income taxes. All of these taxes are related to the levels of income and can be adjusted to affect the levels of income. Corporate net income, excess profits, and payroll taxes can be increased to serve as auxiliary anti-inflation instruments. On the other hand, they can also be adjusted downwards in recessionary periods so as to stimulate business activity, the prospects for profits, and new investment. When these business taxes are used as instruments of fiscal policy, they should usually be used in conjunction with the personal income tax.

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[28] See Harold M. Groves, *Postwar Taxation and Economic Progress.* New York: McGraw-Hill Book Co., 1946, pp. 31-35.

Conclusions

ALTHOUGH THERE ARE THOSE who have urged the complete de-emphasis of business taxation, that seems hardly feasible in the foreseeable future. Because of the way business units function in our economy, there are valid reasons why they should make contributions to the costs of government. Most of them function as economic as well as legal entities. They receive privileges, benefits, and services at the hands of government. They make it necessary for government to incur annual costs, and they cast certain long-run social costs upon the economy.

In this day of great revenue needs, business units do have the ability to meet tax bills; furthermore, these revenues can be collected from business more easily and less expensively than from large numbers of individuals.

In the application of business taxes, care must be taken that we do not acquire a set of indirect consumption taxes. Many business taxes are in fact shifted forward to consumers. Occasionally some are shifted backward to the various factors of production.

Business taxes affect the propensity to invest in business enterprise when the "rate of return" after taxes becomes too low. They affect the ability of the business units to expand plant and equipment from internal sources. They encourage the use of debt capital and the accumulation of fixed charges upon business units.

Business taxation is not just an easy source of revenue. Business taxation is both significant and strategic because it is so proximately related to the functioning of our economic system. Poorly adjusted, it can do noticeable harm. Properly adjusted, it might be stimulating. More is said about business tax policy in subsequent chapters.

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The Taxation of Business Generally

BUSINESS TAXES *are 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.... They are characterized in general by arbitrariness, complexity, and lack of co-ordination.*

—ALVIN H. HANSEN AND HARVEY S. PERLOFF.[1]

Overview

IN THE PREVIOUS CHAPTER we laid down some of the economics of business taxation. The taxation of business now takes place in multifarious ways at the federal, state, and even local levels. This chapter first raises the question as to what forms of business should be taxed and why. This approach is based on the assumption that business as such should be taxed. Next it makes an analysis and appraisal of the various "miscellaneous business" taxes (corporate and non-corporate) levied by the various units of government. It leaves to later chapters a more thorough treatment of such "major business" taxes as the corporate net income, the excess profits, and undistributed profits taxes. Later chapters also deal with the special forms of taxation applied to special types of business. Finally, it is one function of this chapter to raise the question as to how the *quality* of business taxation can be improved and to indicate some ways and means by which a more scientific character and the equity of business taxes can be achieved.

What Forms of Business Should Be Taxed?

THE LOGIC OF AN OVER-ALL BUSINESS TAX

If it is agreed that "business as such" ought to be taxed as such, should business taxes apply to corporate business only or to all forms of business

[1] Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy*. New York: W. W. Norton & Co., 1944, p. 44.

structure as well? Up to the present in the United States, the preponderant weight of business taxation has fallen upon corporate business. Any rational justification of business taxation would logically require tax responsibility by individual proprietorships and partnerships as well as by corporations.

There are logical grounds for distinguishing between incorporated and unincorporated business for tax purposes, but it is a little difficult to justify corporate taxation as the exclusive form of business revenue-raising. In the past the arguments for limiting business taxes to corporations have been several: (1) the difficulties of administration and the supposedly low revenue-yield of applying taxes to large numbers of small taxpayers; (2) the political unpopularity of the corporation based largely on prejudice; (3) a conscious public policy to encourage small business and discourage tendencies toward monopoly.[2] Some of these reasons do not stand up well under more recent experience and economic analysis.

Support of the government is one of the basic costs of a civilized society. Wherever and whenever a business organization exists, the costs of government are in some measure increased. Therefore, it is fair to assume that the additional costs cast upon government by the existence of business should be met by the business responsible for these additional costs *regardless* of the "form or structure" of the business entity. This means that *unincorporated business* should bear its share of business taxes upon some reasonable basis commensurate with its economic characteristics.

THE PROBLEMS OF TAXING BUSINESS IN GENERAL

Under any system of taxing business in general it is logical to classify business into incorporated and unincorporated. The taxation of corporations presents no immediate difficulties of designation because corporations are clearly defined in the law and readily identified in the economy. The taxation of unincorporated business, on the other hand, presents problems of definition right from the beginning. If businesses other than corporations are to be taxed, the question at once arises, what is a business?

At one extreme there is the day laborer working for wages. Is he in business? It is generally agreed that he is not. And so it is with all those who render services for others for wages and salaries. At the other extreme is the organized business partnership manufacturing a consumer's good. Is this a business? Again the answer is quite clear: this is a business. The real difficulty comes in that great area in between where thousands are engaged in selling personal and professional services as independent enterprisers. Is the lawyer in business? Is the shoe repair shop a business? Is farming a business? The task of drawing the line

[2] *Final Report of Committee of National Tax Association on Federal Taxation of Corporations*, 1933, p. 33.

is not easy. Unless almost everyone is to be taxed twice on all income, an arbitrary line of demarcation must be drawn somewhere. Up to the present that line has come between incorporated and unincorporated business. From the administrative point of view it has been a workable line. However, as a result, large areas of business activity have gone untaxed.

One *test* of whether or not a given business ought to be a taxable business is the degree to which "capital" is used in producing the income. If capital is a substantial factor in the process, then perhaps it ought to be taxed as a business. If personal services is the leading ingredient, then the income should be looked upon as personal income and should not be taxed twice.

AN ADJUSTED UNINCORPORATED BUSINESS TAX

The Model Plan of the National Tax Association favors the policy of over-all business taxes upon both incorporated and unincorporated business. The taxation of corporations is now quite well provided for under both federal and state laws. The real problem is that of working out a feasible means of taxing unincorporated business.

New York has developed such a tax and uses a personal service-income test to determine whether a given business shall be taxable. It levies a 3 per cent (4 per cent prior to 1948) business tax on the net income of eligible unincorporated businesses. As a consideration to small business, any unit earning less than $5,000 is exempt from the tax. Furthermore, any business receiving more than 80 per cent of its income from personal services is excluded. This means that many personal service types of business with substantial incomes (such as law, accounting, engineering, educational, medical and other firms) pay no "business taxes" under the law.

Prior to World War II this law was not extremely successful; less than 9,000 firms filed returns. However, in 1945 48,464 firms reported net tax liabilities of $31.8 million. With the reduction in the rate in 1948 the net proceeds dropped to about $16.7 million. This compares with $122 million collected under the state's corporate income tax during the same year.[3] New York has apparently learned to administer the tax and has transformed it into a modest revenue raiser. Connecticut also levies a gross income tax upon unincorporated business. In 1948 the tax yielded about $600,000 as compared with $15 million collected under the state's corporate net income tax.

An unincorporated business tax probably has an appropriate place in state tax structures where it can be administered quite successfully, add to the revenue, and lessen the tax advantage of those firms which compete

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[3] *Annual Report of the New York State Tax Commission, 1948-49*, Albany, 1949, p. 59.

with corporate businesses. New York's experience with this type of tax merits consideration by other states. Some authorities would maintain that this type of business tax should be reserved for the states. Others would advocate it as a workable instrument by which to broaden the federal business tax base.

How Business is Taxed

THROUGHOUT THE VARIOUS STATES in the American economy business is taxed in numerous ways. Many of these taxes are upon incorporated business alone; some of them are upon business in any form. The bases of these taxes involve a range of different measures such as capital stock issued, net income earned, property held, privileges and franchises enjoyed, gross income produced, and surpluses accumulated. The purpose of this section is to survey, analyze and appraise the whole array of *minor business taxes.*

THE GROSS INCOME OR GROSS RECEIPTS TAX

Character of the tax. The gross income tax (often called a gross receipts tax) is levied sometimes as a "business privilege tax" and sometimes as an "in lieu tax" or substitute for a tax on business property—usually in connection with public utilities. Basically the tax is one on the total receipts of the business without deduction for the cost elements incurred in producing the income.

These taxes are more prevalent in the various states than is usually realized. They exist in some form in Arizona, Connecticut, District of Columbia, Indiana, Mississippi, New Mexico, New York City, Washington, and West Virginia. In Indiana and West Virginia their scope is quite broad—on income from all sources within the state, including both service and investment income. In these states, however, there are no net income taxes.

The rates of these taxes are sometimes expressed as low flat rates ranging from as low as .01 per cent to 2 per cent. In some states various types of businesses are classified, and different flat rates are applied to each classification. In others, the rates are expressed as a flat sum of money per $100 of gross receipts or income, and these rates may range from a few cents per $100 to several dollars. The revenue yields of these taxes are quite substantial in some states. Indiana in 1950 collected over $86 million under its gross income tax, or over one-third of its entire revenue receipts.[4]

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[4] *Compendium of State Government Finances in 1950,* Department of Commerce, Bureau of the Census, U. S. Government Printing Office, Washington, D. C., 1951, p. 11.

In the same year West Virginia received about $51 million from its gross income tax or a trifle less than one-third of its total revenues.[5]

An appraisal of gross income taxes. These taxes are an effort on the part of some states to get at business privileges and benefits. Clearly they are not a very accurate measure of benefits. Furthermore, they are an even less accurate gauge of ability to pay. But they are not very difficult to administer, and they are fairly good revenue raisers. Some states are hadicapped by their state constitutions in levying graduated net income taxes and are, therefore, compelled to resort to flat rate gross income taxes. As such they are one means of taking tax toll from those who have "trafficked amongst us."

Serious objections to these taxes are that they are levied on cost elements, they tend to be shifted to the consumer, and they therefore are inclined to be regressive. The net result is that they turn out to be consumption taxes rather than taxes on business.

A gross income tax on business in general results in the "pyramiding" of taxes depending upon the number of transfers involved in the preparation of the product from the raw material stage to the purchase by the ultimate consumer. The result is that the consumer pays taxes on taxes and also pays profit markups on taxes.

Gross income taxes are open to further criticism in that they sometimes bear heavily upon business firms which suffer losses or have a low ratio of net to gross earnings. Then, too, a state gross income tax raises problems of interstate competition. A retailer within the state (except when right on the border) can bear fairly a high business tax because he has very little external competition. However, a manufacturer producing for national distribution may find a gross income tax in the home state a serious handicap when he competes on price in other states.

Another drawback in the gross income tax for state use emerges from the federal constitutional limitation on state interference with interstate commerce. The Supreme Court will permit the apportionment of income earned in interstate commerce under a net income tax, but it will not do so as applied to a gross income tax on the theory that such a tax is in effect a burden upon each unit of goods transported in interstate commerce. The result is that a general gross income tax then becomes limited to purely "intrastate business," much to the disadvantage of that business. However, when states levy a gross receipts tax "in lieu" of a property tax, the courts have been quite generous in accepting the approximation of the burden of the gross receipts tax for that of the property tax for which it was substituted; and, the courts will usually permit an apportionment of gross receipts as between intrastate and interstate business.

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[5] *Ibid.*

The general conclusion is that the gross receipts tax as a revenue instrument is one to be avoided if at all possible. Except in states which are limited by constitutional provisions, there are adequate alternatives.

INCORPORATION AND ENTRANCE FEES

At the time of the commencement of corporate existence, the states generally impose charges for the privilege of incorporating a business within their respective jurisdictions. A similar charge is made when corporations chartered in other states or foreign countries wish to do business within the state. Originally, these were fees to cover the costs of incorporation. After the Civil War, however, they took on the color of taxes as the rates were increased to produce revenues over and above the costs of incorporation.

These taxes are now generally based upon the "par value" of authorized or issued stock, or on a "stated value" if no-par stock is issued, or on the "number of shares" authorized or issued. The incorporation rates applied to the capital stock vary from state to state, but they usually amount to a fraction of 1 per cent. On the whole they are fiscally relatively minor, amounting to less than $100,000 per year in most of the smaller states, about one-half million dollars in California, $2 million in New York, and $175,000 in Delaware.

Incorporation and entrance taxes are true privilege taxes which have a logical place in state business tax structures. They should be distinguished from annual franchise and capital stock taxes which are also levied on the privilege theory (but after the privilege has been granted).

FRANCHISE TAXES

The character of franchise taxes. Still another set of privilege and benefit taxes placed upon corporations by the states is that group usually called franchise taxes. Franchise, used in a broad sense, is synonymous with corporate charter and is a grant of the privilege to engage in business under the terms of the charter. In spite of the fact that in all states corporations pay incorporation taxes at the time they come into legal existence, yet they are often required to pay taxes to *exercise* their privileges and to *continue* in business. As one authority has stated, corporations may be subjected to special taxes on the right to come into existence, continue in business, engage in particular types of enterprise or receive special privileges.[6]

Franchise taxes of one kind or another are found in most states. The thing taxed is the "value of the franchise" to the corporation—in other words, the franchise is the *subject* of the tax. This value may be *measured* by the value of the (1) property, (2) capital stock, (3) business

[6] C. C. Plehn, *Introduction to Public Finance* (5th ed.). New York: The Macmillan Co., 1926, pp. 186-189.

transacted in the state, (4) net income enjoyed, or (5) some other factor. The valuation of the franchise under some of these standards is a difficult task which often yields arbitrary and inequitable results.

Some states, such as Delaware, have lenient incorporation laws for the purpose of inducing corporations to take out charters within their borders. As a corollary they also establish lenient tax laws, usually in the form of low-rate franchise taxes. However, if large numbers of businesses incorporate under these laws, such states collect substantial sums of revenue. This approach is often devised and administered as a means of taxing "foreigners" for the privilege of nominal corporate domicile.

Franchise taxes measured by net income. Three states (California, Minnesota, and Utah) have corporate franchise taxes in which they *measure* the "value of the franchise" by net income. When this is the case the tax becomes in effect a corporate net income tax and is actually administered as such. Such a tax is even more inclusive than a straight corporate net income tax because it makes it possible to tax indirectly the income from government bonds held by corporations. The legal theory which makes this possible is that the franchise tax is on the value of the franchise—not on the income. Income is merely used to "measure" the value of the base.

No generalization can be made about franchise tax rates. The rate structure depends upon the character of the measure. When net income is the measure then a flat rate of 3 or 4 per cent is not uncommon. In Minnesota that rate is 6.3 per cent for general business corporations and 8.4 per cent for banks.[7]

Franchise taxes measured by capital stock. Annual capital-stock taxes of one pattern or another are imposed upon corporations in about two-thirds of the states. The federal government levied a declared-value capital-stock tax for a number of years. This, however, was repealed as of December 31, 1945. Capital-stock taxes are in fact franchise taxes measured by capital stock. Several bases are utilized in operating these taxes. They are imposed on the value of the stock that the corporation has issued or is authorized to issue, or on the capital employed in the state. Difficulty, however, arises in the valuation of the stock for tax purposes. Sometimes par value is taken as the base. In the case of no-par stock a stated value is assumed. These values may be largely arbitrary and may in no way reflect the true value of the stock. Some states attempt to use the market value of the stock as the basis for the tax. This value is also difficult to determine except in the case of listed, active stock. When capital stock is the measure it is common to have a flat rate per given value of stock. In Alabama, for instance, it is $2 per $1,000.

The basic capital-stock taxes are upon domestically chartered corpora-

[7] *Minnesota Statutes 1949*, Chap. 290.

tions. However, it is possible for states to levy a capital stock tax upon foreign corporations doing business within their borders. In that case the courts have held that the tax may be imposed only on the capital used within the taxing state.

Appraisal of franchise taxes. These taxes are an attempt to get at special privileges, some of which have been paid for in the acquisition. Here again there is substantial diversity in methods of taxation, and both the theory and the practice in the levy seem to be confusing and inconsistent. There is a question as to whether the taxation of the franchise (an intangible value comparable to good will) of corporations is not an unfair discrimination against corporations, especially when unincorporated firms enjoy many privileges and advantages in a less formal way. Franchise taxes measured according to net income could better be straight corporate net income taxes.

Capital-stock taxes are regressive in their effect upon small and net-loss corporations; in the case of the latter they represent a greater burden than a full-fledged corporate net income tax. They are not much less arbitrary than occupation taxes. They are administered under a wide variety of bases, rates, procedures, and methods of apportionment. The valuation of the capital stock on an accurate basis is a difficult administrative task. Moreover, capital stock without regard to bonds, and notes, and mortgages gives a distorted picture of the actual capital of the corporation. It is a tax that could well be dropped from the business tax family at the state level, just as it has already been deleted from the federal structure.

OCCUPATIONAL AND BUSINESS LICENSE TAXES

The character of occupational and license taxes. These taxes make up another group of business privilege taxes levied upon both incorporated and unincorporated businesses and occupations. In the past they have been used extensively by state and local governments in the South; more recently, however, there has been heavier resort to them by local governments in other parts of the country and especially in the West. These taxes are largely benefit and privilege taxes, although many of them have regulation features.

Occupational and business license taxes can be classified into a few major groups. Among these are: (1) liquor license taxes, (2) the occupational taxes on service enterprises, (3) license taxes on selling goods, and (4) license taxes on amusements.

Liquor license taxes. Among the most well-established of the business license taxes are those imposed upon the manufacture, wholesaling, and retailing of beers, liquors, and wines. Associated with the privilege and revenue features of these taxes are the control and regulatory objectives. These taxes are very common at the state and local levels, and more recently they have appeared in the federal tax structure as well. Usually

they take a lump-sum form. The manufacturers often pay thousands of dollars per license, wholesalers pay smaller amounts, and retailers pay up into the hundreds of dollars, depending upon the state or locality. Even the federal government levies $220 per year on rectifiers of distilled spirits, $110 on liquor wholesalers and $22 on retailers. From all its liquor license taxes the federal government collected about $9.5 million in 1949. The states and local governments collected many times more.

Occupational taxes on service enterprises. A rather heterogeneous group of taxes is levied upon various kinds of service enterprises especially in the South and West. These are often flat-rate taxes, but there are different flat rates for each type of undertaking. Some states and cities have large numbers of these taxes that apply to warehouses, employment agencies, barber and beauty shops, junk dealers, hotels and restaurants, doctors, lawyers, independent contractors, pawnbrokers, commission merchants, stockbrokers, and many other service types of enterprise, both incorporated and otherwise.

These taxes represent a "crazy-quilt" business tax structure—levies upon dozens of different types of service businesses, on over a dozen different bases, and with many types of rate schedules. They represent a state of arbitrary chaos. Some are based upon a rough measure of the volume of business, but many of them are not based upon any discernible scientific principle at all.

One investigator discovered at least 13 different factors which served as the measure of the taxes. A few of these were: (1) the occupation itself; (2) the population of the locality in which it functions; (3) the number of machines used in production; (4) the kind or size of equipment; (5) floor space or productive capacity of building or factory; and (6) the number of employees.[8]

When applied by a state or municipality to a large number of businesses, these taxes are not easy to administer and enforce. Furthermore, many of the flat-rate taxes tend to be regressive.

License taxes on selling goods. As the distribution side of our economy has become more complex, there has been increased emphasis upon specialization in merchandising. One of the most well-established of the taxes on selling goods is the tax on peddlers. Very often the peddlers' tax is an attempt to penalize outsiders. These taxes are common throughout the country at both the state and local levels, but the bases of the taxes vary widely. In some cases the tax is a flat-amount permit tax which grants the peddler selling rights throughout the state. In other states these taxes are levied and administered at the city or county level.

Generally, permanent residents do not have to pay merchandising licenses for the sale of ordinary goods, except as they may be licensed

[8] Roscoe Arant, "Business Taxation in the Southern States," *Taxes, The Tax Magazine*, Vol. 16, July 1937, p. 463.

in a technical manner and pay a nominal fee as an aid in the administration of the sales taxes in a number of states. However, it is not uncommon to license the sale of particular products such as cigars, cigarettes, tobacco, soft drinks, fireworks, commercial fertilizers, feedstuffs, and illuminating and lubricating oils. In some states the vendors of margarine and other butter substitutes are subject to special selling license taxes.

License taxes on amusements. The amusement field offers both opportunities and problems in business taxation for both state and local governments. Some amusements are looked upon as luxurious and, therefore, a fit subject for taxation and a source of revenue; in other cases sumptuary objectives enter in; and many types of amusement require regulation in the public interest. In the taxation of pool and billiard halls, bowling alleys, juke boxes, pin ball machines, slot machines, race tracks, circuses, carnivals, and road shows the sumptuary and regulatory objectives play a material part. Movie theaters are a common subject of license taxes; community population and seating capacity often make up the measure upon which the tax is based. Dance halls and cabarets also come in for special taxation. Most of these taxes are levied by the city and county units. The surplus of revenue over and above costs of regulation is generally quite satisfactory.

Appraisal of occupational and business license taxes. Many of the so-called occupational taxes are difficult to justify under any ability or benefit theory. This lack of adequate justification becomes even more pronounced when one observes the variety of bases upon which they operate and types of rates that are applied to them. Many of the service businesses selected for license taxing are granted no special privilege by state and local governments that many unlicensed businesses do not enjoy. Because of the multiplicity of classifications and the indistinct lines between them, it is possible for some firms to side-step a classification and thus avoid the tax much more effectively than under a general business tax.[9]

Many of the flat-rate taxes are regressive in their effects and often militate against the small businessman. Some of these taxes have developed by historical accident as the result of pressure-group activity and the need for revenue. At the state and federal levels, they are extremely hard to justify, especially when more scientific and productive alternatives exist for these governments.

At the local levels of government the situation is somewhat different. These units do not have the income taxes at their disposal. Their revenue needs have expanded in recent years. The services and benefits enjoyed by most of the smaller business units come more directly from cities, villages, and counties. Furthermore, many of these taxes by local units

[9] Shultz and Harriss, *op. cit.*, p. 468.

do serve as a regulatory aid. Clearly, at the state and federal layers of government these taxes should be kept at an absolute minimum. Even the local units would do well to reappraise their occupational and business license taxes. If they cannot be abandoned, at least they should be made more equitable and more well-adjusted to the *economics of the base* to which they are applied.

CORPORATE EXCESS TAXES

The nature of corporate excess taxes. Another special impost applied only to corporations (and one which has been declining in importance in recent years) is a species of property levy known as the corporate excess tax. It is to be clearly distinguished from the corporate "excess profits" tax. This type of revenue instrument was first utilized in Massachusetts in 1832. It arose out of the realization of the fact that a corporation as a "going concern" possesses values "over and above" the value of its land, plant, equipment and other tangible assets. The tangible assets are usually assessed under the general property tax, but the intangible elements in the total corporate value (such as good will, going concern value, and trade marks) escaped assessment under the property tax. It was thought, therefore, that corporations ought to pay taxes on this value. In effect the corporate excess tax is a levy upon the value of the corporation in excess of its tangible assets. It can be determined by taking the difference between the fair market value of the total capital stock and the value of the real and personal property of the corporation as listed by the local property assessor.[10]

The tax as it developed in Massachusetts is now administered by the Commissioner of Corporations and Taxation, who utilizes the annual reports of the corporations to set the value of the stock and who uses the assessment rolls of the local assessors to obtain the value of the tangible property. The tax is levied upon both domestic and foreign corporations. Massachusetts in 1949 used both the corporate excess and the corporate income tax and thus received the advantages of both. It levied a tax of $5 for each $1,000 assessed value of corporate excess.[11]

The corporate excess tax is of declining importance. Just before World War I sixteen states had adopted it. Because of administrative difficulties and the growth of the corporate net income tax, only about eight states continue to employ this tax.

Appraisal of the corporate excess tax. Every business which functions as a profitable concern possesses intangible values above its physical assets. It seems rather discriminatory, therefore, when the excess intangible values of corporations only are ferreted out for taxation. Fur-

[10] Alfred G. Buehler, *Public Finance* (3rd ed.). New York: McGraw-Hill Book Co., 1948, p. 542.

[11] *Annotated Laws of Massachusetts 1949*, Vol. 2, Chap. 63.

thermore, this tax reaches the same values touched by the capital stock tax. This tax has also been criticized for militating against the use of stock or equity capital as contrasted with bonds. Finally, the key weakness of the tax lies in valuation. Too often the valuation of corporate assets is poorly done, in which case the tax is inaccurate or just plain arbitrary. The tax is on its way out as a state tax instrument—and perhaps rightly so.

SOCIAL SECURITY PAYROLL TAXES

The field of social security taxation is treated in a later chapter. This is the manner in which social security taxes are dealt with by most writers on public finance. Some writers discuss them along with income and poll taxes. It is both logical and relevant, however, that the social security payroll taxes paid by *employers* (unemployment insurance tax and old age and survivors' insurance tax) be viewed as business taxes. In business accounting they are treated as a cost of doing business, and under the business income tax laws they are allowed as a business deduction.

These taxes on business payrolls, therefore, can well be recognized as business taxes and discussed as such. However, limitations of space demand that they be discussed as social security taxes at a later point in this text.

MISCELLANEOUS BUSINESS TAXES

Stock transfer taxes. Stock transfer taxes became a permanent part of the federal tax structure during World War I, after such taxes had been used as emergency revenue raisers in three wars. New York has taxed security transfers since 1905. At present five other states (Florida, Massachusetts, Pennsylvania, South Carolina, and Texas) levy such taxes. The tax is in effect an *excise* on the "privilege of transferring" the ownership of corporate stock and other securities. The tax is administered by the use of stamps affixed to the certificate at the time of the transfer.

The federal stock transfer tax on par value of stock selling for more than $20 per share amounts to 6 cents per $100 or fraction on the aggregate face value of the stock. On par value stock selling for less than $20 the rate is 5 cents per $100. In the case of no par stock the rate is 5 and 6 cents a share, depending upon the selling price.

One of the main criticisms of stock transfer taxes is that they are arbitrary—that is, they are based upon par values which may bear only a remote relationship to actual market value. Both Great Britain and Sweden use market value as the base. These taxes can have the effect (if the rates are more than nominal) of curbing in some measure the tendencies toward overspeculation. Likewise, however, they can discourage equity investment and the shifting of stock holdings. These taxes cannot be used by those states which do not have organized stock markets. States

like New York stand to take toll on transfers from all over the country, whereas other states cannot make use of them. With the lack of interest in stock financing and stock market activity in recent years, there has been no need to encourage these taxes for antispeculation purposes.

Racing licenses and pari-mutuel taxes. In recent years many states have developed a small structure of taxes associated with racing and betting. This structure has generally taken three forms: (1) the licensing of the racing and betting, (2) flat rate admissions taxes, and (3) a percentage tax on the total betting at each track. About twenty-six states and many local governments now levy these taxes. Kentucky, a state noted for the Kentucky Derby, levies license taxes based on the population of the county in which the race track is located—counties of 200,000 or over, $2,500 per day; counties of 100,000 to 200,000, $1,000 per day; other counties $500 per day. Its admissions tax is 15 cents per ticket and its pari-mutuel tax is 3 per cent of the total amount deposited in the pari-mutuel pools. California has a graduated daily license tax based upon the class of the county and a graduated pari-mutuel tax—4 per cent on $10,000,000 or less; 5 per cent on $10,000,000 to $20,000,000 and 6 per cent on the excess.[12] Florida does not require a license tax, but compels the posting of a $50,000 bond to guarantee the payment of the pari-mutuel taxes. It has a 10 cent or 15 per cent admissions tax, whichever is greater; it collects a 3 per cent tax on the total contributions to the pari-mutuel pools and an additional 5 per cent on the same base, the proceeds of which is allocated to the Old Age Assistance.[13]

As long as racing and betting on the races is permitted, then revenues from these sources should be gathered in ample volume in the form of license, admission, and pari-mutuel taxes. The activity here is luxury in character; those who spend and bet are largely middle- and upper-income group people and the returns to the promoters are very lucrative. The local units of government in which the races are held should also have the right to collect some revenue from one or several of these taxes, preferably under the admissions tax, in order to cover the costs to which local governments are put by large racing crowds.

Other minor business taxes. There are many other minor taxes to which business is subjected; many others could be listed as business taxes, depending upon the emphasis in the definition. Many sales and excise taxes could be labelled business taxes. However, since most of these taxes have a high tendency to be shifted to consumers they will be dealt with under consumption taxes. The various severance taxes associated with the severance or extraction of natural resources are sometimes designated as business taxes, and from one point of view they are; but because the eco-

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[12] *Deering's California Codes, Business and Professional Code,* Sec. 19485.
[13] *Florida Statutes 1947,* Chap. 550.

nomic analysis is more strongly associated with natural resources than business in general, they will be treated in the chapter on the taxation of natural resources.

Improving the Quality of Business Taxation

A CRITIQUE OF BUSINESS TAXATION

It must now be quite apparent to the reader that business taxation in the United States (when viewed from the over-all combination of federal, state, and local business levies) is a conglomeration of hit-and-miss institutions. Especially at state and local levels is found a multiplicity of taxes whose impact is intended to be upon business as such. They are levied for a large number of *purposes* upon a wide range of *bases* under a variety of *rate schemes.* As a result they are both arbitrary and confusing.

These taxes represent very poor measures of benefits received and ability to pay. They make necessary a good deal of bookkeeping and reporting, and they make the costs of tax compliance heavy. Some types of taxes apply to incorporated businesses only, some to unincorporated business, and some to both. The combined economic effect is to repress both investment and consumption. On many business taxes administrative costs run high, and still there is tax avoidance and even evasion. The whole business tax structure is irrational, unco-ordinated, and is not underpinned by any controlling principle. It is badly in need of fundamental overhauling.

SPECIFIC BUSINESS TAX SUGGESTIONS

A statement of business tax weaknesses, although a necessary condition precedent to any effective tax planning, is not sufficient unto itself. Plans for overcoming those weaknesses must be crystallized. Some careful students of the problem have already made some constructive suggestions.

1. *Taxation of all forms of doing business.* Any fair business tax system must not ferret out a particular way of doing business as the sole subject of this type of taxation. Any modernized business tax structure should have a bilateral approach to the problem—(1) the taxation of corporations, and (2) the taxation of unincorporated business. There are enough legal and economic differences between the two to warrant differences in tax treatment. The basic tax upon both forms should be a net income tax adjusted to the characteristics of each.

2. *A co-ordinated business tax.* Though the net income tax should be the core of all forms of business taxation (and since the underlying theory is benefits received), further classification of business should be made on the basis of profitability. A plan of this kind was suggested by

the National Tax Association in the midst of the Great Depression.[14] It proposes three alternative bases, and the tax would be placed upon the base yielding the highest return from the given concern each year: (1) The first alternative would consist of a flat minimum charge for the privilege of business existence and to cover the costs of administration. It would operate as a technique for avoiding the trouble of applying other taxes to small business. For many small businesses this would constitute the major business tax. (2) The real heart of this plan is a business net income tax; it would be paid by all firms which show a net profit. (3) The third element would be a gross income tax applied to large, unprofitable firms that receive benefits and make it necessary for government to incur costs. Under such an arrangement all businesses—large or small, incorporated or unincorporated, profitable or unprofitable—would make some contribution to the revenue needs of government.

3. *Licensing and regulation.* The co-ordinated business tax would be the main revenue obligation of business as such to government. It would not preclude special licensing and regulation in those lines of business where that is necessary in the public interest.

4. *The place of the various units of government.* Under a co-ordinated business tax, it would be proper to have the federal government limit itself to taxing corporations under the income tax. It should minimize its licensing functions and avoid all the minor types of business taxes. The states would operate the co-ordinated business tax upon both incorporated and unincorporated business and with the three alternatives set forth above. They would also be permitted to license and regulate on a state-wide basis those business activities which require state-wide surveillance in the public interest. The business net income tax would be the mainspring of state business tax systems. The local units of government would be permitted to levy a low flat rate on gross business income; they would operate license taxes and regulate the local activities of certain businesses which require regulation.

A truly co-ordinated business tax will not be easy to achieve; it will meet with resistance from many sources; but it is the only solution for the hit-and-miss business tax system that exists today. It is perhaps too much to hope for such a reorganization except in the long run.

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[14] Report of the Committee of the National Tax Association on a Model Plan of State and Local Taxation, *Proceedings* of the National Tax Association, 1933, pp. 391-399.

18

The Taxation of Corporations

CRITICISMS *of the present corporate income tax and suggestions for its revision center largely around the so-called 'double taxation' of distributed corporate profits. Corporations now pay a tax on their profits, and stockholders pay a personal income tax on dividends received.*

—RICHARD GOODE.[1]

Overview

IN THE UNITED STATES neither the federal government nor the states have been able to develop an all-inclusive business tax. The result has been that most of the so-called business taxes fall very largely upon incorporated business only.

In peacetime the heaviest tax upon corporations is the corporate net income tax. And when the corporation pays out dividends to its stockholders, the dividends are also taxed under the personal income tax. The charge is made, therefore, that corporate profits are taxed twice. In view of the strategic economic significance of the business corporation in the functioning of our economic system, it may be well to reappraise the taxation of corporations in the United States.

This chapter examines three "major" corporate taxes: (1) the corporate net income tax, (2) the excess profits tax, and (3) the undistributed profits tax. It will analyze each of the three corporate taxes on various relevant bases and appraise each as an element in the business tax structure. A number of minor corporate taxes are discussed in the previous chapter.

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[1] Richard Goode, "The Postwar Corporation Rate Structure," *How Should Corporations be Taxed?* New York: Tax Institute, 1947, p. 46.

SECTION I

The Taxation of Corporate Net Income

The Legal and Economic Nature of the Corporation

LEGAL STATUS OF CORPORATIONS

Legally speaking, a corporation is a statutory form of organization. It owes its existence to the legislature of the state in which it is organized. It exists, so it is said, "only in the contemplation of the law." A corporation is bestowed by law with certain characteristics. It is a legal entity, distinct and separate from those who organize and own it—the stockholders. A corporation as such may exercise the powers conferred upon it by its charter in the same way as an individual. Thus, in effect, it is an artificial person.

ECONOMIC STATUS OF CORPORATIONS

Though the emphasis in the past has been upon the corporation as a separate *legal* entity, in recent years social scientists have begun to perceive it as an *economic* entity. The corporate business firm is the merger of the various factors of production into a going concern that is more than a bare legal entity. The corporate firm engages in economic operations, creates economic problems, exercises economic power and requires control and regulation by government. The corporation is the most important form of business organization in a modern industrial economy. Corporations contribute a large proportion of the gross national product, and a large percentage of all labor employed is by corporations. Corporations in the United States constitute less than 20 per cent of the number of business concerns, but they account for more than 80 per cent of all capital employed in business. Today it is very difficult to say that corporations exist "only in the contemplation of the law."

The Arguments "For" and "Against" Taxing Corporations

ARGUMENTS FOR CORPORATE TAXATION

The arguments presented for and against the taxation of corporations are quite similar to those applied to the taxation of business in general. On the affirmative side, greater emphasis is placed upon the *special privi-*

leges bestowed upon the corporation and the impersonal ability of the corporate business entity to meet tax bills. On the negative side, greater stress is centered upon the *repressive effects* of corporate taxation upon economic expansion, risk-taking, and investment.

The general benefit and state-partnership, the special privileges, the social costs, the impersonal taxpaying capacity, social expediency, and the social control theories—all are advanced in favor of corporate taxation with greater force and emphasis than when the same arguments are applied to business in general. The special privileges enjoyed by corporations are vigorously stressed. Finally, a great deal of the social control theory of taxation has been directed against the corporation because the corporation offers the best opportunity for great size and exercise of economic power.

ARGUMENTS AGAINST CORPORATE TAXATION

The basic theoretical argument against the taxation of corporations is that the ultimate owners of the income and undivided profits are the stockholders. The corporation is merely a shell and does not have any direct ability to pay taxes; the true ability to pay taxes rests with the owners. Some critics maintain that taxes levied directly upon the business firm as such are apt to repress business activity more than if such taxes were spread among individuals.[2] This is, they say, because the corporation is the most significant form of doing business. Companies today are managed more and more by "hired managers" than by individual owners. Taxes levied upon the corporation are bound to affect managerial decisions more than taxes upon the stockholders. Corporate taxes generally mean smaller dividends. This condition may affect the stockholders' propensity to risk and to invest and thus affect the flow of equity capital to corporations. Whereas if the dividends were larger, stockholders' "take home pay" before taxes would be larger. Their personal taxes would come "after the fact" and would not affect the propensity to invest nearly so directly.

The opponents of the tax also focus their attack on the *double taxation* of the corporation. They contend that the double taxation of the dividend income will reduce business incentive and eventually discourage investments. It is, therefore, detrimental to the growth and development of the economy as a whole. They further insist that the corporate income tax will force corporations to rely more on bond than on stock financing. It is asserted that bond financing may cause insolvency during business recession.

In the general argument against corporate taxation, a special case is advanced against the progressive taxation of corporation income. It is

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[2] Groves, *Postwar Taxation and Economic Progress*, p. 9.

claimed that the volume of income alone does not indicate the ability to pay. It is only by relating the amount of income to the amount of equity capital invested that it is possible to calculate the rate of return and thus judge the corporation's ability to pay. It is possible for two corporations, one with $100,000 capital investment and the other with $1,000,000, to earn the same net income per year—let us say $100,000. The first corporation would clearly have a greater ability to meet tax bills.

It must be remembered that a progressive corporate income tax is impersonal in character and draws no distinction between stockholders. Such a tax would take a good deal more from the "low-income" stockholder. A given small stockholder may be in the 20 per cent bracket under the personal income tax, but his pro rata share of the corporate profits may be taxed at 40 per cent under a graduated corporate tax.

The Present Federal Corporate Income Tax

THE CORPORATE INCOME TAX BASE

"What is income" is much the same for the federal corporate income tax as for the individual income levy. There are probably some elements of income received by individuals which are not received by corporations and vice versa. Most corporations, especially those which have inventories, report on an accrual basis so that an item becomes income as soon as the legal right to collect it accrues. Interest received by the corporation on state and municipal bonds is excluded from income under the corporate tax. The corporate income tax base is not reduced by exemptions as is the personal tax. Furthermore, exemptions for charitable contributions by corporations are limited to 5 per cent of net income (as contrasted with 15 per cent granted individuals). Generally the tax base is reduced by any "ordinary and necessary" expenditure incurred in the production of the income. In this category is a deduction available to corporations but not to partnerships and proprietorships—that is, the salaries of officer-stockholders. In the large numbers of closely-held corporations the major owners are also officers and managers. Their salaries are deductible in calculating taxable income. It is a common practice to make those salaries as substantial as possible and thus minimize corporate net income tax. On the other hand, in corporations of this kind it is also possible to plow the earnings back into the corporation and pay *only* the corporation tax. In either case a good share of the corporately-earned profits is subjected to but one tax. In this situation the owners can enjoy all the advantages of incorporation and may conceivably pay less taxes than unincorporated business.

THE RATE STRUCTURE OF THE CORPORATE INCOME TAX 1946-49

The rate level of the corporate income tax was increased during World War II, and the top rate on net incomes above $50,000 stood at 40 per cent at the close of the War. The rates were reduced slightly in 1946, so that for 1949 the top rate was 38 per cent. The 1949 federal corporate rate structure was divided into two divisions, normal tax and surtax. The following table sets forth the structure in detail.

Table V

FEDERAL CORPORATION INCOME TAX RATES IN 1949

NORMAL TAX

Normal Tax Net Income	*Normal Tax Rates*
Up to $5,000	15%
$5,000-$20,000	$750 plus 17% of excess over $5,000
$20,000-$25,000	$3,300 plus 19% of excess over $20,000
$25,000-$50,000	$4,250 plus 31% of excess over $25,000
Over $50,000	24% of entire amount

SURTAX

Surtax Net Income	*Surtax Rates*
Up to $25,000	6%
$25,000-$50,000	$1,500 plus 22% of excess over $25,000
Over $50,000	14% of entire amount

Source: U. S. Corporation Income Tax Return 1949 Form 1120, p. 3.

As indicated by the tax rate table, some graduation was provided in the rate structure as an encouragement to smaller businesses. Companies with incomes of $5,000 or less paid a combined normal and surtax rate of 21 per cent, whereas corporations with incomes of over $50,000 paid 38 per cent on the entire income commencing with the first taxable dollar. Another observation to be made concerning this rate structure is that for those corporations having less than a $50,000 income, a high rate of 53 per cent was provided in the "notch area" between $25,000 and $50,000. This notch adjustment was necessary so that the effective rate on the net income at $50,000 would be 38 per cent. Some criticism has arisen over the fact that a higher rate was charged on the $25,000 to $50,000 income than on the income above $50,000. On the other hand, it must be remembered that once the income rose above $50,000, then the full 38 per cent applied to the part below as well as above $50,000. The smaller companies, however, got the benefit of the lower bracket rate on each bracket up to $25,000.

This raises the issue whether or not corporate net income tax rates should be progressive or proportional. Generally speaking there is a strong presumption against a high degree of progressivity in a corporate income tax rate structure. However, minor graduation in several lower brackets may do greater good than harm for smaller concerns.

CORPORATE INCOME TAX RATES 1950-51

The *Revenue Act of 1950* made changes in both the structure and the degree of rates under the corporate income tax. The new schedule of rates became effective as of July 1, 1950. The rate structure itself was simplified. First, the 53 per cent "notch rate" between $25,000 and $50,000 was eliminated. Next, a single rate was applied to the entire normal-tax net income, and a single rate was applied to the entire surtax net income. A $25,000 exemption was allowed for surtax purposes.

The number of rate brackets was decreased, and the rates were increased as follows:[3]

	For Calendar Year 1950	*For Tax Years Beginning After June 30, 1950*
Normal Tax	23%	25%
Surtax Tax (on surtax net income in excess of $25,000)	19%	20%
Total	42%	45%

The effect of these changes was to cause $25,000 net income corporations to pay more in both 1950 and 1951 than in 1949, whereas corporations with net incomes of $25,000 to $118,750 paid less in 1950 than in 1949. This was because of the removal of the 53 per cent "notch rate." The net income corporations above $118,750 paid more in 1950 and 1951 than in 1949. The net effect of the act was to place heavier tax burdens upon the smaller and the larger net income corporations, but to grant tax relief to the groups between $25,000 and $118,750. The act was, however, calculated to produce more revenue.

The revenue act passed by Congress in January 1951 made one change in the corporate net income tax rate structure—a two percentage point increase in the surtax (on surtax net income above $25,000) from 20 to 22 per cent. This increased the "over-all rate" on corporations with net incomes in excess of $25,000 from 45 to 47 per cent. The increase was calculated to raise $600,000,000 in additional revenue and was a compromise to avoid a higher excess profits tax rate (to be discussed later in the chapter.)

TREATMENT OF LOSSES

Very important in the thinking of every businessman is the treatment of net business operating losses under the income tax. Prior to 1950 such losses arising in a given year could be carried back against the income of the two preceding years, or they could be carried forward and offset against the income of the two years next succeeding the year of loss.

[3] *Revenue Act of 1950* (with explanation). New York: Prentice-Hall, Inc., 1950, p. 14.

This arrangement injected an element of averaging income over the years; it made the tax more equitable, and it enhanced the appeal of risky investments. The carry-back of losses enabled an established business to recapture some of the taxes paid in prior years and of course made the revenues of government more uncertain. The carry-back allowance is of little value to the new business, whereas the carry-forward can be helpful to both new and old businesses. The carry-back also may be subject to some manipulation. The English practice has been to allow a six-year carry-forward of losses. A number of the leading postwar tax plans have emphasized the value of the longer type of carry-over, with five to six years being commonly suggested. The *Revenue Act of 1950* now allows a one-year carry-back and a five-year carry-over of net operating losses—the very thing the tax plans have been advocating for some time.

INTERCORPORATE DIVIDENDS AND CONSOLIDATED RETURNS

The tax treatment of *dividends received* is different under the corporate from that under the personal tax. Under the latter all cash dividends received are taxable in full. Until 1935 they were entirely exempt under the corporate tax. At present, however, when one corporation receives a dividend from another, the recipient corporation is permitted to deduct 85 per cent of the dividends received. (In effect it pays the regular corporate rate on 15 per cent of the dividends.) The deduction is justified on the theory that the dividends have already been subjected to the full corporate tax in the hands of the paying corporation. The objective of the intercorporate dividend tax is to discourage the use of the holding company and complex corporate structures. Some authorities hold that to be of value as an anti-monopoly instrument a larger proportion of the intercorporate dividends should be subjected to tax.

Another device which also involves anti-monopoly objectives is the special additional tax on *consolidated returns.* Prior to 1934 the parent holding company was permitted to file a single consolidated return for itself and for all the subsidiaries in which it was the controlling stockholder. This often was of a material advantage when the losses of some of the companies could be offset against the net income of others and thus reduce the taxable income for the holding company family. At one time during the war period some holding company systems were actually interested in buying "net loss" companies to cut down the tax liability of the group. Congress began taxing the privilege of using the consolidated return in 1932 at three-quarters of 1 per cent. Two years later this privilege was removed. In 1942 it was restored, but an additional tax of 2 per cent was levied upon the net income of the group as a whole for the privilege.

How Should Corporations Be Taxed?

SINCE THE CLOSE of World War II a good deal of thought and study has been given to the recasting of our federal tax system for long-run, peacetime purposes. A goodly number of postwar tax plans have appeared in recent years. One of the main issues with which most of these plans were concerned is how to tax corporations. Many of the standard arguments "for" and "against" have been reviewed. The argument which has been stressed most heavily has been the *double taxation* of corporately-earned profits. Many plans have come forward with ideas to overcome that objection.

DOUBLE TAXATION OF CORPORATELY-EARNED PROFITS

The existing federal corporation and individual income taxes impose a two-fold tax on that part of corporate income which is distributed in the form of dividends to stockholders. The corporation first pays the full corporate rate (47 per cent in 1951) on its total net income. Then, when part of this net income is distributed, the stockholders must pay the personal tax. Many states use both taxes at lower rates with similar consequences. This double taxation is considered inequitable and repressive by many. It is generally recognized that the combination of the two taxes on distributed profits throws a special burden upon risk-taking by individuals.

Returns from other types of personal investment are not subjected to two layers of taxes by the same unit of government. All the various types of interest payments are taxable only under the personal income tax. The same is true for income from rental real estate. This system, therefore, tends to favor bond financing and to discriminate against equity financing by corporations.[4] Furthermore, the "double-bitted" taxation of dividends places corporations under a tax handicap as compared with other forms of business organization.

RATIONALIZATION OF CORPORATE AND PERSONAL INCOME TAXES

In view of the recognized disadvantages of the double taxation of corporate profit, much attention has been given in recent years to rationalizing or integrating the personal and corporate income taxes so as to eliminate the double burden.

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[4] A corporation taxed at 38 per cent on its net income must earn $1.61 in order to have $1.00 for dividends. The corporation must be able to demonstrate a 61 per cent higher productivity than for debt capital in order to achieve parity between the two. Shultz and Harriss, *op. cit.*, fn. p. 447.

One of the major proposals of this character would confine the corporate tax to a withholding levy and an advance payment of taxes for stockholders if and while earnings are plowed back into the business.[5] This proposal grows out of British experience. The tax would be levied at the so-called "standard" or "normal" rate that is applied to the first bracket of personal income. Under this system a "credit" is extended to individual stockholders on their personal income taxes for any earnings distributed to them. This makes the tax a withholding levy on the distributed part of the corporate income. But at the same time a tax is paid by the corporation (at the "standard" rate) on the part which is not distributed. This is in effect an advance payment which is also credited to stockholders if and when the dividends are later distributed. This eliminates the double taxation of the distributed portion, but at the same time it does draw fair revenues from the retained portion.

Another suggestion is to handle corporations as partnerships and to tax each stockholder on his *pro rata* share of the corporation's total net earnings, whether paid out or not. A third proposal would make nondeductible the bond interest paid by corporations on their debt capital.[6] A fourth proposal would abandon the corporate tax entirely and rely upon the capital gains tax to reach undistributed corporate earnings.[7] A further suggestion attempts to put dividend income on a par with interest income by making dividend payments by the corporation deductible in the same manner as bond interest. A number of other suggestions have been made and various combinations of these suggestions proposed.

EVALUATION AND OUTLOOK ON RATIONALIZATION

The various rationalization proposals present individual merits. Those who favor the integration of the corporate and personal income tax are able to present a strong case. They maintain that taxes are not paid by inanimate objects; that corporations as such do not have the true ability to pay; that ultimately all taxes are paid by natural persons. They aver that the double taxation of corporately-distributed profits has adverse effects upon the propensity of individuals to invest in stock; that the corporation income tax is more likely to be repressive to business activity than "direct taxes" upon stockholders. It puts *stock financing* at a disadvantage as compared with *bond financing*. The incidence of the corporate net income tax is by no means crystal-clear. The advocates of integration recognize the abuses that can arise out of using the corporation as a "savings bank" for undistributed profits and avoidance of the personal tax. However, they maintain that tax institutions can

[5] Groves, *Postwar Taxation and Economic Progress*, pp. 62-67.
[6] Groves, *Financing Government*, (3rd ed.), pp. 179-180.
[7] Groves, *Postwar Taxation and Economic Progress*, pp. 59-62.

be set up which will minimize this problem. These arguments cannot be passed over lightly.

On the other hand, those who would continue the use of the corporate net income tax can also present a forceful case. This was pointed out earlier in the chapter. Furthermore, they say the "change-over" to the integrated tax woud cause "transitional" and "frictional" maladjustments in the economy. It is probably true that those who purchased stock while the corporate tax was in operation have discounted the anticipated tax burden in the prices they paid for the stock; the repeal of the corporate tax would be capitalized into healthy windfall capital gains for stockholders, in addition to the direct gain from possible increased dividends.

The author takes the realistic view that the need for revenue and our governmental responsibilities are now so great that it might be unwise to risk the three-to five-year period of transitional and frictional readjustments that the integration of the corporate and personal tax would involve. If we were now in a more normal postwar period, the author's attitude might be different.

There are many reasonable tax adjustments which can be made within the structure of our present corporate and personal income tax system.

Among the adjustments which would be helpful are: (1) a longer carry-over of business losses (now provided under 1950 act); (2) more latitude in allowances for depreciation; (3) a lowering of corporate income tax rates; (4) tax adjustments for small business; (5) elimination of minor business taxes; (6) more generous allowances for research and development; (7) a more thorough policing of the abuses of corporate hoarding; and (8) the possible taxation of co-operatives on the firm's profits. All of these adjustments can be valuable for both short- and long-run purposes and can contribute to a more rational taxation of corporate business.

SECTION II

The Taxation of Excess Profits

Introduction

THE CORPORATE EXCESS PROFITS TAX, a levy separate and distinct in itself, has been used in the United States primarily as a wartime measure. This country has experimented with an excess-profits tax during two world wars with a mild degree of success. During World War I this tax yielded about $5.5 billion. In the late War it produced about $34

billion in revenue. Because of strong opposition to it by corporate organizations and dissatisfaction with it by the Treasury, in each instance the tax was repealed shortly after the close of hostilities.

This section will analyze our excess profits tax experience in two world wars, appraise the value and significance of a wartime excess profits tax, and consider the possibilities of a peacetime excess profits measure.

The Excess Profits Tax in World War I

EVEN BEFORE the United States entered World War I Congress passed several acts in an attempt to tap excessive war profits. The first was the *Munition Manufacturers' Tax of 1916;* this was directed at the expanded profits of the producers of munitions and implements of war. Two acts in 1917 were passed in an effort to tax heavy war profits in all industries.

THE EXCESS PROFITS TAX OF 1918

Both versions of the 1917 law were extremely complex and poorly drawn. Controversies raged over the interpretation of their provisions and there simply was not enough experience available for them to be administered properly. They were generally observed to be unworkable. In an effort to make the law workable, a nine-man Excess-Profits Tax Advisory Committee was appointed early in 1918 to interpret and clarify various provisions. The work of this committee paved the way for the much-improved and fairly workable *Revenue Act of 1918.*

The excess profits tax of 1918 really consisted of two taxes: a *War Profits Tax* and an *Excess Profits Tax.* Separate designation of the two taxes clearly indicated the intent of Congress to tax not only those profits directly associated with the war, but also to tax non-war profits regarded as excessive in relation to capital invested.[8] By the 1918 law, individuals and all types of business except corporations were excluded from the tax.

War profits tax. This tax was based upon the *excess* of earnings during the war years *over* the average earnings of the same taxpayer during the three prewar years, 1911-13 inclusive (the base period). A "war profits credit" was allowed in the amount of a flat sum of $3,000 plus the average annual net income for the *base period.* Under this version of the tax the rate was 80 per cent of the excess.

Excess profits tax. This tax was based upon the earnings of a corporation in excess of what was considered to be a "normal" rate of return

[8] Kenneth James Curran, *Excess Profits Taxation,* American Council of Public Affairs, Washington, D. C., 1943, p. 63. Dr. Curran presents a rather complete analysis of the technical aspects of the excess profits tax in both World Wars.

(8 per cent in 1918) on *invested capital.* The definition of invested capital remained about the same as in the 1917 law except that the inclusions for intangible assets were somewhat liberalized.

These two taxes were alternative—that is, the federal government collected whichever of the two was the higher. Also, the tax paid was in addition to the regular corporate net income tax, although the corporation could deduct the excess profits or the war profits tax in computing its net income tax.

APPRAISAL OF 1917 AND 1918 LAWS

Aside from the fact that this first excess profits tax was a good revenue producer, there was little to commend it. Corporations, in general, attacked the tax as being exceedingly discriminatory; the Treasury was highly critical of the tax because of its many loopholes and the many difficulties involved in its administration. In his annual report for the fiscal year ended June 30, 1920, the Secretary of the Treasury, David F. Houston, made it very plain how the Treasury and many other government officials felt about the tax:

> The tax does not attain in practice the theoretical end at which it aims. It discriminates against conservatively financed corporations and in favor of those whose capitalization is exaggerated; indeed, many overcapitalized corporations escape with unduly small contributions. It is exceedingly complex in its administration, despite the fact that it is limited to one class of business concerns—corporations.

In spite of the dual nature of the tax, *invested capital* was "the primary standard both in form and fact."[9] The determination of invested capital was the main area of confusion and controversy, and in 1921 hundreds of such cases were awaiting court action. The tax was repealed, effective January 1, 1922, and the government substituted for it an "increased" corporate net income tax.

The Excess Profits Tax in World War II[10]

SECOND REVENUE ACT OF 1940—GENERAL PROVISIONS

Following the collapse of France in the spring of 1940, it became apparent that greatly increased revenues would have to be raised for our expanding defense program. This second major excess profits tax in our history became law as a provision of the *Second Revenue Act of 1940.*

[9] *Ibid.*, p. 81.

[10] From 1933 to 1945 the federal government levied the so-called capital-stock declared-value excess profits tax, but it was not important from the excess profits point of view.

The tax followed, in general, the model used near the close of World War I: it applied solely to business corporations, and the tax was calculated on the same two alternative bases—excess profits over the *base period* or in relation to *invested capital*—although this time, the taxpayer, not the government, had the choice of alternatives. There were several amendments to the 1940 Act, the majority of which were enacted in 1942. The primary intent of these amendments was to increase the revenue by raising the rates; however, the increase in rates was frequently offset by the granting of liberal relief provisions. The recency of our experience with the second excess profits tax gives opportunity to examine closely its actual operation. This will be done in relation to each "base or approach" which the corporation had the option of using in determining the tax. Basically, the provisions will be discussed as they stood at the close of the War in 1945.

THE "BASE PERIOD" APPROACH

Main provisions. Under the base period approach the excess profits were computed on the *excess of profits* in the taxable period over those earned in the four-year, prewar period, 1936-39 inclusive. These years were selected for the purpose of determining average "normal" prewar profits. The corporation was allowed a credit of 95 per cent of average earnings for this period; the excess was taxed at a flat 95 per cent (90 per cent under the 1940 Act). The first $10,000 of excess profits were exempt. In calculating the average earnings for the four-year base period, the corporation was allowed to include the profits of any year as 75 per cent of the average of the other three, even though the net earnings of that year were less than that percentage.[11] This was to overcome the effects of the recession of 1937-38. The above 75 per cent allowance is not to be confused with the 80 per cent limitation to be discussed later under the heading of "relief provisions."

Appraisal. The computation of the tax under this method is much simpler than under the invested capital method, and it is theoretically better adapted to the determination of excess profits attributable to war. However, despite some of its liberal relief provisions, it was open to some fundamental criticisms:

First, the years chosen as the base period for the determination of normal profits were not particularly representative; they were undoubtedly chosen for purposes of expediency. It will be recalled that the Recession of 1937 occurred within this period.

Second, the method generally tended to favor the older, well-established firms whose earnings were relatively high in both the base period and

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[11] Curran, *op. cit.*, p. 184.

the war period as against newer and smaller companies whose income had been steadily increasing during the base years and during the war. Thus, the well-established corporation, with high profits during the base period and some increase in profits during the war period might still pay less in excess profits tax.[12] The Coca-Cola Company represents an outstanding example of this type of situation.[13]

Third, this method tended to discriminate against rapidly growing businesses with fluctuating earnings, those in which the element of risk is normally great, those which had spent years in developing new processes and patents that materialized after the base period, and against those contractors working on projects requiring a number of years to complete.[14]

THE "INVESTED CAPITAL" APPROACH

Main provisions. If the corporation used the invested capital method for calculating earnings subject to the excess profits tax, it was allowed an 8 per cent credit (normal profits) on the first $5 million of its invested capital, 6 per cent on the next $5 million, and 5 per cent on invested capital over $10 million. Under this method the corporation was given $10,000 specific exemption against excess profits. Invested capital included not only those items listed in the 1918 Act but also one-half of the borrowed capital. Restrictions on the inclusion of intangibles were largely removed. However, businesses were not permitted to include appreciation on assets in the invested capital base. As under the base period method, the excess over allowable credits (normal profits) was taxed at a flat 95 per cent. The 1941 Act also provided that the excess profits tax under both methods be computed before deducting the corporate net income tax from the base.

Appraisal. Computation of the excess profits tax under the *invested capital* method is subject to perhaps more serious objections than under the *base period* approach.

First, the determination of the invested capital of a corporation is just as difficult as it sounds in many cases. If the corporation is an old one, the determination of its invested capital entails considerable expense for accountants and lawyers, and it involves an analysis of the mode of acquisition of each item of assets on hand.

Second, the determination of invested capital brought up the controversy over "cost vs. replacement value" for fixed assets in balance sheet presentation and for purposes of recording depreciation. Statutory

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[12] Roswell Magill, *The Impact of Federal Taxation.* New York: Columbia University Press, 1942, pp. 155-156.

[13] Groves, *Financing Government,* p. 194.

[14] Magill, *op. cit.,* p. 156: see also Roy Blough, "Measurement Problems of the Excess Profits Tax," *National Tax Journal,* Vol. 1, December 1948, pp. 353-365.

invested capital may have no particular relation to either the present value or the cost of the assets.

Third, the tax rate was discriminatory on the larger firms—the larger the amount of invested capital, the less the percentage of credit (rate of normal profits) allowed. It was also considered unwise to have exempted individual proprietorships and partnerships from the tax; even the graduated personal income tax rates applied to non-corporate income did not offset the disadvantage of the high corporate rates.

Fourth, certain corporations with large capital investments (such as railroads, public utilities and other "heavy industries") benefited substantially under the invested capital method. Their profits increased materially during the war, yet they were not excessive in relation to the heavy capital investment.

RELIEF PROVISIONS

In order to temper somewhat the 95 per cent rate of the tax, certain liberal relief provisions were inserted into the law.

First, the law stipulated that the corporate income and excess profits taxes combined could not exceed 80 per cent of the taxpayer's net income.

Second, a 10 per cent postwar refund on excess profits tax paid into the Treasury was allowed the corporation. This was a form of "forced saving" in that the taxpayer was given non-interest-bearing and non-negotiable bonds. They could be redeemed at the option of the government at the close of the War on three months notice. By June 1946 over $1 billion or practically all of these bonds had been redeemed.

Third, the carry-back and carry-forward provisions were perhaps the most important of the relief provisions. The most significant was the carry-back of "unused excess profits tax credit." This was especially true for 1946. If, as a result of reconversion, strikes, and other factors in 1946, profits were less than those for the base period or less than "normal profits" under the invested capital method, then the corporation could recapture the difference from the excess profits taxes paid in 1944 and 1945. Most companies in fact earned more than normal profits in 1946 and so had no "unused excess profits tax credit." However, many millions of dollars were paid back to companies that did not get going effectively so soon.

Fourth, the privilege of accelerating the amortization of war facilities was extended to cover outlays made subsequent to December 31, 1939. These relief provisions applied whether the corporation used the base period or the invested capital method.

Fifth, special consideration was given to "unusual or excessive" items of income of any kind. Under Section 721 abnormal income received in an excess profits tax year could, if it had been earned over a long period of time, be allocated back to the years over which it was earned.

This prevented unusual income realized in the taxable year (but earned or recovered over a number of years) from being subject to the high excess profits tax rates. It applied to long-term contracts, the recovery of judgments on patent infringements, and so on.

Sixth, special relief was granted in hardship cases where an excessive tax was due to an inadequate excess profits tax credit ("unusually low" income during the base period). Under Section 722 the corporation was permitted to apply for a "constructive base period average" in computing its excess profits tax. That simply meant that the corporation could establish what its normal earnings *would have been* had the subnormal condition not occurred. Under this section, if the corporation could demonstrate subnormal earnings in 1936-39 because of strikes, fuel shortages, temporary depression peculiar to the taxpayer's business, price-cutting competition, the loss of a major customer, and so forth, then Section 722 relief could be utilized.

THE REPEAL OF THE EXCESS PROFITS TAX IN 1945

Months before hostilities had ceased a good deal of support was given to the idea of the repeal of the excess profits tax at an early date. There was some concern over the problems of reconversion, possible postwar unemployment, and the need for risk capital. It was advocated that repeal would have stimulating effects on the economy. On the other hand, some fiscal students recommended that the tax be retained for one or more years on the theory that the postwar period would be one of high, "war-induced" profits that ought to be treated in the same manner as war profits themselves. However, the former view prevailed, Congress acted in the fall of 1945, and the repeal became effective December 31, 1945.[15]

The Excess Profits Tax in the 1950's

THE EXCESS PROFITS TAX ISSUE REVIVED

With the outbreak of the Korean War in the summer of 1950, the issue arose whether or not an excess profits tax should be reimposed. Congress passed the *Revenue Act of 1950* increasing both personal and corporate income tax rates and then adjourned. It instructed its revenue committees to study the possibilities of re-enacting an excess profits tax and to report when that body reconvened in November. That issue was considered both in and out of Congress in the late fall of 1950. The

[15] An additional technique developed during World War II to aid the federal government in recapturing excessive profits was the renegotiation of war contracts. This will be discussed in Chapter 29 dealing with taxation in wartime.

discussion involved the wisdom of utilizing an excess profits tax in a quasi-war situation. There was strong opposition to the excess profits tax. It was argued that it was too difficult to administer. The Treasury Department took this position. It was maintained that the excess profits tax was injurious to new and small companies. An effort was made to increase the rates of the corporate net income tax *in lieu* of an excess profits tax. However, the concept of the excess profits tax prevailed. The Senate passed the bill on December 22, 1950, and the House of Representatives acted similarly on January 1, 1951.

THE EXCESS PROFITS TAX ACT OF 1950—GENERAL PROVISIONS

The passage of the *Excess Profits Tax Act of 1950* meant that for the third time in its history the federal government resorted to an excess profits tax. The general pattern of the new law was much the same as that used during World War II. The tax applied only to corporations, and the taxpayer was given the option of using either (1) the *base period* or (2) the *invested capital* method in determining excess profits. The tax was designed to absorb a good fraction of profits stemming directly or indirectly from rearmament.

The rate to be applied to defined excess profits was 77 per cent as compared with 95 per cent in World War II. Not more than 62 per cent of the earnings could be taken from a corporation under the combined corporate net income and excess profits tax. This compared with 80 per cent under the previous law. As an incentive consideration to small companies with net incomes of $25,000 or less, complete exemption from the excess profits tax was allowed. The act was made retroactive to July 1, 1950.

THE "BASE PERIOD" APPROACH

Under the "base period" approach, excess profits were defined as the earnings "above" 85 per cent of the corporation's average annual earnings in the three "best" years of the four-year period, 1946-49. The corporation was permitted to eliminate its worst year in determining average base period net income and thus to minimize the excess profits in future years. This option would work to the advantage of those corporations which had had relatively high profits in the postwar years.

THE "INVESTED CAPITAL" APPROACH

The other optional approach to the determination of excess profits was to define them in relation to the amount of capital invested in the business. Under this method excess profits were those "above" 12 per cent on the first $5,000,000 of capital invested, "above" 10 per cent on the second $5,000,000, and "above" 8 per cent on more than $10,000,000 invested.

Under this option 75 per cent of a corporation's borrowed capital would be considered invested capital, and 25 per cent of the interest payments on such capital could be deducted from current income subject to the excess profits tax. In most respects this option was more generous to the taxpayer than the World War II tax.

A feature not present in the World War II Act gives special treatment to the "regulated industries." Excess profits for them were to be related to their "allowed rates of return" under regulation. They were to be allowed *returns* on equity capital, borrowed capital less interest payments, and retained earnings before taxes as follows: 7 per cent for telephone and telegraph services and 6 per cent for electric power, gas and water, surface transportation (including shipping), and petroleum and gas pipelines. Under this method, these corporations are assured a minimum return after normal and surtaxes before being subject to the excess profits tax.

MISCELLANEOUS PROVISIONS

The act contained a number of optional formulas created to meet the needs of certain types of industries in special circumstances. They seek to obviate the general relief procedures of the World War II excess profits tax. They applied to new and growing corporations (television corporations), to firms with substantially enlarged capacities, and to certain depressed industries such as airplane manufacturing, ship building, and machine tool industries.

Full exemption from the excess profits tax is given corporations engaged in mining certain strategic materials. The act further allowed a five-year carry-forward and a one-year carry-back of unused excess profits tax credit as compared with a two-year carry-forward and a two-year carry-back permitted in World War II.

The 1950 excess profits tax, designed for a partial war situation, was much more generous in its impact upon the taxpayer than its predecessor of the 1940's. It is quite likely that if a full-scale war develops, the tax will be materially strengthened. The next section appraises the use of an excess profits tax in a full-fledged war period.

An Appraisal of an Excess Profits Tax in Wartime

JUSTIFICATION OF THE TAX IN WARTIME

An excess profits tax as an emergency measure in wartime has not met with serious resistance in this country. Such a tax can be justified on a number of valid grounds: (1) When able-bodied young men and women are being drafted for military service and when individual in-

comes bear high taxes, it is only fair to drain off corporate profits over and above a reasonable return on investments. Neither corporations nor individuals should be permitted to profit unduly in time of national hardship. (2) In wartime it is government with its huge expenditures that is creating the opportunity for high profits. Government should share in the profits it directly induces. (3) An excess profits tax is a necessary adjunct to an anti-inflationary program. It would be difficult politically to sustain price controls, rationing, and wage controls without an excess profits tax. (4) It prevents the growth of an inequitable distribution of wealth and minimizes the rise of a large body of "war rich." (5) It makes some contribution to checking monopoly. (6) It is an excellent revenue raiser which helps to cut down the cost of the war and the need for more borrowing. In 1945 the excess profits tax brought in over $11 billion. In 1944, '45, and '46 it produced about twice as much as the corporate net income tax.

MAJOR CRITICISMS OF OUR WAR EXCESS PROFITS TAX

The tax could have been much more productive. Professor Groves points out that the tax was set up with noticeably high rates, but with a relatively "easy" base.[16] The 95 per cent rate frightened the corporation lawyers, managers, and accountants, with the result that they resorted to every conceivable device and loophole to keep as much of the "base" from the 95 per cent rate as possible.

Looking at the tax from the standpoint of the taxpaying corporation, the tax lacked much in being "fair and equitable." It attempted to apply one of two approaches to all kinds of corporations, with all kinds of capital structures, risks, and earnings.[17] It is to be noted also that the high tax rates on the margin of income encouraged considerable squandering of income. For example, many firms conducted elaborate advertising campaigns largely at the expense of the federal government (because the income thus spent would otherwise have been taken in taxes). It is said to have contributed to inflation by discouraging resistance to wage and cost increases. Because of the wide variety of industries (with varying economic, risk, and investment characteristics) to which the complex excess profits tax had to be applied, the law was exceedingly difficult to administer. The Treasury was the first to admit this. Many of the criticisms directed at the tax, however, could be adjusted and remedied as a result of World War II experience.

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[16] Groves, *Financing Government*, p. 194.

[17] Magill, *op. cit.*, p. 157.

Possibilities of a Peacetime Excess Profits Tax

OBJECTIONS TO THE TAX IN PEACETIME

The preponderance of opinion is against the levy of an excess profits tax in peacetime. A few authors venture a skeptical "maybe." Some of the more important objections to the use of such a tax in peacetime are as follows: *First*, it would tend to eliminate the incentives for risk-taking and expansion on the one hand, and the efficient use of the factors of production on the other. It would be exceedingly difficult to devise an excess profits tax that would allow for differentials in the risk element or for efficient management.[18]

Second, an excess profits tax would not necessarily control and discourage monopolies. In fact, a special tax on the margin of income would discourage some companies from entering the field and thus aid in perpetuating existing monopolies or in creating new ones. Also, an effective system of price control would have to be integrated with such a tax in order to prevent the incidence of the tax from falling on the consumer in a sellers' market.

Third, monopoly profits in peacetime are difficult to define, measure, and segregate. Monopoly is only a matter of degree; monopolistic competition can and does result in definite benefits to the consumer. There are better ways of controlling monopolies than by an excess profits tax, such as positive regulation of business, lowering of foreign trade barriers, and encouragement of consumers' co-operatives.

Fourth, it would penalize firms with fluctuating profits. Thus, a company which earned 7 per cent regularly might have to pay no excess profits tax, whereas a concern that would alternate between 15 per cent and no income or a deficit might pay a substantial tax in some years. It would also tend to discourage the small, growing business and thereby foster the monopoly of the older, well-established firms.

Fifth, it would "interfere with the function of profits, which in normal times is that of stimulating the flow of investment, guiding the direction of that flow, and inducing reduction of costs." [19]

Sixth, much litigation always results from such a tax law, and the cost of compliance is necessarily higher than under the regular corporate income tax. As Professor Groves has further observed, "... annual accounting is inherently tentative, provisional, and inexact, and it is sorely pressed to give the precise answers required by an excess profits tax." [20]

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[18] Groves, *Postwar Taxation and Economic Progress*, pp. 77-78.
[19] Committee on Postwar Tax Policy, *op. cit.*, p. 130.
[20] Groves, *Postwar Taxation and Economic Progress*, p. 79.

CRITERIA FOR EXCESS PROFITS TAX IN PEACETIME

There are some fiscal authorities who believe that a reasonable, well-adjusted excess profits tax can serve a useful function in the tax structure of our peacetime economy. Certain levers within the excess profits tax itself offer opportunities for adjustment to long-run peacetime purposes. (1) Naturally, for peacetime the *invested capital* method would be more desirable than the *base period* method. Here with experience over time and free from the pressures of a war economy, we might learn to define and establish "invested capital" for excess profits tax purposes just as we have learned to establish the "rate base" in public utility regulation. (2) The next lever that could be adjusted is that of normal and excess profits. The former could be defined more liberally and the latter more strictly than in wartime. (3) Specific exemptions of part of the excess profits could be granted so as not to draw capital away from new and small businesses. (4) The excess profits tax "rate" could be reasonable; it is not necessary to have a 95 per cent rate. (5) The carry-back and carry-over of unused excess profits tax credits could be worked out in such a way as not to injure the risky business with fluctuating income. These adjustments together with others could, say some advocates, produce a workable and yet productive excess profits tax.

In addition, they claim that such a tax could make a contribution to the control of monopoly, yield additional revenue, act as a stabilizing force during boom periods, and tend toward the prevention of greater income inequality.

SECTION III

The Taxation of Undistributed Profits

The Setting and the Problem

UNDER OUR PRESENT SYSTEM of separate corporate and personal income taxes, the claim is continuously made that there is double taxation of corporately-distributed profits. On the other hand, there are those who also claim that the undistributed part of corporate profits pays but one tax. In many corporations it is possible to control the distribution and thus retain a substantial part of the profits subject to but a single tax. Sometimes that is done for the purpose of avoiding personal income

tax for stockholders; sometimes it is done for the purpose of plowing back profits for expansion.

In thousands of closely-held corporations both of these practices are far from academic. Even in many large entities, the second practice is quite common—in fact many large companies have become large by that very process. In the first instance the undistributed corporate profits are the savings of the corporation, but ultimately they are the stockholders' savings which may be enjoyed with a lesser amount of tax. This leads to a serious discrimination against profits earned by individual proprietorships and partnerships which are taxed at the full personal rates, whether the profits are distributed or not.

In addition to the discrimination mentioned above, other social and economic consequences are said to flow from heavy corporate saving. (1) It creates the temptation for management to gain power with stockholders' money, and it strengthens the hold of the board of directors on the corporation. (2) It may not result in the best allocation of investment resources. The decisions of the managers to expand are not tested in the free market of investments. (3) Corporate savings tend to encourage the overexpansion of plant and equipment and contribute to booms and depressions.[21]

On the other hand, the supporters of corporate saving maintain that this is a needed source of business capital. This is particularly true for the small businesses which find it difficult and expensive to acquire capital in the open markets. Most authorities recognize the value of corporate savings and the ease with which they can contribute to business expansion, but some question is raised whether they should be given preferred tax treatment.

The Undistributed Profits Tax of 1936

REASONS FOR PASSAGE OF THE ACT

The idea of taxing undistributed corporate profits did not originate in the social and economic atmosphere of the 1930's. Suggestions for taxing undistributed profits were made at the close of World War I. However, it was not until the concurrence of a number of circumstances in 1936 that an undistributed profits tax received adequate political support. One of the circumstances was the need for revenue. Early in 1936 the *Agricultural Adjustment Act* and its processing taxes were declared unconstitutional. In addition, the passage of the veterans' bonus

[21] Groves, *Postwar Taxation and Economic Progress*, pp. 46-47.

payable in 1936 added $120 million to debt-interest charges. These two events made it necessary to raise an additional $620 million.[22]

In this situation President Roosevelt proposed an undistributed profits tax upon corporations. In his message to Congress on March 3, 1936, he gave several reasons why such a tax was desirable: [23] (1) existing inequalities between incorporated and unincorporated business would be reduced; (2) inequalities between income retained and income distributed would be lessened; (3) the corporate tax system would be simplified; and (4) substantial revenue would be brought in.

THE PROVISIONS OF THE ACT

Section 14 of the 1936 Act levied a surtax on all annual corporate profits that were *not distributed* as dividends. The tax was graduated according to the percentage of the adjusted net income retained. In an effort to protect the capital needs of small business, a specific credit of $5,000 was granted on the adjusted net income of those companies with incomes of less than $50,000.

The rate structure was set up in such a way that the larger the percentage of profits undistributed, the higher the rate of tax.

Table VI

UNDISTRIBUTED PROFITS TAX RATES, 1936-38

Per Cent of Adjusted Net Income Retained	*Rate*
Up to 10%	7%
10-20%	12%
20-40%	17%
40-60%	22%
Over 60%	27%

Note: If a corporation retained all of its income the effective rate would be 20.5 per cent.

The tax produced $145 million in 1936 and $176 million in 1937. In addition, it stimulated the increased payment of dividends in both years (which probably netted about $60 million in personal income taxes).

The Act was not well received by the business world. A law which discouraged direct investment seemed particularly inappropriate at a time when business was being urged to increase employment. The sudden downturn in 1937 was blamed in part on the undistributed profits tax. The recession made the tax more unpopular than ever. The *Revenue Act of 1938* reduced the rates to a flat 2½ per cent, which for all practical purposes meant the repeal of the Act. In 1939 the undistributed profits tax was repealed entirely.

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[22] G. E. Lent, *The Impact of the Undistributed Profits Tax, 1936-37*. New York: Columbia University Press, 1948, pp. 17-18.

[23] A. G. Buehler, *The Undistributed Profits Tax*. New York: McGraw-Hill Book Co., 1937, pp. 22-23.

Appraisal of the Undistributed Profits Tax

THE CASE for the undistributed profits tax has already been set forth. The proponents underestimated the reaction of corporate managers to the tax, the economic consequences of forcing the payment of dividends, and the tapping of corporate savings by taxation.

The experience with the tax from 1936 to 1939 strengthened the case against the tax. The tax was particularly hard on debt-ridden concerns, businesses with fluctuating earnings, and those bound by contractual limitations on the distribution of earnings. The leading arguments against the tax can be summarized as follows: (1) The tax tended to interfere with the policy of building reserves for future contingencies. (2) It would increase business instability by forcing corporations to pay out that which should have been saved for future needs. (3) It hit small and new corporations quite hard by taking from them what they needed for expansion and what they could not easily get in the capital markets. (4) It tended to increase immediate revenues, but it also tended to decrease them in poor years because no reserves for future dividends were likely to be maintained. (5) It resulted in a reduction of business savings available for expansion, and some doubt exists whether the capital markets replaced the funds taken by the tax.[24] (6) The tax had some tendency to curb the propensity of the corporation managers to invest and expand. The repeal of the tax seems to have been fully justified.

Present Supplementary Undistributed Profits Taxes

THE EXPERIENCE with and the repeal of the 1936 tax does not mean that there are no special problems associated with the retention of corporate profits. Those problems are related to the abuses of retention for an ulterior purpose—to avoid personal income taxes. Several specific pieces of legislation have been conceived to prevent the accumulation of profits to avoid income taxes. The two most direct attacks upon this problem are *Section 102 of the Internal Revenue Code* and the special taxation of personal holding companies.

SECTION 102 OF THE INTERNAL REVENUE CODE

Section 102 levies a penalty surtax upon corporations that accumulate profits to prevent the imposition of surtax upon their shareholders. The penalty surtax rates are: 27½ per cent of the first $100,000 of net income undistributed each year and 38½ per cent on the remainder. The ac-

[24] Lent, *op. cit.*, p. 188.

cumulation of profits beyond the reasonable needs of the business is *prima facie* evidence of a purpose to avoid surtax. If a corporation is found guilty of improper accumulation of profits, the entire net income accumulated is subjected to the tax, not just the portion improperly retained.

The returns of closely-held corporations, corporations which have invested in securities or other properties unrelated to their normal business activities, and corporations which have distributed less than 70 per cent of their net earnings for the given year are examined carefully to determine whether the penalty surtax should be levied. In 1946 the Treasury placed a question in the corporate net income tax return asking whether the corporation had distributed 70 per cent of its earnings. The question created much concern among corporate managers, and they complained so heavily that the question was excluded in 1947. Most companies were distributing only about 50 per cent and thinking in terms of reconversion and postwar expansion; they therefore feared the penalty.

The big difficulty lies in proving that the given retention of profits is unreasonable. The federal government has not been very successful in enforcing this penalty surtax. Section 102 is valuable more as a threat than as an effective law under which to prosecute violators. Slightly less than one-half of the cases under the section have been won, which is a very poor showing when it is considered that the government chooses to prosecute those in which the most flagrant violations have occurred. Section 102 is a small tool for a big job. Congress will have to put teeth in the law before it will become effective. The use of the 70 per cent question on the corporate net income tax return is a helpful device from which to observe and investigate but not to prosecute blindly.

OTHER DEVICES FOR TAXING UNDISTRIBUTED PROFITS

Another major technique for getting at accumulating profits to avoid personal income taxes is that of designating certain closely-held corporations whose profits come largely from investments as "personal holding companies" and taxing the retained profits at very high rates. At present, the rates are 75 per cent on the first $2,000 of undistributed profits and 85 per cent on retentions above that. This technique on the whole has been more effective than Section 102.

Then, too, it must be remembered that undistributed profits are often reached in the long run under capital gains taxes. These gains now receive preferential treatment and they can escape income tax accounting, if the stock is held until death and handed on to the next generation. Undistributed profits are also reached in the case of certain stock dividends which are now held to be taxable.

Conclusions on Undistributed Profits Taxation

IF WE WERE TO USE the integrated personal and corporate income tax system, then a special effort should be made to tax the undistributed part of the profits. However, as long as we use a separate personal and corporate net income tax and all corporate net income (whether distributed or not) is subjected to a substantial tax rate, there is no need to become greatly concerned about the further taxation of undistributed profits. If the profits are legitimately plowed back into the business, the increased investment, production, and employment enjoyed by the economy more than compensate for any full-coverage undistributed profits tax.

The main problem is to guard against serious abuse in corporate retentions for personal tax avoidance purposes. The existence of the following types of measures should meet the issue: (1) a corporate net income tax covering all net income whether distributed or not; (2) the personal income tax covering the part actually distributed; (3) capital gains taxes on the sale or exchange of corporate stock during life and its transfer at death; (4) the taxation of most stock dividends; (5) a strengthened and firmly-administered Section 102; and (6) the taxation of personal holding companies at high rates. Under this combination of measures all undistributed profits would be accounted for by the tax system in the long run.

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The Taxation of Special Business · 1. PUBLIC UTILITIES 2. AIRLINES 3. CO-OPERATIVES

THE TAXATION *of public utilities proceeds under the taxing power. It is therefore subject to the constitutional limitations imposed by the rule of equality. Taxation of the various tax subjects must be equal; the central problem, therefore, is one of determining what methods will produce equality of tax burden as between public utilities and other tax subjects.*

—MARTIN G. GLAESER.[1]

Overview

DIFFERENT TYPES of business have different economic characteristics. State governments in taxing business have attempted to recognize these characteristics for tax purposes. Sometimes different tax-treatment is applied because the economic characteristics of a given business require it. At other times a modified tax approach has to be used to insure equality for the particular type of business taxed. And, again, special tax-treatment is resorted to in order to equalize the economic power of several competing businesses. Finally, the taxing power has been exercised upon certain businesses for regulatory purposes.

Among the types of business whose special characteristics have been recognized for tax purposes are railroads, public utilities, co-operatives, airlines, banks, insurance companies, and chain stores. These businesses have been subjected to a wide range of both general and special taxes.

In this chapter, an analysis is made of the taxation of public utilities and railroads, airlines, and co-operatives. The economic soundness and the social justice of these taxes are appraised. Furthermore, better methods of taxing these businesses are vigorously sought out.

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[1] Martin G. Glaeser, *Outlines of Public Utility Economics.* New York: The Macmillan Co., 1927, p. 574.

SECTION I

The Taxation of Public Utilities

THE TAXATION of public utilities is one of the more controversial subjects in the field of taxation. It is quite safe to say that there are as many varieties of public utility taxes as there are states; indeed, there are more, since the same state often taxes different utilities differently. The problems posed by such a situation and the need for widespread improvements call for thoughtful study of the issues and practices involved in utility taxation.

Special Issues in Utility Taxation

JUSTIFICATION FOR TAXING PUBLIC UTILITIES

One finds no general agreement on the question of whether public utilities should be taxed or the degree to which they should be taxed. It is argued by some that public utilities should be entirely exempted from paying taxes on the ground that such taxes are merely sales taxes which fall on consumers. Thus it is claimed that they are regressive and undesirable. Others argue that special taxes should be levied upon utilities to prevent monopoly profits.

Neither of these arguments stands up under close analysis. Utilities are under the supervision of regulatory agencies which supposedly prevent monopoly profits. If they do not, the correction should be an improvement in regulation and not an increase in taxation. On the other hand, consumers do pay the taxes indirectly, but the consumers of utility services are not identical with the general public; so it can be argued that such consumers should pay for the special benefits they receive. If the policy of exempting utilities is followed, the utility does not contribute its share to the cost of government, nor does it compensate the government for benefits received. Conversely, if utilities are subjected to discriminating taxes, the costs of its services will be increased and the result will be a restriction of services to those who can afford the higher price. With these considerations in mind, it would seem that public utilities should be taxed—but on an equal basis with other businesses.

THE PROBLEM OF INCIDENCE

We have already noted that utility taxes are often objected to because they are essentially sales taxes, the burden of which is ultimately borne

by the consumers of utility services. What is the basis for assuming that consumers pay these taxes?

The theory of shifting assumes that the burden of a tax will be passed on to others, if and when it is possible to so pass it on. There is no need to recapitulate the general theory of how this is accomplished. Suffice it to say that nearly all business taxes are shiftable if and when the economic factors are propitious.

Economic factors in the market are not quite so important in determining whether utility taxes will be shifted to their customers. The explanation for this is that taxes on public utilities have been classified under regulatory laws as *costs* of doing business. This treatment of taxes by regulatory bodies is the result of a decision by the United States Supreme Court. In 1921 the Supreme Court in the *Galveston* case [2] posited that taxes constitute a cost of doing business for a utility and that a *fair return* should be earned over and above *all costs*.[3] This decision was reaffirmed in a later case,[4] and since then regulatory bodies have generally set utility service rates high enough to allow a reasonable return "after taxes." However, when new and additional taxes are levied, the wheels of rate regulation often turn slowly, and it may be some time before those taxes are accounted for in higher rates. On occasion the demand for higher rates is refused.

It should be recognized also that regulation cannot be made to operate so precisely that a fair return and no more will be earned. Consequently, taxes may not be shifted to their full extent, or they may actually be shifted to their full amount plus an additional sum and thus increase the net earnings of the utility. Nevertheless, it is safe to say that in the long run, and under effective regulation, any tax imposed upon a utility is a tax imposed upon its customers.

The taxation of public utilities has taken many forms. The *ad valorem* property tax and the gross receipts tax will be discussed in some detail. Others will be given summary analysis.

Taxing Utility Property —Ad Valorem System

THE *ad valorem* tax is easily the most common one used by state and local governments, in the field of public utility taxation and when it is used it frequently constitutes the heavy artillery in the effort to secure revenue from utilities. The *ad valorem* tax is essentially a property tax, and as

[2] *Galveston Electric Co. v. Galveston*, 258 U. S. 388 (1922).

[3] "Public Utility Taxation," *Journal of Land and Public Utility Economics*, Vol. 23, February 1947, p. 42.

[4] *Georgia Railway and Power Co. v. Railroad Commission of Georgia*, 262 U. S. 625 (1923).

such it is open to most of the same theoretical weaknesses that apply to the property tax. One of the more serious objections to this tax is that there is no way of determining what the proper and just value of the property is. A second objection is that the value of property alone is not a true measure of a corporation's worth or of the taxes it should pay. Nor does this tax measure or reflect the ability to pay of the utility. Finally, the tax is not simple, and it is apt to become arbitrary.

On the positive side, it may be said that most of the theoretical objections do not hold true if the tax is administered by a capable and well-staffed commission. It can also be argued in favor of *ad valorem* taxes that they provide large revenues and that since other businesses are taxed on this basis, it is equitable for utilities to be taxed likewise. The property tax is used to secure revenue from numerous types of public utilities, but it is in connection with railroads that it has reached its fullest development.

LOCAL ASSESSMENT OF UTILITY PROPERTY

The property of railroads and other utilities must have a value placed upon it before the tax rate is applied. In the past, and in some states still, it is a common practice for each locality to assess the railroad and utility property under its jurisdiction on a piecemeal basis. The local assessors were usually ill-equipped to do this properly, with the result that inequities and abuses were common. Assessment districts were often gerrymandered to include certain railroad or utility property. The sum of the assessed values of the various segments often exceeded substantially the true value of the property as a whole.

STATE ASSESSMENT UNDER THE UNIT RULE

The weaknesses of local assessment on a piece by piece basis became more and more apparent with experience under the property tax. Gradually, one state after another developed central assessment of utility property under the "unit rule." Wisconsin and California have been leaders in this development. Under central assessment by a state commission, it is possible to develop a staff of competent personnel on a civil service basis. Specialists can be trained. The whole assessment process is kept more uniform throughout the state. All in all, central administration means more efficient but also more equitable administration.

Central assessment also utilizes the so-called "unit rule" which seeks to overcome the deficiencies of piecemeal, local assessment. The approach under this rule is to assess the entire railroad or utility as a *single unit* rather than segment by segment in each local assessment district. The theory behind the unit rule is that a better indication of true market value is obtained when the entire property is evaluated as a unit. The railroad or utility is appraised as a going concern, which means such an intangible as good will is given some significance in the final value.

PROCEDURE UNDER STATE ASSESSMENT AND UNIT RULE

In the states where central assessment and the unit rule have been adopted, the task of administering the property tax as applied to railroads and utilities has been delegated to the state tax commission or some similar body. If the commission is well organized, it may have a special property tax division which does the great bulk of this type of work for the commission.

The application of the *ad valorem* tax under the unit rule involves about four major steps, each with its own procedures and problems: (1) property valuation, (2) apportionment of a fair part of the property unit as a whole to the taxing state, (3) determination of the tax rate, and (4) the distribution of the revenues to the local units.

Valuation of the property. The statutes usually state that property being valued for tax purposes shall be assessed at its "fair market value." The problem of determining such a value is no simple task under the best of circumstances. In the case of railroads it is particularly difficult, for railroads are not ordinarily being bought and sold. In place of what a railroad would be worth in a free exchange, therefore, a special device has been developed which it is believed gives a value representative of the market value. This value has been called a "constructive market value." It is arrived at by weighing various evidences of value: (1) physical value, (2) value of securities, and (3) capitalized income.

(1) *Physical value.* The basic index of value is the appraised value of the operating property. To obtain this value the tax commission may either send its own appraisers out to assess the property, or it may use the data compiled and maintained by the Interstate Commerce Commission or the state's own utility regulatory commission. More and more, however, the commissions are holding hearings at which the railroads and utilities submit their ideas on what their properties are worth. Sometimes, since the companies have the right of appeal from the assessment of the tax commission, the process takes on the characteristics of "bargaining" to agree upon a value.

However, because physical value data are not always complete and because physical value as set up lacks the "fair market value" element, two other evidences are thrown into the scale. These are the value of outstanding securities and capitalized income. They supplement physical value and utilize the market value concept in an indirect way.

(2) *The value of outstanding securities.* It is a relatively simple matter to note the prices at which the securities of a particular railroad are exchanging. These prices are then multiplied by the volume of securities outstanding. From this total must be subtracted the value of real estate and other nonoperating property, for unit rule assessment seeks to find the value of "operating" property. The nonoperating property is locally

assessed like other property under the general property tax. The value remaining, if taken alone, could not safely be used as an indication of the railroad's value, for security prices are affected by too many variables and fluctuate too violently to provide a fair value at a given time. But it can be of some value along with other factors in "constructing" a fair market value.

(3) *Capitalized income.* The third indicator of value is what is known as the *capitalized value* of the income earned by the taxed property. Assume that a given railroad had earned on the average about $5 million per year over the last five years. Then assuming that the railroads have the right to earn a return of 5 per cent per year, we would "capitalize" the $5 million at 5 per cent ($5,000,000 ÷ by .05 = $100,000,000). In other words, based upon capitalizing the income, the worth of the railroad would be about $100 million. Since capitalized income is an important factor in determining the market value of most income-property, it can be of some value in arriving at the market value of a railroad for tax purposes.

After obtaining these evidences of value, the tax commission must assign them their relative weights and determine what the single value will be. Many factors are considered in this process, and it may be said that it is not a foolproof system of arriving at a fair value. The single value arrived at is, in effect, the temporary assessment, for it is used as a basis for hearings at which interested parties may show why it should be changed. After conducting the hearings the commission then meets again and by a process of weighing and balancing decides what the final assessment will be.

Apportionment of a part to the taxing state. After the value of the railroad as a going concern has been determined, the second step is to allocate to the particular state such part of this value as may justly be taxed by that state. When a utility operates over several states the given taxing state using the unit rule must determine the value of the property within the state. This is done in a variety of ways. Perhaps the simplest method is to apportion the value according to the ratio of rail trackage in the various states. Although simple, this method is arbitrary and unscientific. Furthermore, it favors the thinly populated states with heavy track mileage. In fact, if too many states use this single ratio and other states use several more inclusive ratios, it can be quite inequitable to the railroad. Greater accuracy may be attained by using a series of relevant ratios. A set of ratios used in Wisconsin which takes into consideration a fair coverage of relevant factors and thus results in a more accurate and equitable apportionment is:[5] (1) total track mileage, (2) traffic units—ton miles and passenger miles, (3) locomotive and car mileage, (4) physical

[5] Groves, *Financing Government*, p. 268.

property, (5) gross income from the particular state, (6) net income from the particular state, and (7) traffic originating and terminating within the state.

Each ratio is calculated as a proportion of the given factor (track mileage, for instance) within the state and for the railroad as a whole. These ratios are weighted according to their relative importance by the tax commission in arriving at the state's share of the tax base, so that the commission may find that 20 per cent of the track mileage is within the state, 28 per cent of the traffic units, 28 per cent of the locomotive and car mileage, and so forth. Following through the commission may find that about 25 per cent of the railroad is within the state. If the value of the railroad as a complete unit had been determined at $120 million, the commission would conclude that about $30 million of the railroad value was in the taxing state. This would be the "tax base" for the purpose of taxing the given railroad. Some states which use state assessment do not use the unit rule. They proceed directly to assess the part of the railroad within the state.

The determination of the rate. However, before the above $30 million tax base can be used, two things must occur. The average "equalized value" for the state as a whole must be determined. If the commission finds that the equalized value of all property in the state is 60 per cent of the "true value," then the $30 million assessed value (assuming that it represents full fair market value) would be adjusted accordingly and $18 million would become the actual taxable base. This is true because legally "all property" must be assessed at a uniform ratio, to true value.

The other adjustment has to do with the "tax rate." Throughout the state each tax district has its own rate. In order to be fair to the railroad an "average state rate" must be calculated and applied. This is done by "dividing" the total amount of taxes paid on all non-utility property by the total equalized value of that property. This average state rate is then applied to the equalized property base of the railroad. Under this arrangement utility property is given substantially the same tax treatment as all other property in the state.

The distribution of the revenues to local units. It will be recalled that the unit rule under state assessment has developed as a substitute for local assessment. Originally, each locality having tax jurisdiction assessed the property of railroads and levied a tax upon this value. Although the tax is now levied and collected by the central agency, each locality still retains a vested right in its share of the tax collected. Consequently, it is the usual practice to return the entire amount collected, minus expenses, to the separate taxing entities of the state.

This raises the question of whether only those localities possessing railroad property are to receive the allocated monies. This is the common practice, but it would seem that other localities have some claim to a share and should be included in the distribution. Otherwise, some locali-

ties are apt to have more revenue than is needed, whereas others may have inadequate revenue. Another problem, albeit a minor one, is that allocating the tax receipts to a few favored localities has caused gerrymandering of tax districts to include railroad (or utility) property.

There is a great variety of other procedures in the several states in relation to taxing utility property. This is true with respect to (1) assessment, (2) apportionment, and (3) distribution of the revenues.

The Gross Earnings Methods of Taxing Utilities

THE GROSS EARNINGS TAX (levied by state governments) is the second most common method of deriving revenue from utilities. In a few instances it is used in conjunction with the *ad valorem* tax; but in the majority of cases this tax is used *in lieu* of the *ad valorem* property tax. When used as an *in lieu* tax, the amount of the tax must not be greater than would have been the case under the general property tax for which it is substituted. Furthermore, revenues from *in lieu* gross earnings taxes usually have to be distributed among the local governments which would otherwise have levied property taxes on the operating property of the taxed utilities. When the gross earnings tax is supplementary to the *ad valorem* tax, the common practice is to place the revenues in the state treasury. The gross earnings tax is a flat rate upon gross operating revenue—this is its distinguishing feature.

Arguments for gross receipts tax. The gross earnings tax is strongly supported by many students of utility taxation as being the logical and equitable method of taxing utilities. One author has expressed himself quite strongly and argued that we ought to abandon completely the fiction of determining utility property values and substitute the taxation of gross receipts.[6] In substantiating their views, the proponents of the tax set forth a number of advantages: (1) Gross earnings reflect benefits received from government. (2) Earnings are the real basis of the utility's worth and its taxpaying ability. (3) A gross earnings tax is simple and inexpensive to administer. This is one of the strongest points in favor of the tax. (4) Gross earnings are a matter of fact about which there will generally not be disagreement. (5) There is no need for an annual valuation of property.

Arguments against gross receipts tax. Opponents are not without ammunition for rebuttal. They argue *first,* that the gross earnings tax does not obviate the administrative difficulties of the *ad valorem* tax because of constitutional requirements which it must meet. Thus they argue that

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[6] H. L. Lutz, *Public Finance,* (4th ed.). New York: D. Appleton-Century, 1947, p. 401.

even with the earnings tax there are the problems of valuation, apportionment, rate determination, and allocation of the revenues. *Second*, they argue that the constitutional limitations, both federal and state, make this tax either undesirable or impossible to use. *Finally*, they argue that the gross earnings tax is an accurate measure neither of ability to pay nor of benefits received from government.

All in all, it would appear that both gross earnings and property taxes enjoy advantages and suffer disadvantages, and that, as a general proposition, it is impossible to call one better than the other.

Miscellaneous Taxes Upon Utilities

State income taxes. Most of the states having a net income tax have extended it to public utilities, taxing them, along with other corporations, on their annual net income in addition to the regular property or gross earnings taxes. In its favor is the argument that it is a good measure of the ability to pay. Furthermore, it is a simple tax to administer.

Franchise taxes. There are two general classes of franchise taxes. First, utilities may be taxed upon their right to do business and use public property and rights of way. This type of tax fits the name much better than do those falling in the second class. It is a direct privilege tax. The second class of franchise taxes includes a congeries of special levies, the most common of which are:[7] (1) capital stock tax, (2) corporate excess tax, (3) flat sum payment, (4) physical unit tax, (5) franchise tax measured by net income.

These taxes originally developed as supplementary to the general property tax, and they have been used by both the state and local units. The purpose behind this second class of franchise taxes is to reach the intangible something representing the value of the "corporate excess"—that is, the difference between the value of a corporation as derived from the capitalization of its earning power and the value of the corporation as expressed by the par value of its stock.

Sundry utility taxes. In addition to the foregoing taxes, a number of others are often resorted to by the state and local taxing units. Included here are sales taxes, license taxes, production taxes, and services or contributions to the taxing unit. Some states levy as many as four and five taxes on some classes of public utilities. On the whole, these minor taxes are unimportant in the general picture of utility taxation. Their *raison d'etre* is difficult to justify on any grounds other than expediency.

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[7] C. Woody Thompson and Wendell R. Smith, *Public Utility Economics.* New York: McGraw-Hill Book Co., 1941, p. 562.

It can be argued against them that they serve mainly to add confusion to a given tax structure. Furthermore, they place the added burden of bookkeeping and record keeping on the utilities and upon the rates paid by utility service consumers.

Then, too, it must be remembered that the federal government is also in the picture both as a regulatory agent and a taxing body. Federal corporate taxation began in 1909 and applied to public utilities as well as to other corporations. There has been no attempt at the federal level to devise special taxes for public utilities. The federal taxes which have been applied to utilities as well as to other corporations in the past are: (1) capital stock tax, (2) net income tax, (3) excess profits tax, (4) undistributed profits tax, and (5) social security taxes.

These taxes have been discussed elsewhere; there is no need to devote further space to them here. At present, utilities pay net income, excess profits, and social security taxes to the federal government. However, there are a number of federal excise taxes on utility and railroad services, a carry-over from World War II, which have not as yet been substantially reduced or repealed in spite of strong agitation in that direction.

The Taxation of Locally Owned Utilities

IN THE LAST TWENTY YEARS there has been a noticeable increase in the number of cities and other local units which own a number of the various utilities which service their communities. This trend has been strongest in water, electricity, urban transportation, and gas. One of the major arguments in favor of municipal ownership of utilities is that such utilities are exempt from most forms of local, state, and federal taxes.

As to exemption from local taxes in the early years of municipal ownership, it is often claimed that the general taxpayers are subsidizing the service to the utility consumers. But once the utility begins to show a net profit, usually municipal ordinances provide that a part of the profits must be turned over to the city treasury each year. The city of Los Angeles in recent years has been receiving over $10 million per year from its Department of Water and Power. Many other smaller cities have had a similar experience. In the situation where the municipal rates are set high enough to yield substantial returns, this collection has the effect of a gross receipts tax and the consumer-ratepayers are really paying taxes that should be the responsibility of citizens generally.

Some authorities claim that this transfer of revenue as a substitute for taxes is confusing.[8] Besides, this transfer does not include an equivalent

[8] Groves, *Financing Government*, p. 276.

of taxes for county, state, and federal governments. The income of municipally-owned utilities is exempt from both state and federal income taxes. In addition, the interest on the bonds sold by the municipal utilities is exempt from the income tax, which means that municipal utilities can borrow long-term capital at lower rates of interest than can private utilities.

With the growth in municipally-owned utilities (and especially since the rise of the tendency to use the "municipals" as a standard for judging the quality of service and fairness of rates for the "private utilities"), a stronger case can be presented for tax-parity. The application of the "yardstick principle" to private utilities becomes inequitable when there are substantial tax differentials between the two. The issues between the municipal and private utilities on tax exemption are significant enough to require a re-examination by fair-minded citizens.

Conclusions on Utility Taxation

THE BASIC CONCLUSION to be drawn with respect to public utility taxation is that it requires rationalization and simplification. Local units of government require revenues and are quite dependent upon the property tax. It would be unfair to withdraw public utility and railroad property entirely from their reach. All of this property lies within cities and counties; it receives benefits and services from these units.

If a state retains the *ad valorem* property tax as applied to these properties, it should be administered by a central state agency under the unit rule with a series of relevant ratios upon which to work out an apportionment of the base. Furthermore, equitable principles should be followed in distributing the revenues back to the needy local units. If the *ad valorem* approach is to be discarded, then a gross receipts tax *in lieu* makes the most workable and productive substitute. Every effort should be also made to distribute back the gross receipts revenues to the local units on a fair and scientific basis.

The state and federal governments should restrict themselves to corporate net income taxes as applied to this area of business activity. All other minor business taxes should be eliminated. The taxes upon the consumption of utility services should also be kept at an absolute minimum except in serious emergency.

SECTION II

The Taxation of Airlines

The Air Transportation Tax Problem

THE DOMESTIC AIR-TRANSPORT INDUSTRY is a relatively young and rapidly-growing addition to our domestic transport system. Related to the taxation of the industry are several problems characteristic of this form of transportation. Planes can traverse states in a matter of hours without stopping at state borders, planes use airways provided for them by the federal government, and when the planes are on the ground they use airports and facilities paid for by the federal, state, and local governments. For these reasons airlines must pay their share of the costs of government as do other business units.

Property Taxes and Multiple Taxation of Airlines [9]

IN ITS LIABILITY to the property tax, air transportation possesses a characteristic advantage (but also an annoying disadvantage) over other methods of transportation. The advantage possessed by airlines is that little property is involved in the enterprise. Such real estate and stationary personal property as is owned by the airlines can be taxed only by the state in which the property is located. The annoying disadvantage is that the flying properties of the airlines are apt to be in many different taxing jurisdictions during the period of a year. This, of course, leads to the possibilities of "territorial multiple taxation."

THE TAXATION OF FLYING CRAFT AND EQUIPMENT

Difficulty of assessment. The airline properties are usually locally assessed. There are only about ten states in which this type of carrier is centrally assessed. Several states exempt all personal property. The Delaware exemption of all personal property is perhaps the most important, for the passenger carriers incorporated in this state in 1941 owned 87 per cent of the aircraft operated in the United States.[10]

Local assessment of the airlines is very difficult. Many assessors have

[9] See Richard W. Lindholm, *The Public Finance of Air Transportation.* Columbus: Bureau of Business Research, Ohio State University, 1948.

[10] J. H. Frederick, *Commercial Air Transportation.* Chicago: Richard D. Irwin Co., 1947, p. 376.

been persuaded that airplanes domiciled in one state are immune to taxation in another. Those who have not been so persuaded are faced with the task of determining whether to assess all planes found on the field on assessment day or only a fraction thereof. Or is their jurisdiction limited to planes that use the local ports as a base of operations? Then, too, most local assessors do not have the information available to assist in the valuation of this highly technical and expensive equipment.

Method of taxation. When commercial air transport had become significant enough so that the taxation of its "flying stock" would be worth while, it was natural to believe the method would be comparable to that applied to the "rolling stock" of railroads. The courts had permitted the assessment of railroad cars on the basis of the "average number" of cars habitually within the state during the year.[11]

The courts had also upheld other allocation formulas by which the states attempted on a reasonable basis to determine the *proportion* of the total value within their boundaries. By and large the methods had been fairly well worked out and established. Airline operations are quite similar to those of railroads in that they involve movement over regular routes, with stated stops for handling traffic and refueling. It was thought that the taxation of "flying stock" would develop along the same lines.

THE NORTHWEST AIRLINES CASE AND MULTIPLE TAXATION

The decision. The difficulties encountered in taxation of personal property of the airlines was sharply called to the public's attention by a 1944 decision of the United States Supreme Court—the *Northwest Airlines* Case.[12] Northwest Airlines is a Minnesota company and its principal place of business is St. Paul. The "corporate domicile" is Minnesota—that is, Minnesota granted the charter and gave the company legal existence. The Airline carries passengers and mail on regularly scheduled routes through eight states. At six of the scheduled cities Northwest operates maintenance bases, but the main overhauling work is done at St. Paul. Minnesota accounted for about one-sixth of its route mileage.

In 1939 the County Assessor of Ramsay County assessed the "entire fleet" of planes owned by the company, even though they were not within the state on "assessment day" and even though they were out of the state part of the year. The tax was *not* assessed against those planes which were "continuously without the state during the whole of the year."

The assessment of the "entire fleet" was upheld by the Minnesota Supreme Court in 1942 and by the United States Supreme Court in 1944. The latter court maintained that Minnesota could tax the whole "flying stock" because that state was the "corporate domicile" of the company

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[11] *Johnson Oil Refining Co. v. State of Oklahoma*, 290 U. S. 158 (1933).
[12] *Northwest Airlines v. Minnesota*, 322 U. S. 292 (1944).

and that Minnesota remained "the situs of the property notwithstanding its occasional excursion to other ports." Minnesota supplied to Northwest Airlines permanent protection of its facilities and resources, and it was the state which gave Northwest the power to function. The relation between Northwest and Minnesota existed in no other state. Seemingly an important consideration in this case was that none of the ships owned by Northwest had acquired situs in another state by being continuously located therein.

The implications of the decision. The implications of the case were clearly put by Chief Justice Stone in one of the dissenting opinions. He felt the tax was an "undue burden on interstate commerce because the rationale found necessary to support the present tax leaves other states free to impose comparable taxes on the same property used in interstate commerce which Minnesota has already taxed for the entire taxable year and at its full value." He saw clearly the possible heavy burden upon interstate commerce and the possibility of multiple taxation upon air transportation companies. Others saw the decision as placing burdens upon a growing strategic industry.

Efforts to stabilize airline taxation. As a result of the Minnesota-Northwest Airlines tax decision, Congress requested the Civil Aeronautics Board to make a study of the difficult tax question. The Civil Aeronautics Board asked advice from many experts in the industry and from private and state taxation officials.

The Board's report in 1945 found: (1) There was no doubt that Congress had the constitutional power to eliminate burdens upon interstate commerce resulting from conflicting state tax policies. (2) It recommended, however, that attempts be made to modify the tax practices of the several states to avoid multiple taxation. (3) It favored the adoption of a uniform allocation formula. (4) It held to the idea that the remedial action adopted by Congress should entail a minimum interference with fiscal powers of the states.

Congress as yet has not enacted any specific legislation; it has preferred to accept the suggestions of the states that they could solve the problems without federal legislation. It may still be possible for the states to adopt uniform statutes with uniform and reasonable allocation formulas and thus eliminate the possibilities of multiple taxation of airline flying craft and equipment.

Conclusions and Recommendations

A FEW BASIC PRINCIPLES should govern the development of an over-all policy for the taxation of air transportation. Among these are: (1) The personal property taxes upon air transportation should be levied exclu-

sively by the state and local governments. (2) The federal government should not intervene by legislation unless the states fail within a reasonable time to stabilize the situation. (3) The states should proceed by "uniform statutes" to set up a uniform allocation formula involving a minimum of three factors. (4) The "bridge states" should be excluded from personal property taxation on commercial aircraft flying in interstate commerce. (5) The aviation fuel taxes should be levied solely by the federal government. (6) The airlines should pay for the various airport services and use of facilities on a "fee basis," and these fees should be used exclusively to improve aviation facilities.

SECTION III

The Taxation of Co-operatives

IN THE UNITED STATES during the past three decades the membership and volume of business of co-operative associations have continually increased to the extent that their membership almost doubled and their dollar volume of business more than doubled in the period from 1936 to 1944. Increasing at a similar rate has been the opposition to co-operatives which contends, generally, that the rapid growth of co-ops is due to unjustifiable governmental favoritism under the tax system.

All co-ops are liable for such state taxes as the general property tax, retail sales taxes, capital stock taxes, occupational and other licenses, and unemployment contributions, just as are other businesses. They are also subject to federal taxes for old-age insurance and unemployment compensation under the Social Security Act.

Under the net income taxes, however, not all co-ops are subjected to taxation, and many of those that are subjected to it pay little or no tax because of the peculiar concept of what constitutes the net income of a co-operative.

What are Co-operatives?

CO-OPERATIVE DEFINED

A co-operative enterprise is one which belongs to the people who use its services, the control of which rests equally with all the members and the gains from which are distributed to the members (and nonmembers) in proportion to the use they make of its services.[13] The co-operative

[13] *United States Inquiry on Cooperative Enterprise.* Washington, D. C.: U. S. Government Printing Office, 1937, p. 19.

is democratically controlled: each member has one vote regardless of the amount of stock he owns. Most co-operatives are organized as corporations. Both co-operatives and ordinary businesses are private organizations. The chief difference between the two lies in the way they distribute the "control" and the "earnings." The usual capitalistic method of distributing earnings is to divide them among the investors in proportion to the amount they have invested. A co-operative pays dividends on the share capital also, but earnings over and above these dividends are then proportioned to its "patrons" according to the use they make of the co-operative services.

Types of Co-operatives for Tax Purposes

IN THE AMERICAN economic system there are a number of fields in which the co-operative form of organization has been utilized. There are farmers' marketing and purchasing co-ops and urban consumers' co-ops that perform the function of exchange and distribution of products. There are co-operative associations in the public utility field furnishing electricity and telephone service. Performing a financial function there are co-operative credit unions, savings banks, building and loan associations, and insurance companies. Then there are co-operatives which offer services such as housing, medical care, and burial.

Although co-operative associations are being organized in an increasing number of fields of enterprise, the bulk of co-operative activity is centered in the field of agriculture.[14] Almost all co-operation in the United States is in the field of exchange, and most of it is carried on by farmers. The co-operative purchasing of farm supplies accounted for almost $1 billion; the co-operative marketing of farm products accounted for $4 billion in 1944. This total is one-sixth of all United States farm marketing and supplying, and it represents over nine-tenths of the total national co-operative business for the year.[15] Because of the concentration of co-operatives in agriculture, the main issue of taxation is concerned with *farmers' marketing* and *purchasing co-ops.* Some discussion also concerns *urban consumer co-ops.*

The only co-operatives that can gain full exemption from taxation (corporate net income taxation) are those farmers', fruit growers' or like co-ops which comply with Section 101 of the *Internal Revenue Code.* In order to gain the exempt classification, the co-operative must meet certain qualifications and take affirmative steps in reporting its compliance

[14] *Legal Tax-Dodging and its Effect on Growth and Competition.* Chicago: Research Department, National Tax Equality Association, 1947.

[15] "Big Business Without Profit," *Fortune,* Vol. 32, August 1945, p. 154.

to the Bureau of Internal Revenue. The major requirements to become a farm co-operative are: (1) It must be a bona fide farmers' or fruit growers' co-operative. (2) It must operate on a cost basis. (3) Substantially all of the common or voting stock must be held by farmers who patronize the co-operative. (4) Dividends on both common and preferred stock must be limited to 8 per cent per annum. (5) It may not market products for nonmembers in excess of those handled for members. (6) If it is a purchasing co-operative, it may not make purchases for nonmembers who are not farmers in an amount in excess of 15 per cent of all of its purchases. (7) In making patronage refunds it must treat all patrons alike, both members and nonmembers.[16]

What is Exempt and What is Taxable?

NET INCOME OF THE CO-OPERATIVE CORPORATION

If the requirements of an agricultural co-operative are met, the co-operative as an *entity* enjoys certain tax advantages. Broadly stated it is exempt from the federal corporation income tax. More accurately stated: (1) Any patronage dividends paid out by the co-operative are not taxable to it. From the point of view of the co-operative such dividends are conceived as a definite liability payable just as any other debt would be. (2) Dividends paid on the capital stock are exempt to the co-operative up to 8 per cent. (3) Reserves set aside according to state laws or any reasonable amount set aside for necessary business purposes are exempt from the corporate income tax. Farm co-operatives are often given the same advantages under state tax laws. Other co-operatives are exempt only on the income paid out as patronage dividends. In the case of the nonexempt co-operative, corporate income taxes are paid upon dividends distributed to stockholder-members and upon undistributed portions of the net income.

PATRONAGE DIVIDENDS PAID TO PATRONS

Patronage dividends *received by the farmer or fruit grower* in connection with the purchase of supplies or marketing of products for them are a "reduction of costs" which in effect increases income. However, patronage dividends *received by consumer-patrons* need not be reported as income. This is on the theory that such dividends are similar to rebates or discounts. These dividends the patrons share in proportion to their purchases, and this in effect constitutes a retroactive price reduction. A comparable form of dividend to consumers are the trading stamps given by many non-co-operative merchandising concerns.

[16] *Fertile Co-operative Dairy Ass'n. v. Commissioner*, 119 Fed. (2nd) 274 (1941).

REINVESTMENT OF PATRONAGE EQUITY BY THE CO-OP

Another problem arises over the taxation of funds "plowed back" into the co-operative business. The co-operatives argue that in effect the patrons have *loaned* these assets to the entity. Sometimes certificates of indebtedness are issued to the patrons promising to repay the patronage dividends withheld with interest over a certain number of years. Sometimes stock is issued in exchange for the retention of the patronage dividends. The Treasury and the federal courts have held that these are a loan or contribution of capital by the patrons and are not taxable income to the co-operative.

Reform in Co-operative Tax Policy

IF THE CORPORATION income tax and the personal income tax were to be integrated, co-operatives and other private corporations would be on a par as far as the *entity income* is concerned. Or if corporations were permitted to deduct the "interest element" in dividend payments, parity treatment would be closer.

No doubt there have been some tax avoidance abuses among co-operatives. Furthermore, there is some evidence that in the large-scale farm marketing field some of the co-operatives have behaved like other private monopolies. It may be that co-operatives no longer need the benefit of income tax exemption. Then, too, there is always a presumption against exemption and in favor of tax uniformity. It must be remembered, however, that many co-ops already pay regular corporate income taxes. In the long run, business survival is something that should be determined on economic merits and not on political pressures.

The various abuses in the taxation of co-operatives could be minimized if several basic adjustments were effected: (1) A more strict definition of what is meant by reasonable reserves. (2) A requirement that the co-operatives report amounts paid in patronage dividends and thus minimize avoidance. (3) A limitation of the extent to which co-op management can issue debt certificates in lieu of patronage dividends in cash.[17] Patronage dividends should not be taxed as part of the income of the co-operative. Patronage dividends to private consumers should not be defined as income to the consumer. It might be in order, however, to tax the co-operative corporation on all income over and above patronage dividends paid out.

[17] Richard W. Lindholm, *Public Finance and Fiscal Policy*. New York: Pitman Publishing Corp., 1950, p. 550.

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The Taxation of Special Business • 4. BANKS 5. INSURANCE COMPANIES 6. CHAIN STORES

ALTHOUGH FEWER *states today have chain store legislation on their books than before—that is, since this type of tax first came into being in 1931—it remains to be seen what the non-chain-store tax state legislatures will do when, in the event of another depression, independent merchants again raise a hue and cry throughout the land to tax the chain store out of existence.*

—JESSE D. BERMAN.[1]

Overview

SEVERAL OTHER major types of business have been subjected to special types of taxation besides those discussed in the previous chapter. Banks have been subjected to a variety of special taxes. The earliest bank taxes were based on either capital stock or dividends. Special difficulties arose after the federal government began to charter national banks which, as federal agencies, were bound to have some immunities from state taxation unless Congress provided otherwise. This, however, gave all banks shelter from taxation by the states. Little by little, Congress had to increase the ways in which the states could tax banks.

Because of its characteristics the insurance business creates problems in taxation for the states. Many strong arguments are raised against insurance company taxation. The real task in insurance company taxation is arranging it in such a way as to create a minimum of burden and to hamper least the worth-while purposes of insurance.

In the case of the chain stores, taxation was applied in an attempt to equalize the economic power of competing businesses. In most instances the intent of the chain store taxes was to tip the scale of business advan-

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[1] Jesse D. Berman, "The Chain Store Tax—A Study of Its Nature and Effects," *Taxes, the Tax Magazine*, Vol. 25, July 1947, p. 633.

tages back in favor of the independent retailer. This type of taxation should be scrutinized with more than reasonable care from the point of view of both legal validity and economic soundness.

SECTION I

The Taxation of Banks

Characteristics of Banks Relevant to Taxation

BANKS HAVE BEEN SUBJECTED to special forms of taxation largely because of their legal and economic characteristics. By the same token these characteristics have also created special problems in the field of bank taxation. Professor Groves has recognized four characteristics of banks which differentiate them from other businesses and which are relevant to taxation.[2] (1) banks carry a stock of intangible goods; (2) some banks are chartered by the federal government; (3) banks possess credit-creating power; and (4) banks are heavy holders of government securities.

For the purposes of state and local taxation, especially under the property tax, the fact that banks hold an inventory of intangible goods is significant. Their assets are comprised largely of promises and orders to pay, such as notes (secured and unsecured), bonds (corporate and government), paper money, and balances with other banks. Ordinary businesses usually hold tangible goods which are generally taxed under the property levy. But to tax the banks on their intangibles raises the problems of discovery, valuation, and double taxation, because intangibles are commonly representative of or secured by other tangible property.

In the second place, national banks are instrumentalities of the federal government, since they are chartered by the Comptroller of the Currency under federal law. This exempts such banks from taxation by the states except under conditions permitted by Congress. This is part of the old intergovernmental immunity doctrine enunciated by Chief Justice Marshall in an early Supreme Court decision in which he recognized that the power to tax could be the power to destroy.[3]

A third characteristic lies in the credit-creating power of banks. Thus today, on the basis of each dollar of gold certificates in Federal Reserve Banks, several dollars in credit can be extended within the banking system.[4]

[2] Groves, *Financing Government*, pp. 357-358.

[3] *McCulloch v. Maryland*, 4 Wheaton 316 (1819).

[4] Federal Reserve Banks are required to keep a 25 per cent reserve in gold certificates against deposits and Federal Reserve Notes. Commercial banks are required to keep an average of about 20 per cent in legal reserves behind demand deposits.

Hence banks can and do make loans beyond the total value of their capital, surplus, and cash resources. In view of this power the problem arises of how and what should be taxed.

Finally, during the last twenty years all banks have become major owners of government securities. Again, under the old intergovernmental immunities doctrine, the interest on these instruments is exempt from state taxation. This creates problems in taxation as between different types of business by the states.

Federal Legislation Protective of Banks

THE HEAVIEST and most numerous issues on bank taxation have grown out of the fact that some banks are chartered by the federal government. Controversy over the "federal taxation" of *state banks* has been minor since the Act of 1865 that levied a tax of 10 per cent on state bank notes was upheld by the Supreme Court.[5] This has been because all federal taxes on banks, brokers, checks, drafts, and other negotiable instruments have been applied with equal severity to both national and state banks.

The dramatic controversy has come the other way around—on "state taxation" of *national banks.* Congress has attempted to shield national banks from state taxation. In the process, however, it has protected banking generally.

THE ACTS OF 1863 AND 1864—"SECTION 5219"

Provisions of the acts. The first federal legislation protecting national banks dates back to the Act of 1863 which created the national banking system. After several revisions, the legislation took on a stable form under the controversial "Section 5219."[6] This section delineated the rules for state taxation of national banks. It permitted such taxation in two ways: (1) taxation of the real estate of national banks on the same basis as other real estate, and (2) the taxation of "all shares of national banking associations located within the state, subject only to the two restrictions, that the taxation shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such state, and that the shares of any national banking association owned by nonresidents of any state shall be taxed in the city or town where the bank is located, and not elsewhere."

Obviously, it was the intention of Congress to protect national banks,

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[5] *Veazie Bank v. Fenno,* 8 Wall. 533 (1869); Thomas Joel Anderson, Jr., *Federal and State Control of Banking.* New York: Bankers' Publishing Co., 1934. See especially Chap. 6, "Controversy on Bank Taxation."

[6] The law is now officially Section 548, Title 12, Chap. 4, U.S. Code.

which are instrumentalities of the federal government, against hostile taxation by the states. The second tax was in effect upon the shareholders rather than upon the banks as such. Yet, in its application and administration the tax was upon the banks; collection was from the banks, and it was generally looked upon and accepted as a bank tax.

Interpretation and application. Early problems which arose under "Section 5219" were slight. This was largely because the unmodified general property tax was the dominant source of state and local revenue. Bank shares were taxed through the banks along with all other personal property at a uniform rate in each taxing district. It was decided during the early years that the value of federal bonds owned by national banks need not be deducted from the capital before estimating the value of the shares of the bank, since the tax was upon the property of the shareholder rather than on the banking corporation.[7] It was further decided that the phrase "other moneyed capital" used in "Section 5219" referred only to that moneyed capital that might compete with national banks.[8] As a practical matter, from the 1860's to the 1920's the section was interpreted to mean that national bank stock could not be taxed at a higher rate than state bank stock.

Increasing Difficulties in Bank Taxation

EFFECTS OF STATE PROPERTY TAX MODIFICATION

In the first quarter of the twentieth century some states began to adopt "classified" property taxation under which they frequently placed intangibles in special classifications at low rates, or they exempted intangibles completely. Yet these very same states usually continued to tax bank shares at the regular property tax rates because this meant fairly good revenues. This created a problem of "discrimination" against bank shares as compared with other intangibles.

THE RICHMOND CASE AND THE DEMAND FOR OTHER METHODS

One case of this sort was carried to the Federal Supreme Court. The Court reinterpreted "other moneyed capital in the hands of individual citizens" from "Section 5219" to include "not only money invested in private banking . . . but investments of individuals in securities that represent money at interest and other evidences of indebtedness such as normally enter in the business of banking."[9] Thus the Court encompassed a substantial part of all intangibles within its interpretation of "other

[7] *Van Allen v. The Assessors*, 3 Wall. 573 (1865).
[8] *Mercantile Bank v. New York*, 121 U. S. 138 (1887).
[9] *Merchants National Bank v. City of Richmond*, 256 U. S. 635, 639 (1921).

moneyed capital." The conclusion was that bank shares should have been given the same tax treatment as most other intangibles, not merely that national bank shares should be taxed the same as state bank shares (as had been the practice previously).

Classified-property-tax states were, therefore, left with the alternative of either giving up the bank shares taxes at property tax rates or going back to the practice of taxing all intangibles at property tax rates. Since at this time the states had no other ways of taxing banks, demands were forced upon Congress for additional methods of taxing national banks.

Federal Bank Tax Legislation of the 1920's

REVISIONS UNDER THE ACT OF 1923

The paucity of methods for taxing national banks led to remedial legislation in 1923. Congress added two alternative methods to the share tax. Banks could now be taxed (1) on their shares, or (2) on their net income, or (3) on their dividends.[10] Only one device could be used at a time. The law provided, however, that if corporation income and dividends were both taxed in the case of general business corporations, they both could be taxed in the case of banks.

The 1923 revision provided also that "bonds, notes or other evidences of indebtedness in the hands of individual citizens not employed or engaged in the banking or investment 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 purpose of this provision was to remove the effect of the *Richmond* decision and to make possible, by classification, the segregation of bank stock from "other intangibles" for tax purposes. Obviously, if these instruments were not to be deemed moneyed capital, then a higher tax rate upon bank shares would not be a violation of "Section 5219." It was thought by some that this provision restricted "moneyed capital" to intangibles in some form of banking business.

THE HARTFORD BANK CASE AND THE ACT OF 1926

State taxation of national banks suffered both a setback and a gain within the next few years. The setback occurred when the Federal Supreme Court in *First National Bank of Hartford v. City of Hartford*[11] once again restricted the segregation of bank stock from other intangibles for tax purposes. It did so by expanding the concept of "moneyed

[10] Groves, *Financing Government*, p. 359.

[11] 273 U. S. 548 (1927). See also *First National Bank of Guthrie Center v. Anderson*, 269, U. S. 341 (1926).

capital" to include all cases where capital is substantial in amount compared with the capitalization of national banks and is employed (a) either in a business or by private investors, (b) in the same kind of transactions as those in which national banks engage, and (c) in the same locality in which they do business.[12] This meant, therefore, that national bank shares had to be taxed the same as the shares of the greatly expanding private financial institutions whose shares were often exempt or taxed at low mill rates with other intangible property under the classified property tax.

The gain in tax powers occurred through a further revision of "Section 5219" in 1926. This gave the states the power to levy an "excise" upon the franchise of a bank—the value of the franchise to be "measured by" its net income. This tax was superior to a straight net income tax because it was possible to include as part of the tax base the income from the large bank holdings of federal bonds—holdings ordinarily exempt from state taxation. This provision was upheld in two subsequent Supreme Court decisions.[13] It brought the number of methods of taxing national banks to four.

Bank Taxation as Practiced in the States

FOUR ALTERNATIVE METHODS of bank taxation are now available for use by the states: (1) bank shares tax under property tax, (2) taxation of net income, (3) taxation of dividends on bank shares, and (4) an excise tax on the bank franchise "measured by" net income. A number of states have adopted each method.

Some fourteen states (including such states as Illinois, Louisiana, Missouri, Tennessee, Texas, and West Virginia) still cling to the old *ad valorem* bank shares tax under the general property levy. In these states all intangible property is subject to the regular general property tax.

A number of states apply a share tax at a special rate under a classified property tax, but bank shares are treated on a par with all other intangibles. In such states bank taxation is relatively light. Among these states are Delaware, Indiana, Kentucky, Maine, New Jersey, and Virginia.

About thirteen states have adopted the excise tax on bank franchises measured by net income. Among these states are California, Colorado, Connecticut, Massachusetts, New York, and Oregon. This method is probably quite productive from the revenue point of view.

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[12] T. J. Anderson, Jr., *op. cit.*, p. 224.

[13] *MacAllen v. Massachusetts*, 279 U. S. 620 (1929); and *Pacific Company v. Johnson*, 285 U. S. 480 (1932) which upheld a California corporation franchise tax law enacted in 1929.

Only Wisconsin and South Carolina have shifted to the net income approach; Michigan and Vermont use the dividend method. Another tax which should be considered as part of the bank tax picture is the tax on bank deposits. It is usually the property tax that is applied to this form of intangibles. Over half the states tax bank deposits. In most of the states which levy taxes on deposits, the impact is directly on the depositor in connection with his other property tax liabilities.

All in all, there is no uniformity in the methods applied in bank taxation. Much of this has grown out of federal concern for national banks. Furthermore, there are no sound economic reasons why banks should be subjected to but one tax. Like other businesses they should pay on their property, tangible and intangible, as well as their income.

Conclusions on Bank Taxation

BANKS SHOULD NOT BE subjected to any more severe taxation than other types of corporate business. At the federal level the main approach should be under the net income tax. At the state and local levels, especially under the property tax, adjustments may have to be made because of the intangible character of much bank property. But the adjustments should be of the character to make the bank taxes more scientific and equitable—that is, related to the economic characteristics of banks. The need for special protection of national banks by Congress has long since passed. States and local governments should be given the right to tax banks like other businesses; and states and local governments should be limited only by the common law injunction that the taxes be nondiscriminatory.

SECTION II

The Taxation of Insurance Companies

Problems in State Insurance Taxation

THE PROBLEMS of insurance company taxation have been most extensive and serious at the state level of government. Insurance companies developed home offices first in a few major states, yet they sold insurance in many of the states in the Union. Except for the "home-office states" the general property tax was not very well suited to insurance company taxation, and so there was an early tendency to shift away from that tax.

For that reason the states had to explore other possibilities. In this they had more freedom than was the case in the taxation of banks. This was true for two reasons: (1) Insurance companies are not chartered by the federal government, but by the several states. The central unit, therefore, had no direct control over them, nor any particular interest in protecting them. (2) The courts once held that entering into a contract of insurance was not interstate commerce, even as between the "home office" in one state and the policy holder in another. Since that was so, insurance companies were not given the protection of the interstate commerce clause of the Constitution when the states proceeded to tax them in various ways. Other problems, however, grow out of the fact that both foreign and domestic firms do business in a given state, and that some companies are stock companies and others are mutuals.

Characteristics of Insurance Companies

ECONOMICS OF THE INSURANCE BUSINESS

The insurance business is a combination of risk assumption and spreading, saving, investment, and loss payment functions. Under it, individuals and businesses sign an aleatory contract to pay certain money premiums to an insurance company in exchange for specified life and property protection against loss. The premiums are collected to pay (1) expenses of administration, (2) current losses, and to provide (3) reserves against future losses. The reserves are usually invested in various bonds, notes, mortgages, and other high-grade intangibles (more recently in real estate and direct loans to business). These investment reserves yield an income. If the gross premiums and reserve income exceeds business costs, current losses, and legal reserves requirements, the balance may be added to surplus or distributed to policyholders or stockholders.

In our national economy the insurance business is playing an increasingly significant role. With the rise in individual and business income has come an increase in the volume of insurance of all kinds and an increase in the economic power of insurance companies. In 1948 in the life field alone there was $202 billion in insurance in force.[14] In life insurance premiums $7.2 billion was paid. Total income was $9.5 billion. Total investment income amounted to $2.3 billion.[15] In the same year United States life insurance companies made investments of $11.4 billion, bringing total investments up to $55.6 billion.[16] These figures are for life insurance alone and do not include all the other forms of insurance. It is to a busi-

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[14] *The Life Insurance Fact Book.* New York: Institute of Life Insurance, 1949. p. 8.

[15] *Ibid.*, p. 40.

[16] *Ibid.*, p. 69.

ness of the above character and economic significance that the tax system must apply.

CHARACTERISTICS OPPOSED TO TAXATION

Those who are strongly interested in insurance maintain that insurance companies should be free of all taxes except tangible property taxes. They claim that the characteristics of the insurance business are not such as lend themselves to scientific and equitable taxation: (1) Insurance company property consists very largely of bonds, notes, mortgages, and other intangibles. This is mostly "representative property" and therefore, when taxed, results in double taxation. (2) The incidence of insurance taxes is upon policyholders. This results in higher-cost premiums for those who are attempting to save and protect themselves. In effect these are taxes on thrift which are regressive because they do not take into consideration the needs of the policyholder. (3) Insurance companies render a valuable social security service and encourage self-reliance in life and property protection—a type of service which should be encouraged rather than be burdened by taxation. (4) Many insurance companies are mutual companies (70 per cent of life insurance in force in 1948 was held by mutual companies). They are in effect nonprofit in that no dividends are paid to formal stockholders. Surplus revenues go to reduce premiums for the policyholders.[17]

CHARACTERISTICS FAVORABLE TO TAXATION

In theory the above arguments seem valid enough to be given due weight in tax policy. However, viewed realistically, there is a good deal about insurance companies, their characteristics, and the way they do business which warrants that they contribute to public revenues: (1) They receive substantial benefits from government; their contracts are protected in the courts—in fact a large fraction of the cases on the dockets of our state trial courts involves insurance companies. They thereby increase the costs of government. (2) In the public interest, insurance companies require regulation which makes necessary additional expenditure. (3) Savings and investments in insurance companies are not very different from those in other taxed businesses. (4) Insurance companies have increased in income, resources, and economic power. (5) The "stock" insurance companies are organized for private profit just like any other general business corporation and, therefore, should be taxed accordingly. All types of insurance account for over $10 billion in premiums paid in each year and total investments that tally six to eight times that much.

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[17] For a comparable analysis see Groves, *Financing Government*, p. 363.

Types of Insurance Taxation

THE CHARACTERISTICS of the insurance business indicate that there are a number of junctures at which these companies can be taxed: (1) *on property*: real and tangible personal, and investment reserves (intangibles); (2) *on proprietary interests*: capital stock and dividends; (3) *on income*: investment income, net income and gross premiums; and (4) *on costs*: claims and business expenses. Generally, we attempt to avoid direct taxes on costs, so that it can be ruled out. In practice the other three areas are taxed in some manner somewhere in the several states. The more common types of insurance taxes are: (1) gross premiums, (2) real and personal property, (3) investment income, (4) net income, (5) capital stock, and (6) dividend taxes. In addition, there are a number of fees, license, and franchise taxes.

Gross premiums tax. The most generally used insurance company tax is the gross premiums tax. In effect it is a gross sales tax on all policy sales within a state. In some states it is truly "gross" in that no adjustments are made whatsoever. In others, however, the companies are permitted to deduct return premiums and dividends. In the life insurance field every state in the union levies such a tax, and the rates range from 1 to 4 per cent. The 2 per cent rate is the most common. In a few states the domestic firms do not pay the tax. In California an "offset" is granted for real estate taxes paid by the insurance company.

In the fields of insurance other than life (fire, casualty and marine), the gross premiums approach is almost universal. Here, however, domestic firms usually pay lower rates than the out-of-state corporations. In addition, there is a special fire marshal tax of .5 per cent in a number of states. In 1948 the gross premiums tax (all types of insurance) produced about $190 million in revenue for the states.

The main arguments raised for the gross premiums tax are: (1) it is easy to collect and administer; (2) it produces substantial revenues; (3) it actually works and is accepted as a going institution among the states; and (4) it is the best tax for getting at foreign corporations doing business within the state.

On the other hand, some good theoretical arguments are marshalled against the tax: (1) It is likely to be shifted to policy-purchasers and is regressive in relation to low income groups. This is particularly true of industrial insurance. (2) It gives no consideration to cost elements in the premium. (3) If the rates get above 3 per cent, it puts an undue burden on insurance. All in all, if the rates remain below 3 per cent, no serious harm can be done, and it is a workable tax for the states.

Property taxes on insurance companies. The property tax is not very significant in the taxation of insurance companies. In the "home office"

states the real and tangible personal property is taxed. Some states attempt to integrate the property with the gross premiums tax by granting an "offset" for property taxes against the gross premiums tax. This inures to the benefit of "home office" companies. The investment reserves can also serve as a property tax base. The taxation of such reserves conflicts with the trend towards exempting intangibles, however. But it could be a good revenue-raiser for strong insurance company states. One of these, Massachusetts, utilizes this tax.

Taxation of investment income. Another tax that is productive for states with many domestic insurance companies is the taxation of the returns on the various intangibles. This tax gets at income arising from the wise investment of funds rather than from insurance services, and therefore this source may be more suited to taxation. This is utilized by a few states, notably Connecticut, which is an important "home office" state.

Taxation of net income. True net income is not easy to determine in the insurance field. The element of risk of heavy losses is high and the responsibility of insurance companies under their contracts is long-term and not easily calculated on an annual basis. The federal government does not levy a special insurance tax, but it does attempt to tax the companies under the corporate net income tax. In operation it turns out to be a tax on investment income. Life insurance companies are required to report only interest, dividends, and rent. They are also allowed a special reserve and policy liability credit.

Miscellaneous insurance taxes. A few states levy capital stock taxes upon insurance companies. They tend to be arbitrary and are not satisfactory. Among other taxes levied are license taxes upon the companies, annual filing fees, fire marshal taxes, agents' license fees, publication fees, insurance brokers' fees, and others. Some of these are necessary to effective regulation, whereas others could be discarded with advantage.

Interstate Commerce and State Insurance Taxation

The South-Eastern Underwriters decision. Until 1944 the Supreme Court had held that insurance was not interstate commerce, and consequently the states did not have to worry about complying with the requirements of the interstate commerce clause in the taxation of insurance companies. However, in that year the Supreme Court in the *South-Eastern Underwriters* case decided that insurance activity was interstate commerce.[18] It meant in effect that most of the large insurance com-

[18] *U. S. v. South-Eastern Underwriters Association,* 322 U. S. 533 (1944).

panies were engaged in interstate commerce. From the point of view of the taxation of insurance companies by the states, the implications were that the interstate commerce clause could serve as a limitation upon the states. They could not tax in such a way as to interfere with or be a burden upon such commerce. It was feared that in those cases where the states had levied higher taxes upon foreign than domestic companies, constitutional difficulties might be encountered.

Congressional legislation. Congress, however, recognized the contingency and endeavored to stabilize the situation for the time being. In 1945 it passed the so-called McCarran Act in which it said: (1) that it was in the public interest for the several states to continue to regulate and tax the business of insurance, and (2) that silence on the part of Congress was not to be construed to impose any barrier to the taxation of such business by the states. The act seemed to imply that Congress would not act on the subject for some time.

Recent decisions. This congressional attitude did not prevent large interstate insurance companies from seeking the protection of the Constitution in the courts. In California one of the large eastern companies challenged an insurance tax as discriminatory to foreign companies and therefore a burden upon interstate commerce. However, the Supreme Court sustained the state law and held the tax a proper exercise of the state taxing power as applied to interstate insurance companies.[19] Several other decisions have held the same way. It seems that the Court is attempting to carry out the intent expressed by Congress in the McCarran Act and that until Congress "speaks," the states may go on taxing insurance companies about as they have in the past.

SECTION III

The Taxation of Chain Stores

THE TAXATION of chain stores differs materially in purpose from the taxation of other special businesses. Protection of the independent merchant and the restriction of the chain store looms large in every state chain store tax law. Although this tax movement had some beginnings in the 1920's, it was not until the Indiana chain store tax was upheld in 1931 that it developed full momentum. It was largely a depression phenomenon. Thousands of small independent storekeepers had suffered severe financial losses during the period of heavy unemployment and low national income.

[19] *Prudential Life Insurance Co. v. Benjamin*, 328 U. S. 408 (1945).

They were prone to blame part of their troubles on the chain stores. And so they took their troubles and political pressures to the state legislatures.

Arguments for and Against Chain Store Taxation

ARGUMENTS FOR

When the independents appeared before the legislative committees they were armed with economic and political arguments against chain stores and for their special taxation. These arguments can be analyzed under several categories: (1) Chain stores enjoyed special advantages under the property tax. It was claimed that there was inventory manipulation on assessment day, even cases of hauling goods away just prior to that day. It was claimed that chain store property tax information was inaccessible —very often located in some regional accounting office. It was also argued that the "chains" could carry a small stock of goods because of more rapid turnover and because company trucks brought new supplies each night, whereas the independent had to maintain a "little warehouse" at the rear of the store on which he was assessed.

(2) Chains possess unfair economic advantages. Their ability to buy large quantities and get quantity discounts and to take advantage of cash discounts was called "unfair."

(3) Chain stores were called a social menace. It was said that they did not pay taxes locally, that they did not contribute to community welfare, that they drove out small businesses and made clerks out of proprietors.

(4) It was charged that the "chains" took advantage of the farmers and producers from whom they bought goods; that they sought to control their sources of supply; that they controlled the prices of small cheese factories, condenseries, and canneries or bought them up.

All in all, there was a good deal of anti-monopoly philosophy in the whole case. There was some truth in much of it, but there was a strong element of merely political appeal in it also.

ARGUMENTS AGAINST

The advocates of chain store merchandising were not without evidence and argument to support their case. It was well organized and well presented and proceeded along the following lines:[20] (1) The efficiency of chain store methods of distribution have benefited the *consumer* by effecting lower prices through quantity buying economies and efficient

[20] A good analysis of the case for chain stores is found in David Bloomfield, *Chain Stores and Legislation.* New York: The H. W. Wilson Co., 1939, pp. 431 *et seq.*

marketing, and by conserving purchasing power and contributing to a better standard of living. (2) The chain system has aided the *manufacturer* by supplementing mass production with mass distribution methods. (3) It has assisted the *farmer and dairyman* by absorbing perishable products requiring quick sale. (4) Chain store management methods are more efficient due to specialization, experienced and scientific buying, efficient stockkeeping, layout, display, and equipment. (5) The chain idea meets a *public need* for a wide assortment of quality goods at reasonable prices. (6) Chain stores are an asset to the *community* because they attract trade to the neighborhoods, thus benefiting other types of merchants. They leave more money in the community by selling at lower prices and thus conserve purchasing power to be spent on other things.

Thus the claims of the opponents of chain store taxation are marshalled —sometimes with a good deal of truth, sometimes with some exaggeration, and sometimes with a conscious omission of weaknesses in the case. Nevertheless, during the 1930's the advocates of chain store taxation were able to gain legislative support in well over a third of the states. Most of these chain store tax laws are still in operation, although the whole chain taxation issue during the 1940's and '50's has been relatively quiescent.

The Constitutional Issues in Chain Store Taxation

THE PASSAGE of chain store tax laws by the state legislatures did not guarantee that these laws would be effective. They still had to be tested in the courts. Since chain store tax legislation involves placing chain stores in a separate classification from others, constitutional issues are raised. Under the Federal Constitution the chain stores could claim unreasonable classification and the denial of the equal protection of the laws under the Fourteenth Amendment. During the 1930's most of the challenges took place under the Fourteenth Amendment.

GRADUATION BASED ON NUMBER IN STATE

The most common form of chain store tax levied (used by a dozen states) is the type under which the chain stores are taxed at graduated rates with a bracket system based upon the number of chain units "within" the taxing state. Under this approach the chains are taxed at a different rate for each bracket. For instance, $25 is levied for each of the first ten units, $50 each for the 11 to 20 unit bracket and $75 each for the 21 to 30 unit bracket.

Indiana was one of the first states to pass this type of tax in 1928; it was also the first to be tested in the Federal Supreme Court.[21] A Mr.

[21] *State Board of Tax Commissioners v. Jackson*, 283 U. S. 527 (1931).

Fayette A. Jackson owned a chain of 225 stores in the state. The tax was graduated from $3 on one store to $25 on each store in excess of 20. He showed that he would be compelled to pay $5,443 tax for all of his stores, whereas the tax on the same number of independent stores would be only $625. The taxpayer claimed that the classification was unreasonable and arbitrary, that the law was depriving him of property without due process of law, and that it denied him equal protection of the laws (Fourteenth Amendment).

The Court, however, upheld the Indiana statute and said: "we cannot pronounce the classification made by the statute to be arbitrary and unreasonable." The Court found the basis for "reasonable classification" in the many business and economic differences between independents and chains, such as: (1) quantity buying, (2) buying for cash, (3) skill in buying, (4) efficiency in warehousing and distributing to the units, (5) abundant supply of capital, (6) greater turnover, (7) national and unified advertising, (8) standard forms of display, and (9) standardization of store management, sales policies, and of the goods sold. These differences and advantages possessed by the chains were sufficient to place the chain stores in a separate classification and to tax them accordingly without the violation of any constitutional rights.

GRADUATION BASED ON COUNTY LINE

Florida in her chain store tax law used a somewhat different approach. It classified chains for separate taxation and then graduated the rates according to whether or not the units extended into more than one county. The majority held this to be unreasonable classification and a denial of equal protection. And so the law was declared unconstitutional.[22] The Court said, "There was no more reason for adopting the county line as a measure of the tax than there would be in taking ward lines in cities, or arbitrary lines drawn through the state regardless of county boundaries." [23]

Apparently the Florida law was drawn to favor "local chains" in the large cities. Under it, it would be possible for some large "local chain" to get by easier than a small chain that happened to extend into more than one county.

GRADUATED GROSS RECEIPTS TAX

In 1930 Kentucky levied a tax upon all retailers (chain or not), *graduated* according to the "gross sales." The rates varied from one-twentieth of 1 per cent on the first $400,000 to 1 per cent on gross sales over $1 million.

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[22] *Louis K. Liggett Co. v. Lee*, 288 U. S. 517 (1933).
[23] *Ibid.*, p. 534.

The Supreme Court held the tax unconstitutional on the theory that the classification containing all retailers (regardless of business methods used) and the graduation according to "gross receipts" was arbitrary and unreasonable.[24] It reasoned that insufficient evidence had been introduced to show that there was a reasonable relationship between gross receipts and net profits (or the ability to pay taxes on a graduated basis). The Court, however, admitted that "generally speaking" profits increase with sales, but it pointed out that "so many exceptions and reservations must be made that averages are misleading." It is possible to have substantial gross receipts and no net profits. It must be noted that this was a "graduated gross receipts"—not a "flat" rate gross receipts or "net" income tax.

GRADUATION BASED ON NUMBER IN THE SYSTEM

Louisiana during the Huey Long administration developed and adopted in 1932 one of the most severe forms of chain store taxation. The rates are graduated according to the total number of stores in the entire chain throughout the nation. The Louisiana act prescribes that the tax per store "in Louisiana" is $10 if the total number in the entire chain is not over 10. However, if the total number of stores in the entire chain is over 500, then each store in the state would pay $550 (the top bracket rate).

The Great Atlantic and Pacific Tea Company in the 1930's operated over 15,000 stores in the United States and Canada; it had 106 stores in the State of Louisiana. The company challenged the Louisiana tax on the grounds that it was an arbitrary discrimination in favor of "local chains," that it was an attempt to tax property beyond the jurisdiction of the state, and that it was a burden upon interstate commerce. However, the Supreme Court held the tax constitutional.[25]

The Court reviewed the various business and economic advantages enjoyed by chain stores as compared with independent stores by saying that "... 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 advantages in advertising, the greater the capital employed, the greater the social and economic consequences and the lower the cost of distribution and overhead."

Then the Court went on to emphasize: "If the competitive advantages of a chain increase with the number of its component links, it is hard to

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[24] *Stewart Dry Goods Co. v. Lewis*, 294 U. S. 550 (1935).
[25] *Great Atlantic and Pacific Tea Co. v. Grosjean*, 301 U. S. 412 (1937).

see how these advantages cease at the state line. Under the findings, a store belonging to a chain of one hundred, all located in Louisiana, has not the same competitive advantages as one of one hundred Louisiana stores belonging to a national chain of one thousand."

The Court found this tax would not result in the taxation of property and business in other states because the "subject" of the tax was the stores "within" Louisiana and that membership in the longer chain is merely a "measure" of the tax. Nor could the Court find that the tax levied on the stores within the state interfered with interstate commerce.

The conclusions to be drawn from the decisions of the Supreme Court on which types of chain store taxes are valid and which are not are these: (1) Taxes graduated according to the number of stores "within" the state (whether under the bracket system or the totality rate schedule) are valid. (2) Those graduated according to extension over some geographical line (such as county line) are arbitrary and invalid. (3) Graduated gross receipts taxes are invalid. (4) Taxes graduated according to the number of stores in a national chain (but applied only to stores "within" the state under a totality schedule) are valid.

Conclusions on Chain Store Taxation

CHAIN STORE TAXES are largely a phenomenon of the depression and in recent years have been losing ground. The revenue yield has been disappointing to state governments.[26] In most states the rates have been relatively light and therefore have not accomplished their objectives. In a few states the rates have been supplemented by other taxes and have been more burdensome. Here these taxes have caused some withdrawal of chain stores from the state. In some instances they have caused the chains to increase their efficiency to absorb the higher costs, and they may have had something to do with reducing the number of units and the development of the chain "supermarket." These taxes have not reduced chain store net profits, nor have they materially strengthened the competitive advantages of independent stores.

The levy of special taxes upon more efficient methods of serving the public is economically undesirable. Issues of efficiency and economy in the distribution of goods should not be decided in the political arena, but rather on the merits in the market. Too often in chain store tax legislation, the interests of millions of consumers for more efficient distribution methods have been subordinated to the short-run interests of dis-

[26] See Lyle E. Craine, "Chain Store Taxes as Revenue Measures," *National Tax Journal*, Vol. 2, September 1949, pp. 280-283.

tributors who ought to increase their own efficiency. In recent years, the independents, often learning from the chains, have improved their marketing methods.

If there is abuse of economic power by the chains, it must be dealt with directly under the police power by the state and federal governments. Lump-sum chain store taxes are not likely to curb abuses. On the revenue side, some consideration must be given to state and local governments in relation to foreign chain store corporations. The states can compel them to account for net income (produced within the state) under state income tax statutes and so do not need special chain store taxes for revenue. The local units are not in quite as strong a position. Yet they do not fare so badly under the property tax on chain stores. Essentially, most chain store taxes are taxes on efficiency and should be retired by the states from their revenue systems.

Part Six

THE TAXATION OF CONSUMPTION

XXI. THE ECONOMICS OF CONSUMPTION TAXATION

XXII. PARTICULAR CONSUMPTION TAXES

XXIII. MOTOR VEHICLE AND HIGHWAY TAXES

21

The Economics of Consumption Taxation

THE CONCLUSION *to be drawn from this historical survey is that the general 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.*

—EDWIN R. A. SELIGMAN.[1]

Overview

THE ADOPTION of sales tax laws in many of the American states has been one of the most striking developments in the field of taxation since World War I. The economic depression which followed the stock market crash of 1929 did a good deal to stimulate the growth of general sales taxes. The desire to relieve the burden of the property tax lent substantial support to the passage of sales tax statutes in a number of states.

This chapter deals with the economics of consumption taxes generally. It analyzes and discusses: (1) the revenue importance of consumption taxes at the various levels of government; (2) the economics of consumption taxation—nature and theory, shifting and incidence, and effects; (3) an appraisal of consumption taxation; and (4) consumption taxation as an instrument of fiscal policy.

Fiscal Significance of Consumption Taxes

GENERAL SIGNIFICANCE

The unusual increase in the utilization of consumption taxes during the 1930's has emphasized many of the diverse problems pertaining to consumption taxation and has brought into being a myriad of others. These

[1] Edwin R. A. Seligman, *Studies in Public Finance.* New York: The Macmillan Co., 1925, pp. 131-138.

consumer-borne imposts are of significance for the following reasons: (1) Excises and sales taxes provide a substantial quantity of revenue for federal and state governments and for a number of local units. (2) Traditionally, consumption taxation has been a source of nonfiscal sumptuary control. (3) Excise and sales tax usage raises serious problems of equity, because consumption taxes tend to be regressive. (4) Difficult problems of fiscal administration are occasioned by both excise and sales taxes. (5) Problems of "double taxation" result from the application of consumption taxes. (6) The incidence of many excise taxes is doubtful and frequently falls on the merchant instead of the consumer.

The whole issue of maintaining consumption taxes as a permanent part of the revenue system has become one of the most important problems disputed in current tax literature.

REVENUE IMPORTANCE TO FEDERAL UNIT

Consumption taxes have played a decreasing "relative" role in the federal revenue structure. Nevertheless, they still provide a substantial "absolute" quantity of revenue annually for the United States Treasury. Out of a total federal receipts of some $42 billion in 1949 (before deductions), excises accounted for roughly $7½ billion, or over 17 per cent of the revenues collected. Customs receipts added over $384 million more.

Table VII

FEDERAL TAX COLLECTIONS BY SOURCE, 1949 *

(*In millions*)

Source	*Amount*
Individual Income Tax	$17,929
Corporation Income Tax	11,343
Excess Profits Tax	211
Estate and Gift Tax	797
Excise Taxes	7,551
Customs	384
Other	4,559
Total	$42,774

* *Source*. The Budget of the United States Government for the Fiscal Year Ending June 30, 1951, Washington, D. C., 1950.

However, the significance of federal consumption taxes cannot be comprehended fully by observing statistically their contribution to the total revenue. Such factors as the equity of consumption levies, the ultimate incidence of excises, their effects on purchasing power, and their usage as vehicles of sumptuary control—all very significant at the federal level—are not reducible to mathematical calculations. It must be noted, however, that when federal consumption taxes run $8 to $10 billion per year the weight of these factors becomes more significant.

REVENUE IMPORTANCE TO THE STATE UNITS

In contrast to the federal level, consumption tax revenues have dwarfed income tax revenues at the state level. As may be noted from Table VIII, consumption taxes provide well over half the total receipts collected by the forty-eight states. The income taxes, on the other hand, produce only 15 per cent of the total state revenues.

Table VIII

STATE TAX COLLECTIONS BY SOURCE, 1946-49 *

(*In millions*)

Source	*1946*	*1947*	*1948*	*1949*
Sales and Gross Receipts	$2,806	$3,415	$4,045	$4,363
License and Privilege	765	868	981	1,077
Individual Income	389	418	499	575
Corporation Income	442	451	585	661
Property	253	261	279	280
Death and Gift	142	165	180	179
Severance	90	94	131	200
Other	47	48	31	34
	$4,935	$5,721	$6,732	$7,369 [2]

* *Source*. U.S. Bureau of the Census, "State Tax Collections in 1949," *State Finances*, 1949, No 4, Washington, D. C., August 1949, 10 pp. tables

On the state level the regressivity of sales and excise levies becomes an even more serious problem than on the federal level because most state taxes are judged by fiscal adequacy and expediency rather than by the ability to pay. Regardless of moral and fiscal drawbacks, state consumption taxes have shown themselves to be reliable and convenient revenue raisers and promising instruments of sumptuary control.

REVENUE IMPORTANCE TO LOCAL UNITS

Consumption levies are comparatively insignificant for local governments at the present time. For the fiscal year of 1947, for example, consumption excises accounted for only 5 per cent of total local revenues as compared with 90.6 per cent for the property tax. Yet it would not be wise to project this condition too far in the future. If past trends may be taken as portending future developments, one may expect local governments to obtain a growing proportion of their revenues from consumption taxes. More than 200 cities now levy sales taxes. Table IX shows the trend through 1947 for local governments.

It is particularly significant to note that although the bulwark of local revenue (the property tax) has been decreasing relative to other local revenues, *consumption taxes* are the main replacing factor. Even more

[2] Includes local shares of state-imposed taxes, whether collected and distributed by the state or collected and retained by local governments. Excludes unemployment compensation taxes.

important is the fact that the relative increase in these taxes has taken place in a period of prosperity. This may indicate that should a downswing occur in the business cycle, the relative importance of consumption taxes at the local level may increase materially. Property tax receipts tend to fall with deflated real and personal property values, whereas consumption revenues remain relatively stable because of inelastic consumer demand, especially for necessities.

Table IX

PERCENTAGE DISTRIBUTION TOTAL LOCAL TAXES, 1932-47
QUANTITATIVE DISTRIBUTION FOR 1947 *

Fiscal Years

Source	*1932*	*1942*	*1945*	*1946*	*1947*	(Quantitative—in millions) *1947*
Property	97.4%	93 %	93.4%	92.6%	90.6%	$5,251
Income		.7	.6	.7	.7	43
Consumption	2.6	2.6	2.8	3.2	5.0	288
Social Insurance	—	.2	(a)	(a)	(a)	2
Licenses, Permits, and other	—	3.6	3.0	3.4	3.7	212

* *Source:* Department of Commerce. (a) Less than .05 of 1 per cent

The Economics of Consumption Taxation

NATURE OF CONSUMPTION TAXES

Consumption taxes may be defined as all levies upon commodities and transactions whose ultimate incidence usually falls upon the consumer in the price paid for goods or services. The legislative intent is irrelevant; if the tax usually falls upon the consumer, then it is a consumption tax. Consumption taxes differ from property and income taxes, but they are often confused with business taxes because they are collected through business transactions. However, when we view their true economic base we see that they are levied upon *expenditure for consumption* (as contrasted with property taxes which are levied upon the value of property owned and income taxes which are levied upon a flow of economic power between two points of time).

Their existence as consumption levies depends (1) upon the legal impact upon the purchaser in the case of some of these taxes, or (2) upon the likelihood of shifting the tax to the purchaser in the case of others. By and large, consumers are not able to shift these taxes to other groups. It is now generally conceded that here is a family of taxes which can be quite accurately designated as consumption taxes. They may be categorized into six major classifications: (1) customs. (2) excise, (3) sales,

(4) use, (5) transfer, and (6) gasoline taxes. Each of these is discussed in detail in the two following chapters.

SHIFTING AND INCIDENCE OF CONSUMPTION TAXES

The extent to which consumption taxes are shifted to the consumer is not immediately evident. Shifting may also be in other directions. The nature and amount of shifting depends upon the conditions of the particular case.[3]

Regardless of whether they are specific or *ad valorem*, consumption taxes are taxes per unit upon the production or sale of goods. This type of tax is a burden upon the marginal producer and the marginal production of intramarginal firms. It therefore tends very strongly to be shifted forward as well as backward to suppliers of the resources. This is accomplished in the long run through a reduction in supply of the taxed goods.

Determinants of shifting. The amount of forward and backward shifting of a consumption tax depends upon the particular circumstances under which the tax is applied, as well as upon the economic characteristics of the particular commodity market and of the suppliers of resources to that market. In review, the amount and ease of shifting depends upon (1) the elasticity of demand for the products taxed (determined largely by substitute products available, whether the item is a luxury or a necessity, and so on); (2) the shape of the supply curve (whether increasing, constant, or decreasing costs); and (3) the degree of competition in the industry.

It depends also upon: (4) the "universality" with which the tax is applied to products and regions—this affects the relative price of substitutes and thus the elasticity of the demand curve, as well as the number of marginal producers affected by the tax; (5) the role of custom in setting the price of a product (producers dislike changing a price to which consumers have long been accustomed); (6) the degree to which the tax can be transformed or absorbed; and (7) the extent to which retail price maintenance and other legal and semi-legal institutions restrict price changes.

Furthermore, taxes are less likely to be shifted in the short run than after sufficient time has elapsed to permit adjustment of production to new conditions. The change in prices depends, too, upon the manner in which the tax money is spent by the taxing governments.

Shifting of selective excises and local sales taxes. The availability of untaxed substitutes determines the elasticity of a taxed product's demand curve. This helps determine the ease of shifting the tax. There is

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[3] For a well-balanced analysis of sales tax shifting, see John F. Due, "Incidence of a General Sales Tax," *Public Finance*, Vol. 5, No. 3, 1950, pp. 222-239.

greater difficulty, for example, in shifting selective excises on relatively few products than in shifting a general sales or gross receipts tax which strikes a large number of commodities and services. In the same manner, there is greater difficulty in shifting even a general sales tax, if it is applied in only a small area, such as a city, than if it is applied more generally. It would be particularly difficult for merchants on the fringe of a geographical area to shift the tax. They must either bear the burden or go out of business or both.

Any application of consumption taxes which leaves a number of easily available substitutes untaxed tends to injure the merchants and producers of the taxed products. To promote shiftability and to increase governmental revenue it is, therefore, desirable to apply consumption taxes over relatively large geographical areas and on most possible substitutes. "Use" taxes are one state device to accomplish this in conjunction with sales taxes.

Shifting of luxury excises. Excise taxes on true "luxuries" are difficult to shift because the demand curve for luxuries is very elastic except in highly prosperous periods. This is especially true if substitute items are left untaxed. As a result, taxes upon specific luxuries are usually quite successful in reducing the consumption of these items. Sumptuary taxation (but with resulting loss of revenue) here appears feasible.

Most people can recall cases, however, in which the taxation of "luxuries" reduces only slightly their consumption. The taxation of beer and tobacco probably reduces their use only moderately. This may be explained by the fact that many people no longer consider beer and tobacco luxuries but "conventional necessities." Consumption of these items will be maintained even at the expense of a desirable standard of diet. Through long custom or because of the satisfaction of a psychological or physical craving the demand curve for such products has become quite inelastic.

Backward shifting. Any reduction of supply of a good which permits a tax to be shifted forward is simultaneously a reduction in demand for the factors of production which produce the good. This reduction may result in what is known as a "shifting backward" of the tax. The extent to which this reduction in demand will result in unemployment for the factors of production and in a reduction of supply of goods used from "previous stages" depends upon a number of conditions.

Backward shifting depends upon the degree of "monopsonistic" buying in an industry. Some business organizations are almost the sole buyers of certain types of labor or capital or of certain types of goods. When this condition exists, a consumption tax (probably an excise tax) on the business organization may seriously reduce the total demand for such factors of production or goods. The stage is set for strong bargaining pressures and "backward shifting" of the tax.

Such backward shifting, it will be noted, takes place through a change in *demand* for the factors and goods rather than through an initial change in their supply, as in the usual analysis. By the same token, it is sometimes said that consumers, too, can shift a tax backward by means of a change in their consumption pattern which a sales or excise tax may cause. This, however, is more frequently referred to as an "effect" of taxation.

Conclusion. It is generally agreed that most sales taxes are among the least resistant to shifting and that under many conditions they are shifted forward to consumers. At times they may be absorbed or shifted backward to the factors of production. What occurs in the given instance can only be determined by a careful analysis of all the conditions under which the tax is levied.

At times, however, it is the expressed legislative intent that certain consumption taxes be shifted to the consumer. This is facilitated by means of such devices as the "use" tax described later, "tax tokens" to permit payment of the sales tax in exact mills, application of the tax to each item separately rather than to gross receipts, and the requirement that the tax on each item be displayed separately from the sales price in retail establishments. Whatever the legislative intent, however, it appears that the preponderance of sales and excise taxes are in fact borne by the consumer, and such taxes deserve rightly to be called "consumption" taxes.

An Appraisal of Consumption Taxes

ARGUMENTS FOR CONSUMPTION LEVIES

Throughout the historical battle between those favoring and condemning consumption taxation, several major arguments have been presented by the former to justify their position: (1) Consumption taxes are adequate and the revenue flows immediately. (2) They are easily adaptable for sumptuary control. (3) They provide a relatively stable source of revenue over the business cycle. (4) They promote tax consciousness. (5) They are economical to collect and convenient to pay. (6) They offset other tax burdens.

Adequacy. Although no claim is made by the proponents of consumption levies that such revenues are *totally* adequate, they do maintain that consumption taxes provide a substantial amount of needed revenue annually; and the advocates believe that to dispense with this revenue vehicle would result in either a drastic restriction of governmental functions or a shift in the tax burden to another income-raising source. Proponents of this argument maintain that other sources are already bearing their full share of the taxation burden and that resort must be made to sales and excise taxes.

Sumptuary control. The main aspect of the sumptuary control argument which proponents of consumption levies emphasize is that taxes may be placed on goods which are considered "harmful" to the community.

It should be recognized that this argument is clearly an ethical proposal and must be based on the assumption that a community is in substantial unity upon those items considered to be deleterious. Thus, for example, both cigarettes and liquor have been heavily taxed upon the grounds that they were "harmful."

In addition, the argument assumes that levying an excise on alleged "luxuries" will cause an automatic diminution of their consumption. Judging by the increased popularity of "luxury" purchases, this assumption appears to be none too realistic, for quite as often as not a tax on cigarettes, liquor, and so forth results not in a decrease in consumption of the taxed commodity but in a decrease in expenditures for other goods. The girl who foregoes her dental fillings for such "luxuries" as lipstick, rouge, and powder is all too familiar. There can be little doubt that what is and is not a luxury needs an extensive reclassification, if the argument is to possess validity and strength.

Stability. Consumption taxation proponents point to the "cycle sensitiveness" of the income tax in condemning its usage as the major or exclusive source of treasury revenues, and such advocates maintain that if a government wishes to function during depressions, it must have a relatively stable supply of funds. Consumption taxes fit the bill, they claim, because most consumer expenditures are relatively stable over the cycle.

Tax consciousness. It is frequently maintained that in a democracy where the political and economic issues are largely determined at the polls, everyone should be made to realize the consequences of his vote by sharing a portion of the expense of this demand for governmental services. Consumption levies, it is held, impress upon the greatest single "class" in society—the consumer—the necessity of tempering its demands for governmental services. Critics of the argument have maintained that there are many other ways of promoting this goal besides the use of a regressive tax. Furthermore, many of these taxes are "hidden" in the price of the goods and therefore create no tax consciousness.

Ease of payment and economy in collection. Consumption taxes have been defended as adhering closely to Adam Smith's famous canon that all taxes should be convenient to pay. Few people object to paying a small tax at the time of purchasing a good, but they would object strenuously to the payment of an accumulative tax bill at the end of a year. Consumption levies are easy to pay—a few pennies now and a few pennies later.

Offset other taxes. Closely akin to the first argument of adequacy is the proposal that consumption levies are desirable because they offset other tax burdens and, therefore, spread the total costs of government over a wider range of individual taxpayers. They are said to offset the progressive income and inheritance taxes. In addition one hears frequently the cry that increased taxes on property will result in tax delinquencies, property-owner "strikes," and so on; the best way to prevent such occurrences is to initiate new or increase old consumption levies to cover proposed governmental expenses. Particularly on the local level are such arguments heard today.

ARGUMENTS AGAINST CONSUMPTION LEVIES

Although some of the arguments against consumption levies may have been implied in the section above, there are those who would present other criticisms. These critics break down the arguments into two major classifications: (1) those which are of special significance to the individual, and (2) those which affect the economy as a whole.

1. FROM THE POINT OF VIEW OF THE INDIVIDUAL

The consumption taxes have been called "upside down income taxes" and taxes that are based upon the "inability to resist" rather than the ability to pay taxes. Those who oppose these taxes maintain that the case against them is socially and economically quite convincing.

Regressive in effect. Consumption taxes, it is argued, are uniform in rate upon all. The rich man and poor man pay exactly the same rate. They hit the lower income groups hardest in that they take from them a larger percentage of their income than from the wealthy. A study of the Treasury Department in 1943 gives some credence to this argument. This study found that a 10 per cent federal sales tax would result in an "effective rate" of 7.7 per cent for those with incomes of $500 to $1,000, but 2.1 per cent for those with incomes of $10,000 or over. A 10 per cent tax with food exempt would result in "effective" rates of 4.5 per cent and 1.4 per cent respectively.[4]

Disregard ability to pay. The critics further maintain that these taxes make no adjustments for the consumer's ability to pay. They take no account of dependents and other "need" factors such as illness and education. Nor do they give any consideration to the unemployed; in fact these taxes embezzle away part of the unemployment allowances. There is usually no immunity, although food is exempt in some cases.

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[4] "Considerations Respecting a Federal Retail Sales Tax," *Revenue Revision of 1943*, Hearings before the Ways and Means Committee, House of Representatives, p. 1166; see also Haskell P. Wald, "A Comparative Analysis of Three Variations of Retail Sales Taxes," *American Economic Review*, Vol. 34, June 1944, pp. 280-302.

These taxes take from the poor man the dollars which have a "high utility" to him. They place upon him a maximum sacrifice.

Can be pyramided. One of the more subtle features of a sales tax is its tendency to take more from the pockets of the taxpayer than the government intends or receives. Pyramiding occurs particularly in connection with manufacturers' sales taxes and general sales taxes. While a product is passing from the raw material to the finished stage and through the hands of various distributors to the ultimate consumer, several sales may be involved before it reaches the end of its journey. Since the value of the commodity increases as it approaches the consumer, the percentage tax adds an ever-increasing burden which is *compounded* with each additional sale. And in addition, profit markups are calculated on the basis of the compounded tax costs.

Such taxes tend to "snowball" in proportion to the number of intermediate stages between producer and consumer. The Canadian sales tax levied in the middle 1930's at the rate of 6 per cent was claimed by Canadian retailers to have increased prices by about 10 per cent.

II. FROM THE POINT OF VIEW OF THE ECONOMY AS A WHOLE

Those who oppose the use of consumption taxes do so not only on the ground that such taxes affect adversely the low-income groups, but also on the ground that under certain circumstances these taxes can affect the operation of the economic system.

Deplete over-all purchasing power. Consumption taxes, they claim, strike at a strategic point in the operation of our economic system. These taxes appropriate purchasing power from those who would ordinarily spend it for private consumption.

Whenever consumption levies subtract from the *total purchasing power* of a community, the *effective demand* for goods is decreased, unless the expenditures by the government are returned to consumers in the same proportion as taxed. The preponderant majority of governmental expenditures are redirected into the economy, but there is no planned re-apportionment along consumers' lines. In a given situation, expenditure for battleships and planes or Marshall Plan relief in Europe would have but a remote and indirect stimulating effect upon purchasing power. On the other hand, an expenditure for public education or direct services to the people taxed would have a direct effect. The important point, though, is that low-income groups suffer a direct, immediate loss, with only a possibility that they will recoup a portion of the tax by an indirect, remote expenditure.

Curtail employment and investment.[5] Whenever there is a reduction

[5] This argument may well deserve re-analysis and re-appraisal; see John F. Due, "A General Sales Tax and the Level of Employment," *National Tax Journal,* Vol. 2, June 1949, pp. 122-131.

in total effective demand in an economy, sellers of goods are the first to receive the impact. Sales decrease, inventories accumulate, and total receipts decline. This is turned back on the producer, for he must adjust his output to equilibrate the volume sold. The producer may be forced to re-apportion his production of goods and allocate his resources into different combinations.

Consumption levies which curtail production force the layoff of employees. This in turn forces additional decreases in total purchasing power and effective demand. Investors, sizing up the possible markets for their funds, keep a close eye on total receipts and profit margins of different industries, and, if their outlook is dampened by the decreased demand, they will withhold their idle funds from investment.

Cyclically rigid. One of the main arguments advanced by proponents of consumption levies is that they are relatively stable revenue producers regardless of the phase of the business cycle. Although this may be a great attribute from one point of view, it may be a condemnation from another.

Taxes which run counterclockwise to the cycle produce rigidities in price variations. A consumption tax may be only nominal at inflated wages and prices in prosperity, but it will be burdensome during deflated conditions in depression. In addition, consumption levies may have little effect on curtailing price rises during booms, but they may serve as an anchor on business expansion at the cyclical trough.

Affect business methods. One of the chief objections to sales taxes in foreign countries has been the disrupting effect they have had upon business structure. They tend to eliminate the middleman by fostering the growth of large, multiple process establishments at the expense of smaller concerns. They tend toward the *integration* of business firms, the substitution of brokers for wholesalers, the extension of selling on consignment and other changes in business structure in order to avoid the sales tax.

Tend to injure small business. Because of highly competitive conditions in many retail businesses, it is often argued that small retail establishments are forced to absorb part or all of the sales tax. This is sometimes true in communities where there are large department stores and several chain stores with competitive price policies. They must all collect sales taxes, but the larger retail units may be able to charge lower prices. This may create a smaller base upon which to apply the sales tax. It is even more true in communities near state boundaries where the small business may have to compete with those "across the river" not affected by a state sales tax. Ordinarily, in the latter situation, they are either forced to absorb the tax or else suffer a loss in the volume of business.

The absorption of sales taxes and the loss of sales affect small outlets

in several ways. *First*, this condition cuts into their profits. *Second*, it reduces the purchasing power of the small business people and their families. And *third*, it eats into their capital for expansion and improvement.

APPRAISAL OF THE CONSUMPTION TAX ARGUMENTS

In recent years the intensity of the arguments against consumption taxes has increased. At the same time, because of greater revenue needs, heavier reliance has been placed upon these taxes. Those who oppose consumption taxes have, on occasion, overdrawn the arguments. A few basic observations should be made in this controversial area. It is dangerous to make blanket arguments either for or against these taxes. Some of their characteristics are but tendencies which do not always work out in fact. The generalizations should take into consideration the phase of the business cycle, the existing tax structure, revenue needs, and other factors.

Consumption Taxes and Fiscal Policy

SOME WRITERS on fiscal policy since 1940, and especially during the war period, have claimed that consumption levies can be used as counter-cycle tax levers. These proponents maintain that these taxes can be used to apply "brakes" to inflationary booms by draining off surplus funds from consumers' demands for scarce goods.

In wartime this analysis may have greater validity than at any other time, but this is to some extent because other factors are operating in aid of consumption taxes.[6] Patriotic restraint and direct controls are strong restraining forces in a war economy. Under war conditions 20-30 per cent excise taxes, a 5 per cent sales tax or an over-all spendings tax would have useful anti-inflationary effects. This is true because if the taxes are high enough, since they are levied at the point of "consumer decision," they may deter many consumers from buying. They also deter in the future in the sense that they absorb purchasing power which might otherwise have been thrown into the market to put further pressure on prices. We know, of course, that this is by no means a perfect mechanism. Those with high incomes who want things badly enough are often willing to pay high taxes, black-market prices, and bonuses to achieve their purposes. It is at this point, even in wartime, where the right kind of income tax can be helpful.

[6] Marius Farioletti, "A Federal Retail Sales Tax as a Fiscal Device for Curbing Inflation in Wartime," Symposium: *Curbing Inflation Through Taxation.* New York: Tax Institute, 1944, p. 63.

Some fiscal authorities maintain that the same factors that make consumption taxes a valid anti-inflationary tool in wartime are present in a peacetime boom period. They argue, therefore, that sales and excise taxes should be utilized as a counter-cycle force against rapidly rising prices in a non-war prosperity period.

On the other hand, some critics challenge the resort to this means in such a period. They maintain that patriotic restraint and direct controls are not present to assist. Furthermore, these taxes in and of themselves tend to be inflationary. Taxes added to the prices of goods that enter into the cost of living might become the basis of demands for wage increases and thus contribute to a wage-price spiral. In a sellers' market there is a tendency to shift more than the amount of the tax.

Moreover, they say, low-income and fixed-income people do not disappear during prosperous times. Emphasis upon consumption taxes deprives these people (in a larger measure) of an opportunity to improve or maintain existing standards of living. With the natural tendency of prices to rise in a prosperous period, it seems illogical to add to these tendencies by sales and excise taxes and thus add to the burdens of low- and fixed-income peoples. Under these circumstances, a well-adjusted income tax could operate more efficiently as an anti-inflationary device.

In periods of depression the heavy use of consumption taxes can contribute further to depressed conditions. They cut into the declining demand for goods to the extent of the taxes and thus further depress production, employment, and investment. Consumption taxes in times of depression absorb part of the meager standard of living of those on relief and living on unemployment compensation. Clearly in such periods all units should endeavor to minimize consumption tax burdens.

All in all, consumption taxes are not the most desirable instruments of fiscal policy. Except in a war emergency or extreme inflationary periods, the federal government should limit its levies to reasonable customs duties and selected excises. The states would do well not to depend too much on retail sales taxes, but rather they could well afford to improve their income tax systems. New York and Wisconsin have demonstrated that this is possible.

Conclusions on Economics of Consumption Taxes

GOVERNMENTS SHOULD NOT BE "mouse-trapped" into heavy reliance upon consumption taxes merely because of their fiscal adequacy and steady yield. The basic regressivity of general sales taxes, many customs duties, and excise taxes should never be lost sight of. For the long-run functioning of our economic system at high levels of production and employment,

the tax system must give balanced consideration to the maintenance of a strong effective demand. Surely it should not cut into that demand inequitably as against low- and fixed-income people.

That does not mean that all consumption taxes are always economically undesirable. In times of high revenue need these taxes and those upon whom they fall may have to contribute in good measure. Some, of course, say that the same ends can be achieved by the use of the income tax—with greater equity and in a more accurate relation to ability to contribute.

Consumption taxes are helpful levers of fiscal policy which should be utilized (along with other instruments both fiscal and monetary) where they are valid and efficient—namely, in wartime and inflationary peacetime periods. Realistically, however, under a federal system of government such as ours, certain types of consumption taxes may have to contribute to the revenue of state and local units in some measure for a long time to come. At the federal level, except in wartime or in an extreme inflationary period, they should play a subordinate revenue and fiscal policy role.

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Particular Consumption Taxes

THE ROLE PLAYED *by consumption taxes in our tax systems varies from decade to decade. There is a marked change both in the kinds of consumption taxes and in the jurisdictions levying them; but the increased importance of such taxes in state and local systems has been offset by the declining importance in the Federal system.*

—MABEL NEWCOMER [1]

Overview

CONSUMPTION TAXES were significant at the federal level long before they were utilized by state and local governments. Prior to 1913 customs duties and excise taxes were the main sources of federal revenue. Consumption taxes did not become fiscally important to the states until after World War I when many states began to develop gasoline taxes, a little later sales taxes, and more recently excise taxes. Gasoline and sales taxes are among the best revenue raisers for many states today.

Our analysis takes up the various types of consumption taxes in the following order: (1) excise taxes, (2) sales taxes, (3) use taxes, (4) spendings taxes, and (5) tariffs and customs duties.

It is appropriate to analyze each of the recognized types with respect to its: (1) nature and characteristics, (2) development in the American economy, (3) revenue importance, (4) purposes and effects, and (5) problems in administration.

Excise Taxation

NATURE OF EXCISE TAXES

Excise taxes are levied upon goods or services produced or sold within the boundaries of the governmental unit levying the tax. Generally, the legal impact of these taxes is upon the producer or distributor,

[1] Mabel Newcomer, "Taxation and the Consumer," *The Annals of the American Academy of Political and Social Science*, Vol. 266, November 1949, p. 61.

although the ultimate incidence may be upon the consumer. During World Wars I and II, certain luxury excises were levied directly upon the consumer. Usually, however, they are looked upon as "indirect taxes" and are distinguished from sales or purchases taxes. Often there is an element of privilege involved—a tax upon the privilege of manufacturing or selling goods or services.

Usually "specific goods" are selected for excise taxation—that is, taxes are levied at given rates upon narrow classes of goods, such as beer and liquors, tobacco, leather goods, entertainment, jewelry, and so forth. In this they are differentiated from general property and retail sales taxes. Little semblance of uniformity exists in this form of taxation. In the United States they have been limited to luxuries and semi-luxuries, although in some European countries they have been placed upon basic necessities such as salt and sugar.

ALCOHOLIC BEVERAGE TAXES

Fiscal significance. Beer, liquor, and wine excise taxes are levied by the federal government at the rate of $8 per barrel for beer, $9 per proof gallon for whiskey, and low, flat rates on wine depending upon the percentage of alcoholic content. From this source the federal government raised more than $2.2 billion in 1950 or about 5.7 per cent of total national revenues.

Some twenty-eight states now levy flat rate taxes of from 50 cents to $3 per gallon on distilled spirits. About sixteen states have liquor-monopoly systems, and three states prohibit the sale of liquors with more than a low alcoholic content. In 1948 the taxing states raised over $495 million from these sources, whereas the liquor-monopoly states earned about $159 million in net profits from their enterprises.

Social and fiscal objectives. Basically, of course, these taxes are levied for revenue purposes, and the yields are quite substantial at both the state and federal levels. Interwoven with the revenue objectives is the sumptuary purpose—an intent to discourage the consumption of these beverages. Many citizens question the effectiveness of the sumptuary purposes, and the issue is well raised when one looks at the heavy flow of revenue. Nevertheless, with many millions of people the high price of liquor is a forceful deterrent. For those whose marginal utility of another drink runs high and whose demand for liquor is relatively inelastic, price does not deter very well. However, the tax is sumptuary in the sense that it absorbs purchasing power which for many would otherwise have been spent for liquor. It may have another adverse effect in that it might encourage the use of the cheaper and more injurious qualities of alcoholic beverages.

Perhaps some consideration should be given to the development of greater temperateness in our drinking. Perhaps by maintaining high

taxes on the hard liquors and by easing up on beer excises some adjustment might be made in our drinking tendencies. To paraphrase Thomas R. Marshall, Vice-President under Woodrow Wilson, we might say: "What this country needs is a good five cent glass of beer."

Problems of administration. The hard liquor taxes especially present problems in administration. With the imposition of high rates, the inducements to "moonshining" and "bootlegging" are very strong. The big enforcement problem seems to be that of getting at illicit stills in the first instance. The costs here run high, but hundreds of illicit stills are confiscated each year. In the long run vigilance and firm enforcement are necessary to maintain taxpayer morale and revenue.

Separation of sources. The liquor tax field is one in which the concept of separation of sources might well be applied. It was hoped that with the repeal of prohibition the federal government and the states could have agreed upon a division of tax territory. However, that hope was not fulfilled. The result has been conflict and overlapping of both excise and license taxes. On principle it would be ideal if the federal government were to levy the excise taxes and if the whole license taxing process were left exclusively to the states. The federal government is best able to levy excise taxes at the source. And the states and local governments are best able to license the manufacture and distribution within their borders.

THE TOBACCO CONSUMPTION EXCISES

Fiscal significance. The tobacco taxes have been of high fiscal significance to the federal government since the Civil War. The government levies excise taxes upon tobacco, snuff, cigars, cigarettes, and cigarette paper. The great bulk of the revenue comes from cigarettes (at the rate of 7 cents per package of 20). Total federal tobacco taxes amounted to $1.34 billion in 1950.

Beginning in 1921 the states also began to edge into the field of tobacco excise taxation. In 1950 about thirty-eight states were active in the field. Cigarette taxes at about 3 cents a package are the most common. In 1948 they yielded the states over $344 million. In New York at a 3-cent rate, cigarette taxes returned over $52 million or 7 per cent of all state revenues in 1949. In Michigan the yield was $22.5 million or 6 per cent of state revenue.

Social and fiscal objectives. Tobacco taxes are looked upon as good revenue raisers and are utilized as such. Again these taxes involve an element of sumptuary purpose, but the volume of cigarettes sold and the taxes paid seem to indicate that the sumptuary effects are minor. Some sumptuary effects may come from the absorption of purchasing power, but the sumptuary purposes are ineffective as far as the adult population is concerned. The package-a-day cigarette smoker pays over

$25 in taxes per year. His demand is quite inelastic, even in periods of unemployment. In the case of adolescents, however, there is reason to believe that many more cigarettes would be consumed if they sold for 10 cents or less per package. Cigar smokers get by easier under both federal and state taxes. Even those cigars which retail for 20 cents each are taxed at a rate of only 2 cents. The expenditure of the same sum for cigarettes involves more than 7 cents in taxes. The federal taxation of cigarette papers made up in packages seems a bit regressive in that it places a burden upon those low-income persons who might prefer to "roll their own."

Administration and separation of sources. The federal government administers tobacco taxes very efficiently and at low cost. They are collected directly from the manufacturer at the source. The manufacturer buys the necessary revenue stamps to correlate with his production. Federal inspectors see to it that a stamp is affixed to each package before it leaves the plant.

The states, on the other hand, have a difficult time in administering tobacco taxes. Since cigarettes are manufactured in a few states, the great majority of states are not able to tax them at the source. They must tax them either as they come into the state—which is very difficult, especially when the cigarettes are sent in small quantities by express or by mail—or when in the hands of wholesalers and retailers, of which there are large numbers in each state.

For these reasons, the tobacco tax field is looked upon as an ideal area for separation of sources. Some authorities believe that tobacco excises should be left to the federal government and that the licensing of all sales and distribution should be reserved to the states.

AMUSEMENT EXCISE TAXES

History and theory. The federal government entered the amusement tax field in World War I and never completely withdrew. In the period before World War II the rate was 1 cent for each 10 cents of admission or fraction thereof. Since 1943 rates have remained at 20 per cent. In 1950 the federal treasury collected about $441 million in admissions and dues taxes. This was about $21 million less than in 1949. Television was beginning to have its effects upon federal revenue. Many city governments had hoped that the federal government would withdraw from this field and thus open up a local source of revenue for them.

Amusement excises are levied partly on the theory that entertainment is a luxury and therefore can bear taxes. These taxes as applied to the great majority of American movie houses are regressive in that a little movie entertainment is a poor man's necessity. As applied to racing, the legitimate theater, and major athletic contests where the admissions run from $1 to $5, this is not true. Before 1943 low-priced admissions

were exempt. A move in that direction may be desirable if and when revenue conditions permit.

Miscellaneous peacetime excises. The federal government since World War I has levied a number of excises on goods classed as luxuries or semi-luxuries. Among these are excises on playing cards, cosmetics, some manufacturers' excises, oleomargarine (until recently), and a number of others. They have been levied for revenue as well as for sumptuary purposes. Most of them have been steady revenue-producers over the years.

A number of southern states have taxed soft drinks for a number of years. South Carolina and Louisiana have collected several million dollars per year from this source.

THE WAR EXCISE TAXES

Expansion of federal excises during the War. Under the pressure of revenue needs in World War II, federal excise taxes were increased both in number and rates. At the close of the War they included the "admission and dues" taxes which had been doubled in rate and stood at 20 per cent. The "manufacturers' excise" taxes, usually laid on manufacturers' sales prices, included automobiles, accessories and parts, cameras, electric light bulbs, tires, electrical appliances, sporting goods, refrigerators, musical instruments, and radios. The rates ranged from 5 to 25 per cent. The "retailers' excise" taxes are based on retail sales of furs, jewelry, toilet preparations, and luggage. These carry rates of 20 per cent. A fourth group was called "excises on facilities"; they included taxes on communications, electrical energy, and transportation of persons and property at rates varying from 3 per cent to 25 per cent. In addition there were the increased liquor and tobacco taxes and miscellaneous excise taxes. Toward the close of the War, the federal excises brought about $5 billion a year or well over four times the amount raised by these means in 1939.

Purposes of war excises. The objectives of the war excises were several. Naturally, raising revenue was a prime factor. It was also hoped that these taxes would have anti-inflationary effects. A third objective was to discourage the purchase of certain scarce items such as tires, tubes, and leather goods. Finally, the intent was to place some additional burden on luxury goods such as furs, toilet preparations, jewelry, and luggage.

Long-run adjustments in war excises. Five years after the War the excises remained much the same as during the War period. Congress had been working on a measure to reduce many of the rates up to 50 per cent. However, the rise of the Korean problem may have stopped further consideration of immediate downward adjustments. Nevertheless, it is relevant to consider the long-run adjustments that ought to be made in the war excise taxes. If our country is compelled to remain on a

quasi-war footing, then attention to these adjustments might have to be indefinitely postponed.

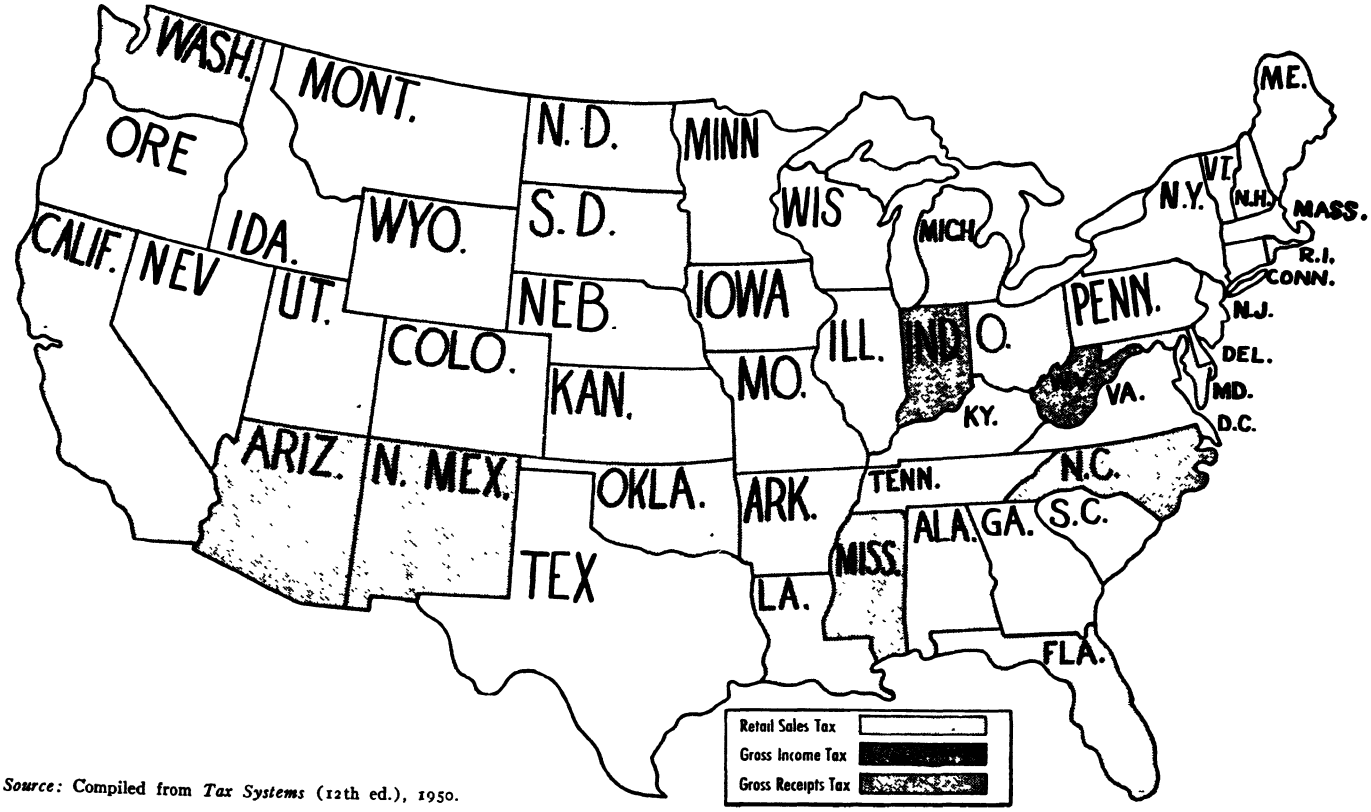
The following long-run objectives may at least be kept in mind: (1) No excise taxes should be levied on the goods and services generally recognized as basic necessities. (2) Due weight should be given to the sumptuary aspects of excise taxation. Those goods which are generally recognized as harmful should bear relatively heavy rates. The country does not need cheap whiskey, although the 5-cent glass of beer might be a contribution to more temperate drinking. (3) Goods of the "luxury type" should bear excise tax rates. (4) Care should be taken not to injure particular industries by the use of excise taxes, especially after inflationary forces have begun to subside. The jewelry and the luggage businesses seem to have suffered a slump in demand in 1949 and early 1950. The 20-per-cent excise tax has been marked as a cause. Some of the excises may have to be adjusted to the phases of the cycle. The excise taxes as they affect the railroads and airlines also should be adjusted downward when traffic drops off because many individual firms in these industries have a difficult time earning a fair rate of return except in more prosperous periods.

The Revenue Act of 1950 and federal excises. The federal excises remain about the same under the new act. The downward adjustments contemplated by Congress in the spring of 1950 were not made. Instead, a number of new items were placed under excise taxes for anti-inflationary purposes. A 10-per cent tax was placed upon television sets and deep-freeze units. Excise taxes on slot machines were increased, and excises were made to apply to transactions at post exchanges, ship stores, and other federal organizations. In addition, excise taxes were made applicable to heretofore exempt auctions of jewelry and furs in private homes. Thus the war excises are again expanding and rightly so.

The Various Sales Taxes

THE CHARACTER OF SALES TAXES

Whereas excise taxes are levies (specific or *ad valorem*) upon specific commodities or narrow classes of commodities, a sales tax is more "general." It may be levied at a single flat rate upon all goods or a given level of production. It is possible, therefore, to have (1) a manufacturers' sales tax, (2) a wholesalers' sales tax, (3) a retail sales tax, and (4) a general or multiple level sales tax. The base of these taxes can be broadened further by the inclusion of various types of services. When the tax is adjusted to cover all kinds of transactions at all levels of production, it becomes a "gross income tax." The retail sales tax is the one used most extensively by the state governments. The heaviest emphasis will be placed upon its analysis.



Source: Compiled from *Tax Systems* (12th ed.), 1950.

FIGURE 19. *Types of General Sales Taxes in Use in the United States, 1949.*

DEVELOPMENT AND PRACTICE

Development of American sales taxes. The federal government has never used a sales tax, although one was considered in 1932 and during World War II. The development of sales taxes has been largely by states and recently by cities. The majority of the state sales taxes were not adopted until the depression of the '30's made such a step quite necessary. Several factors stimulated the growth of the sales tax movement: (1) property tax delinquency ran high; (2) revenues from personal and corporate income were off; (3) needs for education and unemployment relief were mounting; (4) there was resistance to raising property tax rates—in fact some states had applied limitations to such rates; and (5) some states were prevented from using income taxes by constitutional restrictions.

State sales tax practice. In the period from 1933 to 1936, sales taxes were levied by thirty-one states.[2] At present, however, twenty-one states and the District of Columbia levy retail sales taxes, four states levy gross receipts taxes and two levy gross income taxes. It is quite difficult to distinguish among general sales, gross income, and gross receipts taxes. California, Illinois, Michigan, and Ohio are the leading retail sales tax states. In 1949 California collected $294 million from this source, or 39.6 per cent of her total revenues; Illinois, $172 million or 46 per cent; Michigan, $194 million or 52 per cent; and Ohio, $138 million or 40 per cent of her total revenues.

Sales tax exemptions. Generally the exemptions from sales taxes in the several states are not very numerous. Some states grant but few exemptions. The pattern of the exemptions falls into five classes: (1) certain types of goods already taxed under excise taxes, such as gasoline, liquor, and tobacco; (2) certain types of commodities exempt for reasons of social policy, such as food in California, and fertilizer, seeds, and feed in agricultural states, and services and rents; (3) sales to charitable and religious institutions and sales to specified units of government; (4) irregular and casual sales between individuals; and (5) sales in interstate commerce for constitutional reasons.

Some states do not grant exemptions for food. This raises questions of social policy. A sales tax which does not exempt food is particularly regressive because it taxes human subsistence. However, no sales tax exempts clothing, which seems second in importance to food as an everyday necessity.

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[2] Roy G. and Gladys C. Blakey, *Sales Taxes and Other Excises.* Chicago: Public Administration Service, 1945, p. 2.

ISSUES IN RETAIL SALES TAXATION

In this section we devote our attention to problems in retail sales taxation. Gross receipts and income taxes have already been treated in the chapters on business taxation. Most of the problems are associated with administration, small purchases, incidence, exemptions, and conflicts with interstate commerce.

Problems in administration. The administration of a retail sales tax is not as easy as it is sometimes argued to be. This is especially true in states where there are literally thousands of retail outlets. In sales tax administration, three parties are involved in each sales tax transaction, and there are three areas in which problems can arise. The three parties are the consumer-taxpayer, the retailer-taxpayer, and the tax administrator. The process involves administrative costs on the part of the administrative agency and compliance costs on the part of the consumer-taxpayer and the retailer-taxpayer.

The sales tax statute must be carefully drafted in the first instance, if the law is to be well administered and understood. The administrative agency must get full retail-outlet coverage. That is not easy in a state like California, which has over 260,000 retail outlets—many of them "two-by-four" stores run by small retailers whose accounting and records are often very poor. Some states license all retailers as an aid to sales tax collection. The agency must issue understandable instructions and create effective tax report forms.

The strategic point in retail sales tax administration is the retailer-taxpayer himself. If he collects well the money from purchasers, keeps good records, files good reports, and sends in the sales tax money regularly, the whole process will run smoothly. If he does not, it means that the administrative agency must have effective investigation and auditing divisions. On these the costs run high.

The state's cost of administration need not run high. Some states have incurred administrative costs as high as 4 to 5 per cent of collections—a figure which is too high by good administrative standards. Properly organized and administered, sales taxes should be collected for less than 2 per cent.

Small sales. Another problem which caused some difficulty in the early years of sales tax administration was the application of the tax to small sales. As first set up, the statutes merely prescribed the percentage rate without designating how the rate was to be applied to sales of varying size. The result was that merchants charged a full cent on 5- and 10-cent sales. This meant that on a 10-cent purchase the consumer was paying a 10-per cent tax rather than 2 or 3 per cent. This problem has now been adjusted in most states by the use of fractional tokens or a bracket system on purchases, often with the first bracket exempt from taxation.

A bracket system for a 3-per cent tax could operate as follows: a purchase of 1 to 13 cents, no tax; 14 to 42 cents, 1 cent; 43 to 74 cents, 2 cents; 75 cents to $1.00, 3 cents. Such a system avoids overpayment of tax on small purchases. Care must be taken, however, not to get the first bracket too large, or injury can be done to the merchant who has a large proportion of small sales.

Probably a more accurate way to handle this problem is to issue tokens (aluminum or plastic) stamped in mills. Under such a system the tax can be paid to one-tenth of a cent. Tokens are a nuisance to carry around, however, and they can be easily counterfeited.

Sales taxes and interstate commerce. One of the serious problems in selected and general commodity taxation is the treatment of interstate transactions. The Constitution prohibits the states from taxing interstate commerce without the consent of Congress. The volume of business crossing state boundaries is large in the aggregate. States which tax the manufacture or distribution of commodities can tax neither sales completed in other states nor goods imported by local buyers. This narrows the base of the tax, reduces collections, and permits interstate business to escape with lighter taxes than intrastate business. The situation is further complicated by the fact that concerns in a state which levies a sales tax must meet the competition of other sellers in foreign and domestic markets who may not be subject to similar taxes.

Further complications arise when consumers living near the border of a state with a sales tax cross the boundary to shop in another state where there is no sales tax or where the tax is lower; or they may shop by mail in other states. However, the Supreme Court has strengthened the powers of the states to tax such transactions if the vendor operates a business within the state. The legal theory is that the state has the right to require the out-of-state mail order house to collect the tax for it as a condition to operating unit stores and branches within the state.[3]

The use tax supplement. Because many buyers in sales tax states attempt to avoid paying sales taxes by purchasing goods in non-sales tax states, it has become necessary to utilize the concept of the "use" tax. Since the states are prevented from taxing the goods in interstate commerce, an effort must be made to tax the goods "after" they have come "within" the taxing state. Use taxes are therefore imposed on the use, storage, or consumption of all tangible personal property that would be subject to the sales tax if bought within the state. In effect such a tax serves as a "backstop" or supplement to the sales tax.

The use tax has been upheld by the United States Supreme Court on the theory that the state is merely taxing *the use within the state* after

[3] *Nelson v. Sears Roebuck & Company*, 312 U. S. 359 (1941).

the interstate commerce has ceased. This use is something over which the state has jurisdiction. The Court further intimated that use taxes were necessary to enforce the sales taxes.[4] Use taxes are now found in most of the states which employ sales taxes and are ordinarily incorporated in the sales tax law instead of being established as separate taxes. Like the sales taxes, the use taxes are *ad valorem* taxes, and they carry the same rates. Exemptions are usually the same as for the sales tax. Almost all states exempt personal property brought into the state by nonresidents for personal, nonbusiness purposes.

MUNICIPAL SALES TAXES

Development. Municipal government, the unit of government closest to the people, has undergone many changes during the past few decades. It has faced problems of establishing and maintaining services for a growing urban population and financing these operations.

It was during the era of the growth of state sales taxes that the cities also entered the field in small numbers. However, since their basic powers to tax are derived from the states, they have had to await enabling statutes by the state legislatures before they could proceed. Pursuant to enabling acts by the state legislatures, the following cities entered the sales tax field: Philadelphia—1932, New York City—1934, and New Orleans—1936. By 1941 Kansas City, Missouri, and Tampa, Florida, and certain cities in West Virginia had sales taxes on their books. The first city retail sales tax in California was levied by San Bernardino in January 1945, but it was only after Los Angeles entered the field in May 1946 that there was a rush by many cities to tap this newly-discovered source of revenue.[5] By 1950 138 cities in California imposed retail sales taxes and collected $31 million in sales taxes. For the country as a whole over 200 cities now utilize the sales levy.

Problems of municipal sales taxes. City sales taxes are somewhat more difficult to administer than state sales taxes. The retail type is better suited to local administration than the general sales tax which would include manufacturing and wholesaling. Retailing is fairly well concentrated within the cities. To protect the revenues a use tax on major articles imported may be necessary. The inter-community aspects raise some problems similar to those of the interstate character for the states. The tendency to avoid city sales taxes by purchases in other communities is even stronger than in the case of state sales taxes.

One authority recommends that if sales taxes are to be utilized by local governments, it might be advisable for the cities to levy a sales surtax

[4] *Henneford v. Silas Mason Co.*, 300 U. S. 577 (1937).

[5] Louise F. Wright, "City Sales Taxes in California," *The Tax Digest*, September 1948, pp. 301 ff.

above the normal rate levied by the state to be collected by the states and distributed back to the cities.[6]

Value of sales taxes to cities. Sales taxes have clearly been a boon to city revenues. They give the municipalities greater fiscal independence and reduce the need for state aids. In 1948 Huntington Park, California, raised total revenues of $427,000, and $262,000 came from the sales tax. For many medium-sized American cities, the sales tax will be a fiscal stabilizer. Though it has been helpful in our large cities like New York and Los Angeles, it has not solved their fiscal problems.

The use of this tax aids in taking some burden off the general property tax and forestalls raising property tax rates. It collects some revenue from suburbanites and tax colonizers who work and buy in the city. The steady revenue characteristics of the tax will have a stabilizing influence upon city finances.

AN OVER-ALL SPENDINGS TAX

Development of the concept. Another consumption tax concept which deserves at least passing consideration is the over-all spendings tax. This type of "sales" tax would be based on "total" rather than on "specific" expenditures and would be administered through personal reports like a net income tax. Other features resembling those of the net income tax would be graduated rates and personal exemptions. Services purchased by consumers could be readily included without the great administrative difficulty involved in making this extension in the retail sales tax.

The idea is by no means new. In the early 1900's Professor Irving Fisher championed a spendings tax on the theory that there was no income to the individual until earnings were spent and consumed. As late as 1942 he still advocated such a spendings tax and would have substituted it for our present personal income tax.[7] Our discussion of the issue here, however, is directed to the spendings tax as supplementary to the income tax and not as a complete substitute for it. During and after World War I this type of tax was considered.[8] In September 1942 (in World War II) the Treasury presented to the Senate Finance Committee such a graduated spendings tax for the express purpose of curbing inflation. It was not adopted, however.

Appraisal of the spendings tax. It may be that a spendings tax, if inaugurated at the right time, could be a useful instrument of fiscal policy

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[6] Neil H. Jacoby, *Retail Sales Taxation.* New York: Commerce Clearing House, Inc., 1938.

[7] Irving Fisher and Herbert W. Fisher, *Constructive Income Taxation.* New York: Harper and Brothers, 1942.

[8] A. G. Buehler, "Taxing Consumer Spending," *Bulletin of the National Tax Association,* Vol. 28, January 1943, p. 127.

in a war emergency. It no doubt could be a good revenue raiser and perhaps could serve as a buffer against inflation. It would get at luxury and conspicuous consumption. Furthermore, it could encourage saving at a time when additional capital formation was necessary.

Whether or not such a broad consumption tax could be of real value in a peacetime period is another question, for there are some serious objections to the tax. It would mean the addition of complexities to income tax reporting and administration. The personal income tax is already too complex, and if this new tax were added to the federal tax superstructure and the new tax returns were made even more complicated, both taxes would suffer from resultant confusion to the taxpayer. A far more feasible and palatable approach is found in a selective consumption tax system operated largely on the excise principle.

A GRADUATED PURCHASE TAX

Another form of graduated consumption tax not used in the United States as yet (but one which has been employed in Great Britain since 1940) is the purchase tax. It is levied upon purchases from manufacturers and wholesalers by retailers of certain commodities classified into five categories according to the degree of luxury or necessity represented by the particular commodity. Those goods recognized as most luxurious are taxed at 100 per cent of the wholesale price, the second class at 66⅔ per cent, the third at 33⅓ per cent, and the fourth at 16⅔ per cent. The fifth category consisting of such necessities as food, essential clothing, fuel, utility services, shoes, furniture, and others is exempt.

In recent years this tax has accounted for about 4 per cent of the taxes levied by the national government in Great Britain. It has, therefore, become recognized as a fairly good revenue-raiser. This tax was originally conceived as an anti-inflationary instrument and has been helpful to that end without being markedly regressive. It is relatively easy to administer because it applies to fewer business units than a tax levied at the retail level. It accomplishes the same objectives as a spendings tax and is probably more acceptable.

The Taxation of Imported Goods

THE CONCEPT OF CUSTOMS DUTIES

Definition of customs duties. Tariff or customs duties are taxes levied upon goods crossing national boundaries, and they are generally collected from importers seeking advantage in the country which levies said duties. Consequently, such duties can be considered a "premium" upon the economic advantage the producers of one country can gain by selling

their commodities in foreign markets. At times some countries have levied taxes upon exports. Export taxes, however, have never recaptured their former significance. In the United States there is a constitutional prohibition against them, and so they have never been used. In our day customs duties or tariffs are almost universally levied upon goods entering a country.

Basic classification of tariff rates. Tariff duties are levied in two basic patterns: (1) specific duties and (2) *ad valorem* duties. Specific duties are levied as a definite sum of money upon the given units of goods—such as 2 cents per pound on sugar or $1 a gallon on Scotch whiskey. *Ad valorem* duties, on the other hand, are levied according to the value of the imported good—such as 25 per cent on the value of diamonds or 20 per cent on the value of automobiles. Specific duties are more inflexible and are inclined to be regressive in relation to the cheaper goods. They are easier to administer because there is no process of valuation involved. *Ad valorem* duties are more flexible and are not so regressive as applied to cheaper goods. The latter are more expensive and difficult to administer because of the valuation problem.

Basic objectives of tariff rates. In setting up a system of tariff rates three objectives can be followed. They are: (1) the free list, (2) tariff for revenue, and (3) tariff for protection. Those commodities which are placed on the free list may enter without any custom duty payment. These goods are free to flow without tax hindrance. A tariff for revenue is one where the rates are set at a level that will not discourage the goods from coming in but at a level that will secure the greatest net revenue yield. A tariff for protection is one where the rates are set high enough to give domestic producers adequate protection. A truly protective tariff will yield very little revenue because it will actually keep the goods out.

FISCAL SIGNIFICANCE OF CUSTOMS DUTIES

Though our tariffs have been usually called protective, they have, nevertheless, raised substantial revenues. On many items the rates were not high. Even on the high rates, especially during prosperous periods, goods flowed in over the walls of protection. From 1789 to 1862 customs duties usually amounted to over 90 per cent of total federal revenues. From about 1868 to 1910 they constituted between 40 to 50 per cent of national receipts. During the 1920's tariff revenues were the greatest in dollar volume—they averaged well over $500 million per year or about 12 per cent of total revenues. They dropped off about 40 per cent in the 1930's. Since the close of World War II customs duties have averaged somewhat over $400 million per year—in several instances less than 1 per cent of total federal tax receipts.

PROBLEMS OF CUSTOMS ADMINISTRATION

To facilitate the collection of duties the tariff laws require that all imported goods be brought in at certain designated "ports of entry" where customs houses are maintained. One of the continuous difficulties facing customs administrators is that of smuggling and evasion. In a country with extensive border lines that problem is a serious one which requires adequate and well-trained personnel. In addition there must be a constant vigilance against the numerous ingenious devices of evasion, even with respect to the goods passing through the customs houses.

The valuation problem under *ad valorem* tariffs is especially difficult, because here the task is not merely one of valuation based upon "internal" fair market values. The Act of 1922 granted several alternative valuation standards depending upon their satisfactoriness to the customs officials. Among these standards were: (1) foreign value or export value, whichever is higher, (2) United States value, (3) cost of production, or (4) the selling price of a comparable American article. Often these values are not easily determined.

Furthermore, the opportunities for fraud on valuation are plentiful. Duties are sometimes evaded by the use of fictitious invoices; expensive goods may be packed with goods of lower value; expensive goods are camouflaged as cheaper goods in various ways. In the case of goods with a number of quality classifications, the difficulty of drawing the lines between classes is obvious.

The administrative costs of customs duties tend to run high in comparison with those of internal revenues. Many overhead costs tend to remain relatively fixed regardless of the volume of imports. Collection costs, therefore, tend to vary inversely with imports and total receipts. In 1948 the Customs Bureau spent over $32 million to collect about $426 million in customs duties. It cost about $5.95 to collect each $100 of duties.[9] Usually when those costs rise above 3 per cent they are considered high.

THE ECONOMICS OF THE TARIFF

Tariffs for revenue. The basic objective of many individual tariff rates is to raise revenue rather than protect home industry. In order to produce the largest net revenue certain principles should be considered: (1) Tariffs should be levied upon those goods which cannot be produced within the country or those which can be produced only at a material disadvantage. (2) They should be levied upon a small number of selected commodities for which there is a wide and inelastic demand and upon luxuries. (3) Generally, they should not be levied upon the basic

[9] *Annual Report of the Secretary of the Treasury*, 1948, pp. 596-597.

necessities of a fair standard of living. (4) The rates should be kept reasonable so as to minimize smuggling and evasion.[10]

In setting the tariff rates (for maximum revenue) consideration must be given to elasticity of demand for the various items taxed and the behavior of the marginal consumer. If the rates reach the point where marginal consumers forego the purchase of the goods, imports and revenues will drop off.

It is sometimes said that a "tariff for revenue only" will have no noticeable effects upon the internal economy. This is too strong a generalization, for every tariff is bound to have some economic consequences. There are always some marginal consumers at every price. Given rates may cause some shift in demand to substitute products. For other consumers it may mean that they will have less purchasing power available for other goods.

Tariffs for protection. A protective tariff places major emphasis upon tariff rates high enough to "keep out" certain goods so as to protect domestic industries from foreign competition. Many economic arguments have been advanced in favor of such tariffs: (1) to protect and encourage "infant industries" until they can increase their productivity and lower their costs to compete in world markets; (2) to conserve the "home market" for domestic producers; (3) to aid in building a diversified economy; (4) to insure economic self-sufficiency in the event of war; (5) to maintain the wages and standard of living of the domestic workers; and (6) to protect against the "dumping" of cheap foreign goods upon the domestic market.

Those who favor a freer trade also can present strong economic arguments. The big one, of course, is that for all these protections it is the "domestic consumer" who ultimately pays the price. Quite often the rise in prices is greater than the tariff rates and the consumer in effect pays a premium to the domestic producer, in addition to the amount of the tariff. It results in higher profits, a stronger grip on the domestic market and tends toward internal monopoly, for the tariff has often been designated as the "mother of trusts." All of this can also affect the distribution of income in the domestic economy—it tends to take more purchasing power away from consumers and push it in the direction of stockholders and business men.

The broader economic argument against protective tariffs is that it interferes with the territorial division of labor and negates the application of the principle of the greatest comparative economic advantage. This results in unwise and inefficient use of resources by those protected and a waste and less than full effective use by those who possess the economic

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[10] John Stuart Mill, *Principles of Political Economy*. New York: D. Appleton and Company, 1887, pp. 587-589.

advantages. In the long run, whole economies, together with their producers and consumers, are the losers.

Tariff making by reciprocal trade agreements. The tariff policies of the United States and other countries after World War I led to many injurious international trade practices. Our tariff walls were the highest in our history—so high that many debtor nations were unable to sell us sufficient goods to pay their debts to us. It resulted in protective tariff retaliation, import quotas, blocked exchange, bilateral barter and other barrier practices. International trade slowed down substantially and domestic economies were adversely affected. Each country thought that it could "export its unemployment" and refuse to accept goods (employment) from other countries.

The folly of all this became strongly apparent by the 1930's. In the United States efforts were begun in 1934 to break down the barriers. First, Congress delegated some of the tariff-making powers to the President and the Tariff Commission. The President was given the power to raise or lower tariff rates by not more than 50 per cent. Under Secretary of State Cordell Hull, Congress granted the power to enter into reciprocal trade agreements with foreign nations subject to the 50 per cent limitation. The State Department had a great deal to do with the negotiations whereas the President had the power to issue the proclamations. During the 1930's such agreements were entered into with 22 nations, about half of them South American countries. The original act granted the power for a three year period. The legislation has been extended several times. In 1948 the extension met with some resistance, but, nevertheless, was granted. In effect this procedure is tariff-making by "bilateral bargaining" within the terms set by Congress.

Conclusions on Consumption Taxes

IT IS NOT A HAPPY SIGN that there has been a material expansion of consumption taxes (especially sales and excise) during the last twenty years by all three levels of government, and by the states in particular. This has probably been due to the rapid growth of revenue needs and the substantial, quick, and steady yield of revenue by these taxes. This development seems to be away from ability-to-pay taxation and toward greater regressivity. That may be unfortunate. And yet, not all states have tended to move in that direction. The New York and Wisconsin state governments have done quite well without heavy emphasis upon sales taxes. Other states could do the same if they had the courage to strengthen their income taxes. However, once the taste of the easy flow of sales taxes has been enjoyed, the retreat becomes more difficult.

In spite of the economic disadvantages, there seem to be a number of factors which point to the maintenance and even future development of sales taxation by the states. Among these are: (1) a strengthening of the movement to transfer a larger portion of governmental costs from property to other sources; (2) a continued extension of state functions; (3) assumption by state governments of an increasing share of local financial responsibilities; and (4) the possibility that there will be unemployment relief loads from time to time of substantial proportions.

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Motor Vehicle and Highway Taxes

ONE OF THE PRINCIPAL FUNCTIONS *of government is to facilitate transportation. In the United States in recent years this has taken the form mainly of providing highly improved roads for automobiles, busses, and trucks. Collateral to the outlay for this purpose there has developed a system of motor vehicle taxes. These taxes were "sold" largely on the ground that those who use the highways should pay for them.*

—HAROLD M. GROVES [1]

Overview

IT IS DIFFICULT to discuss motor vehicle taxes without considering highway taxes. Fundamentally, in this country they have become one and the same thing. In recent years much of the highway system in the United States has been constructed and maintained from the special taxation of motorists and the vehicles which use these highways. The highway revenues come primarily from two state taxes—the motor vehicle license tax and the motor vehicle fuel tax.

Until quite recently this area of taxation has been occupied by the states almost exclusively. The states, therefore, insist that they have a prior claim to the right to tax in this field. Since 1932, however, the federal government has imposed a gasoline tax; from 1941 to 1945 it levied a $5 annual "use" tax on motor vehicles, partly as a revenue measure and partly to discourage the use of automobiles during the war period.

Among the issues the reader should bear in mind when studying the problems in this field are: (1) How should we pay for the construction and maintenance of our streets and highways? (2) What part should motor vehicle taxes play in such a program? (3) What part should other types of taxes play in such a program? (4) Under what circumstances, if any, should the diversion of highway funds to other purposes be permitted?

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[1] Harold M. Groves, *Viewpoints in Public Finance*. New York: Henry Holt and Co., 1947, p. 376.

The Problem of Financing Highways

STATEMENT OF THE PROBLEM

With the advent of the motor vehicle in the United States, the construction and maintenance of highways, roads, streets, and bridges has become a prime concern to all levels of government, but more particularly to the state and local units. Not only has there been a tremendous increase in the number of motor vehicles, but likewise there has been a great increase in the number of miles traveled by each vehicle. The demand for more and better highways is constantly rising. The motor vehicle, at first a luxury, has become a necessity in the modern day world. In the United States today there are over 43 million passenger cars, buses, and motor trucks using the highways.[2] This is 1.4 families per passenger car.[3] In 1948 these vehicles traveled over 400 billion miles, or an average of 9,850 miles per vehicle.[4] In addition to the problem of providing adequate roads to carry these vehicles, governments are called upon to solve the attendant problems of providing parking, pedestrian safety, and traffic control facilities. Large squads of traffic and highway police also must be maintained.

PAST AND PRESENT SOURCES OF HIGHWAY FUNDS

Historically highway revenues have been derived in varying proportions from highway users, from special assessments on adjoining land, from property owners, from general funds, and by borrowing. Table X shows the percentage of total highway and street revenues derived from the various sources from 1921 through 1948. It is to be noted that in the last twenty-eight years, highway users have contributed 41 per cent of the total, city and county property owners 39 per cent, the general taxpayers through contributions of the federal government 17.2 per cent, and miscellaneous sources including tolls and interest 2.8 per cent. Special assessments are included with the property tax revenues. For the single year 1948, highway users bore 61.8 per cent of the total burden, property taxpayers 22 per cent, the general funds from all taxpayers 13.4 per cent, and miscellaneous sources 2.8 per cent. It is also to be observed that during the 1920's property taxpayers, city and county, contributed, on the average, two-thirds or better of the funds. In recent years, the reverse has been true; highway users have been contributing about 60 per cent of the revenues.

[2] Estimated by the U. S. Department of Commerce, Bureau of Public Roads, in August 1949.

[3] Automobile Manufacturers Association, *Automobile Facts and Figures,* (29th ed.), 1949, p. 25.

[4] *Ibid.,* p. 36.

Table X

TOTAL HIGHWAY AND STREET REVENUES FROM VARIOUS SOURCES
1921-1948—SELECTED YEARS

Percentages

Year	Federal Government	State Highway Users	Others*	County and Local	Urban Places	Grand Total
1921	8.0	11.7	7.6	39.5	33.2	100.0
1925	6.5	24.6	4.4	27.8	36.7	100.0
1926	5.5	26.2	3.5	28.8	36.0	100.0
1930	6.3	34.7	2.6	22.6	33.8	100.0
1931	9.1	37.5	2.5	22.1	28.8	100.0
1935	28.8	39.5	1.1	13.2	17.4	100.0
1936	41.3	33.8	0.8	10.3	13.8	100.0
1940	30.2	43.4	1.0	11.4	14.0	100.0
1941	23.1	51.2	1.6	11.4	12.7	100.0
1945	4.2	61.8	4.3	15.8	13.9	100.0
1946	7.0	60.6	6.5	13.0	12.9	100.0
1947	12.3	60.6	3.0	12.2	12.0	100.0
1948	13.4	61.8	2.7	11.1	10.9	100.0
28 year Average	17.2	41.0	2.8	17.8	21.2	100.0

Source U S Public Roads Administration (Table HF-1)

Federal and state data are for calendar years. County and local data are for varying fiscal years, as reported Data for most recent years are partly-estimated

* Includes tolls from roads, bridges, and ferries; earnings on debt service fund; and miscellaneous state imposts and revenues

WHO ARE THE BENEFICIARIES OF HIGHWAYS?

Does the foregoing represent the proper assignment of highway costs to highway beneficiaries? It is quite commonly believed that the motoring public is the principal beneficiary of public highways, and therefore the highway users should bear the entire burden of highway costs. A closer study will reveal that there are beneficiaries other than the motoring public. Stated in the form of broad classes, these beneficiaries fall into three groups: (1) general public, (2) property owners, and (3) highway users.

ALLOCATION OF BURDEN AMONG HIGHWAY BENEFICIARIES

It is well agreed that the allocation of the tax burden among the various beneficiaries should be on a use-enjoyed or cost-of-service basis. This is true because the service and use is observable and measurable. It is on the allocation of the burden that the most difficult problems arise. Equitable and scientific allocation involves careful analysis in two areas: (1) the

types of beneficiaries and the character of their use and benefits, and (2) the component parts of the street and highway system to ascertain who uses or benefits from the various parts.

Allocation to the general public. Based upon the general benefits received by the general public, some contribution should be made out of the "general funds" of the federal government and those of city and county governments. This is especially true of national highways, military access highways, and "through" and business streets in our cities. The "percentage" contribution need not be large (20 to 25 per cent) except in the case of military access roads; there the federal contribution should be substantial.

Allocation to property owners. By and large, property owners should not be required to contribute except in a minor way for national highways, state trunk highways, and freeways out of our large cities. However, in the case of residential streets, property owners (on the theory of land service) should contribute materially under the general property tax and special assessments. In the case of "through" and main streets, which are part of the state highway system, the share of the property owners should be substantially reduced. A practical way to allocate here is to have property owners contribute directly to a strip and the curb and gutter on each side of the street, whereas a major-travel strip down the middle should be provided by highway users under the gasoline tax. Even those whose property does not immediately front on the improved street receive benefits and should contribute on a "zone" basis.

Business property along business streets should contribute to the parking strip and the curb and gutter along each side of the street. Corner and other strategic locations should contribute in proportion to their special advantages. Again, the central travel strip should be paid for by highway users and the general public from gasoline tax and general funds. In 1948 property owners contributed about 21 per cent of total street and highway costs. Some critics believe this is too small a proportion of the total, especially in view of the fact that in 1921 the proportion was 72.7 per cent. The real test, however, is whether or not property owners are paying their fair share of street costs where "land service" and other economic benefits are involved. In recent years more gasoline tax money has been allocated to cities (and properly so), with the result that the contributions under special assessments and the property tax could be less.

Allocation to street and highway users. There is little doubt that the highway users are the most active and direct beneficiaries and heaviest motivators of highway costs. The first problem is that of determining the types of streets and highways to which they should contribute most. National, state, and county trunk highways should be financed very largely from highway-user revenues. "Through" streets and streets which are parts of the above types of trunks fall into the same group.

Since residential property owners are also auto owners and pay gasoline taxes, such taxes should make some contribution to the cost of residential streets also.

Another problem relates to the allocation of costs as between different types of users. Depending upon the purpose of use and the impact of wear and tear placed upon the highways, there are three types: (1) private passenger vehicles, (2) private commercial vehicles, and (3) for-hire commercial vehicles.

Since benefits received are a bit difficult to measure, this theory must be combined with a "use theory" which attempts to charge the user in direct proportion to the extent he uses the facilities. Use can be measured by the number of miles traveled times the weight carried. For private passenger vehicles the problem is not too difficult, because consumption of taxed gasoline will measure the extent of the use of the highway facility quite well. The problems of allocation and measurement are far more difficult for commercial uses of the highway.

Commercial use of the highways requires a heavier allocation of cost because (1) the public is in effect furnishing part of the capital in the business, (2) heavier roads and extra traffic lanes have to be constructed for such use, and (3) commercial use causes a heavier impact of wear and tear upon the highway. In commercial use both "mileage" and "weight carried" should be measured and accounted for in assessing costs to users. Although many intensive studies designed to give primary attention to finding the basis for an equitable apportionment of the financial responsibility for highway services among different classes of users have been made, none of the answers given has been considered conclusive. Changes are constantly occurring in motive power, design, and size and weight limitations. Commercial vehicles and traffic are increasing in relation to total vehicles and traffic.

The actual allocation of the revenues to types of highways. After the revenue has been collected, there is still the problem of spending the money to provide the greatest benefit to the taxpayer for his dollar. Expenditures must be related to the factors of mileage and traffic carried by the state highway, county road, and city street systems. In 1948 from data furnished by the Bureau of Public Roads it was found that state highways represented 6.5 per cent of total mileage, but carried about 42 per cent of the traffic and received 57.7 per cent of the total expenditures. State highways must be of a better quality and maintained in good condition. County highways represented 84 per cent of the total mileage, but carried only 8.6 per cent of the total traffic, and received 24.3 per cent of the total expenditures. City streets on the other hand represented 9.5 per cent of the total mileage and carried 49.4 per cent of the total traffic, yet they received only 16.8 per cent of the expenditures. The latter situation existed in many states because rural representatives in the legislatures

were often in the majority and, therefore, voted more funds for state and county highways. For years in many states the claim has been that cities have been "short-changed" on allocations of gasoline tax money. It is not for us to say what percentage should go to each type of highway. The real point is that a problem is present for which a scientific and equitable formula based on relevant factors must be worked out.

Once the allocation policies have been worked out, then the task becomes one of selecting the taxes which will best carry out those policies. Here we are concerned with the highway-user taxes, the most significant of which are the motor vehicle license tax and the gasoline tax.

The Motor Vehicle License Tax

Development of the tax. Of the two major highway-user taxes, the license tax developed and had twenty years of experience before the gasoline tax appeared in strength. In its earliest form, the motor vehicle license charge was a nonrecurrent fee (rather than a tax) paid at the time of the purchase of the automobile.

The first state to levy the motor vehicle license tax was New York in 1901. The constitutionality of the license fee was called to question shortly after its introduction. It was claimed that there was unfair discrimination between the manufacturer of automobiles and the customer-owner. The manufacturer was not required to have a license for each vehicle which he completed; therefore, it was argued, a particular class of automobile owners was being singled out for taxation. However, in 1903 the courts held that there was a clear difference in the two classes of automobile owners, and the state had it within its powers to tax one and not the other.[5]

The revenue possibilities of automobile registration were not fully appreciated at first. The flow of revenue gained momentum gradually as registration was made an annual responsibility and the fees were increased. The concept of the graduation of registration taxes began to appear in 1906 when several states used horsepower as the basis of classification. Thereafter, the motor vehicle license taxes became more complex as other factors were utilized as the basis for graduation. In some states, California for example, these taxes on an *ad valorem* basis became substitutes for direct personal property taxes on motor vehicles.[6] By 1910 most states had installed some form of auto license taxation, and the tax began to take its more settled form. On the revenue side the growth has been quite

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[5] *People v. McWilliams*, 86 N. Y. Supp. 357 (1903).

[6] Shultz and Harriss, *American Public Finance*, p. 542.

phenomenal. In 1901 New York collected $954 in auto license fees.[7] In 1949 this state collected over $67 million from this source, or 9 per cent of its total revenue receipts. In 1948 in all states the returns were $689 million, or a trifle better than half of the total state collections under the gasoline tax, and the auto license fees ranked fifth among all state taxes in revenue yield.

The tax as it finally matured amounts to a "recurring annual charge" for the right to use motor vehicles on the public streets and highways.[8] Combined with this, however, are regulatory features such as the registration of legal title for proof of ownership, for identification in case of accidents, traffic violations, and crimes.

Motor vehicle license tax base. There is a bewildering variety of motor vehicle license tax bases. Most states have differing bases for passenger cars, trucks, and buses, with superimposed variations for private, commercial, and common carrier vehicles. No two states have an identical combination of bases. The most common factors that are used solely or in part to make up the tax base are:

Factor	*No. of States*	*Factor*	*No. of States*
Weight (gross/net)	35	Horsepower	8
Seating capacity	14	Ownership	5
Classification	9	Cost	3
Flat rate	8	Mileage	2
Operation/Use	14	Value	1

The classification for the major motor-vehicle-license-using states as applied to private passenger cars is as follows:

State	*Factor*	*Rate*
California	Flat Rate	$ 6. all cars
Illinois	Horsepower/weight	$ 6.50–$22
Michigan	Weight	$ .35 cwt.
New York	Weight	$ .50 cwt.
		$ .75 cwt. @ 3500 lbs.
Pennsylvania	Flat rate	$10.
Ohio	Flat rate	$10.
Wisconsin	Flat rate	$16.

It is evident from an analysis of the two tables that weight seems to be the major factor for fixing the tax base and the tax rate. The logic of this is evident when it is realized that there is a direct relation between vehicle weight and highway wear. For private passenger cars net or manufacturer's weight is the most common. Gross weight is used very extensively for trucks, buses, and other commercial vehicles. Gross

[7] Austin F. MacDonald, *American State Government and Administration.* New York: Thomas Y. Crowell Co., 1946, p. 507.

[8] During World War II the federal government attempted to levy a $5 per year "automobile use tax." It had no machinery to enforce it except wartime patriotism and some voluntary help from local officials. It was wisely repealed at the end of 1945.

weight is probably the most relevant factor. (Gross weight is net weight plus the standard load.) It more nearly measures the total impact brought to bear upon the highway and therefore is more accurately correlated to the cost of service.

Merits of a good license tax. Though the gasoline tax raises about twice as much revenue and is less expensive to administer than the license fee, yet it would be unwise to operate a highway-user tax system without a license tax in the structure. This tax makes its contributions toward the total motor vehicle tax objectives:

(1) When used along with the gasoline tax, it makes possible two moderate taxes rather than one severe one which might be difficult to enforce.

(2) The license tax system serves a useful regulatory and policing function which becomes increasingly important as the automobile population runs more and more up into the millions.

(3) It can be substantiated as "fixed charge" on the ownership of an auto whether the highways are used frequently or not. The person who uses the highways only on such days as Memorial Day, the Fourth of July, and Labor Day makes a marginal contribution to the "peak load." It is argued that all the highway services and traffic control must be adjusted to meet that peak load. That involves additional costs to which every potential user of the highways should contribute.[9]

(4) Another well-recognized merit is that it can serve as a supplement to the gasoline tax and correct the low correlation between gross weight and consumption of gasoline. The gasoline tax correlates well with benefits and cost of service in the case of the average passenger car, but not so well for trucks and buses. A well-designed license tax takes "added weight" into consideration.

Auto license tax administration. It is probably true that the motor vehicle license tax is not easily evaded or avoided. The fact that the license plate must be displayed on both the front and rear of the car makes it difficult to use the public highways without having applied for and paid for the license. Nevertheless, adequate administrative procedure is required to check and prevent the understatement of the various factors used in graduation such as weight, capacity, and so on. If the machinery and the techniques for such checking are adequate, the success of evasion or avoidance can be kept at a minimum. Good administration is as much a condition precedent to the effectiveness of a motor vehicle license tax as to any other tax.[10]

The responsibility for the administration of the motor vehicle tax has been given to a number of different agencies throughout the several states. In most instances those agencies are state, but in some they are county.

[9] Groves, *Financing Government* (3rd ed.), p. 311.

[10] Shultz and Harriss, *op. cit.*, p. 547. This work contains an excellent, compact discussion of auto license administration.

At the latter level one state administers by means of county assessors, five by county treasurers, one by county court clerks, and one by judges of probate. When the tax is administered by a state agency, departments of taxation, commissioners of revenue, departments of motor vehicles, secretaries of state, and highway commissions are commonly represented. Twenty-five states utilize special motor vehicle departments or divisions.[11]

The sounder administrative practice would be to provide a special division within a well-organized department of taxation. However, that has occurred in seven states only. Nevertheless, many of the separate motor vehicle divisions perform efficient services in the administration of the tax and the issuance of the license plates.

The costs of motor vehicle license tax administration run comparatively high. The ratio of administrative costs to gross receipts is commonly between 5 to 7 per cent, whereas it amounts to less than 1 per cent for the gasoline tax. It must be remembered that a number of regulative, recording, and policing functions are performed in conjunction with the collection of the license tax.

The Motor Fuel Tax

THE GASOLINE TAX is the most productive member of the motor vehicle tax family. It has been also one of the most well-received taxes on the American scene. This is probably true because the benefits enjoyed are discernible under the very wheels of those who pay the tax.

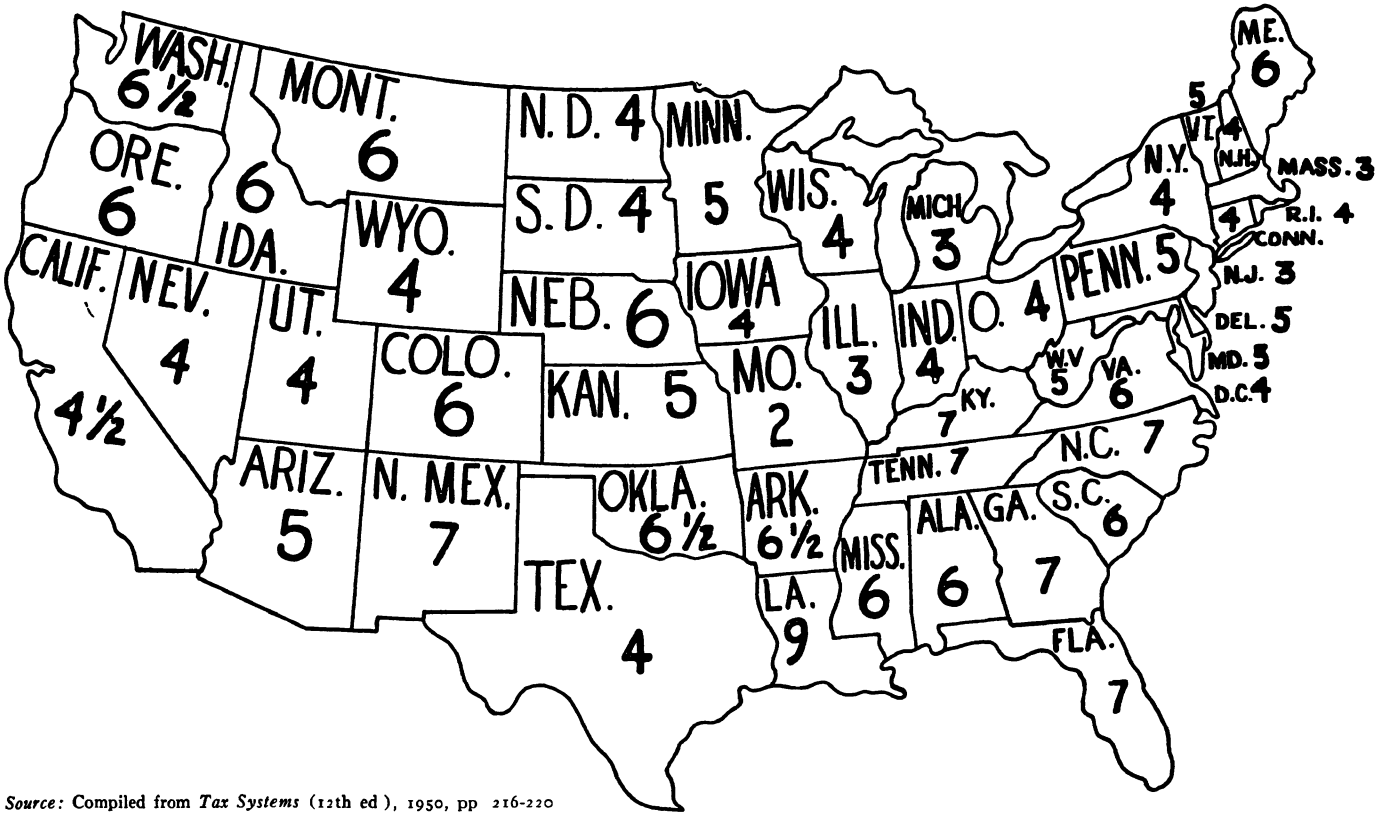
The development of the tax. Oregon levied the first gasoline tax in February 1919. Three other states followed in the same year. The tax spread rapidly until in a span of one decade every state had entered the field.

The first Oregon tax was 1 cent per gallon. In 1921 the tax was increased to 2 cents. South Carolina entered the field in 1922 with a 2-cent tax, and 2 cents became the minimum tax. So it progressed with new states entering the field and others increasing their rates, and by 1935 the median tax was 4 cents for all states. In 1951 Louisiana levied a 9-cent tax, whereas a number of states levied a tax of 7 cents per gallon. The lowest rate was 2 cents, but that was found in only one state—Missouri; 4-, 5-, and 6-cent rates were very common.

The revenue yield from state gasoline taxes amounted to about $1 million in 1919. This had risen to $1.566 billion in 1950. In California alone in 1949 the yield was over $128 million, or about 17 per cent of the total revenue collections. In Georgia the yield amounted to 36 per cent, in Kentucky 32 per cent, and in Florida 33½ per cent of total state revenues.

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[11] *Tax Systems* (12th ed.), 1950, pp. 243-251.



Source: Compiled from *Tax Systems* (12th ed.), 1950, pp 216-220

FIGURE 20. *Gasoline Tax Rates in the United States, 1949 (in cents).*

These percentages are exceeded only by retail sales taxes collections in a number of states.

In 1932 when the need for revenue was great, a federal levy of 1 cent per gallon was instituted. An increase of ½ cent was levied in 1945, and the federal tax stands today at 1½ cents. By and large the tax has been left to the states. There are those who advocate that the federal government withdraw completely from the gasoline tax field. But the revenue return from the tax would seem to justify its continued imposition, especially during emergency periods. In 1950 the national government collected $604 million from combined gasoline and oil taxes.

Administration of gasoline taxes. Until 1929, administration of the gasoline tax was very easy, the rates being low and the number of taxpayers small. Since then several factors have made administration more difficult. Evasion and bootlegging became profitable as the rates increased. The number of retail outlets and distributors has increased enormously. Loopholes were found in the laws, and the small staffs of administrators were unable to cope with the situation. It was, therefore, necessary to seek the aid of the legislators to secure legal provisions to combat evasion.

Nevertheless, this tax is one of the least expensive taxes to administer. It must be noted that private agencies incur compliance costs in aiding the states to collect the tax. At present the average cost to the states ranges between ½ to 1 per cent of total gasoline revenues.

Unfortunately, from the point of view of effective administrative organization, gasoline tax collection is too often placed in the hands of the comptroller, the auditing department, the commissioner of motor vehicles, the state oil inspector, and others. This tax is important enough to be administered by a special division within a well-organized department of taxation—an agency primarily charged with tax administration.

When the rates get up to 5, 6, and 7 cents a gallon, the propensity to evasion increases. Evasion may be effected in several ways: by blending, smuggling, diversion of shipments, and substitution. Many techniques have been worked out by the states to minimize evasion: (1) licensing of distributors, (2) bonding of distributors, (3) reports from all common carriers transporting gasoline, (4) making the tax a lien on property of the evader, (5) report of a sale or cessation of business, (6) rewards for reporting violations, (7) refunds by permit only, and (8) exchange of information between states.

Another factor to be noticed is *where* the law places the legal impact of the gasoline tax. If it is upon dealers and distributors and they shift it to consumers, it has been not possible to take gasoline taxes as a deduction on the federal income tax. Users of private gasoline in California suffered this disadvantage. In Wisconsin, where the legal impact is upon the gasoline purchaser, such tax was deductible. In 1951 Congress passed an

act permitting the gasoline tax deduction on the federal income tax regardless of the legal impact of state gasoline taxes.

Exemptions and refunds. As a general rule most states exempt the motor fuel not used on the highways. This is only logical because the very intent of the gasoline tax is to build and maintain highways on a benefits received basis.

These provisions take two forms: exemptions and refunds. An exemption makes it unnecessary for certain users to pay a tax at the time of the purchase. A refund is a return of the tax paid on gasoline used for nontaxable purposes.

The exemptions common to all states are on interstate commerce and sales to the federal government, both the result of Supreme Court decisions. Some states make no provision beyond these exemptions. By ignoring the subject of refunds and exemptions the administrative side of the law is much simplified; costs of collection are lower and the largest single cause of evasion is removed.

In 1930, one state, Kansas, allowed exemptions but no refunds. Gasoline exempted increased from 15.9 per cent of sales in 1930 to 29.1 per cent in 1931. Evasion became so serious that the Kansas legislature was forced to appropriate large sums for enforcement. Collection costs in that state stood at 3.2 per cent, one of the highest in the nation.

Most states provide for refunds only. The most common bases for refunds are non-highway purposes, cleaning, dyeing, tractors, and motorboats. Five states provided for both refunds and exemptions.

Refund claims are such a serious problem in tax administration that the privilege has gradually been limited. There is generally a time period during which claims must be filed. Some states require a declaration at the time of purchase that the gasoline is for a nontaxable purpose. Other states limit refunds to a portion of the tax. At least four states refuse refunds on small purchases. Two states have experimented with refund permits.

Refunds have ranged from nothing to 40 per cent of gross collections. In California, they averaged about 9.5 per cent during the 1930's and had increased to 11.6 per cent by 1946. Although this is a considerable proportion of revenues, it has been estimated that gasoline used for non-highway purposes is between 8 per cent and 8.5 per cent of all gasoline sold. Whereas refunds are entirely proper in theory, evasion cannot be regarded lightly.

Since refunds are in effect exemptions from the tax after administrative costs have been incurred in the collection of the refund tax, the refund privilege should be kept at a minimum. Making the refund also involves administrative costs. Therefore, a strong "burden of proof" should be placed upon the party seeking the refund.

Appraisal of the Gasoline Tax

MERITS OF THE TAX

The gasoline tax is one of the easiest to support both in theory and practice. Its wide popularity atttests to its good qualities. Among its major merits are:

(1) *It is the best measure of the use of the road.* There is a reasonably high correlation between the gasoline consumed, the tax paid, and the benefits enjoyed from the use of highways. This is especially true for the great bulk of private passenger cars.

(2) *It aids railroads to compete with trucks and buses.* It is well proven that railroads are at a decided disadvantage when compared to truck and bus lines. The gasoline tax helps to remove this disadvantage.

(3) *It secures revenue from tourists.* Tourists make full use of highways and roads, though they contribute nothing to their construction. The gasoline taxes are well designed to get at this transient population.

(4) *It is convenient to pay.* As in most other "pay-as-you-go" tax plans, the taxpayer has little idea how much tax he is paying as long as it is extracted a few cents at a time. This is one of the features that makes it a "popular" tax.

(5) *It is easy to administer.* By collecting from the distributor the administration needs to deal with only a limited number of taxpayers. Thus expenses and problems arising from sheer numbers are largely eliminated.

(6) *Collection costs are low.* Again, by limiting the number of collection points, the trouble and expenses involved in collecting from the individual are largely avoided.

(7) *It is a good and steady revenue raiser.* The demand for gasoline seems quite inelastic. Therefore, the flow of funds from this source holds up quite well in good times and in bad. During the depression years of the 1930's, when the general property tax revenues dropped off as much as 50 per cent, gasoline tax revenue dwindled less than 5 per cent. Some decline in the price of gasoline helped to sustain the demand, however.

THE DEMERITS OF THE TAX

The criticisms of the gasoline tax are somewhat forced and possess an artificial ring. Some of those advanced are:

(1) *It is unjust unless there is a general sales tax.* This argument advanced by the oil industry ignores the benefit-received principle and the apparent inelasticity of demand.

(2) *Funds are diverted.* But this is not generally true, and strong resistance hinders any further move toward diversion.

(3) *It is a tax on essential transportation.* This argument of the trucking companies is merely an attempt to maintain their present tax advantage over railroads.

(4) *It is a burden on the automobile industry.* This is true, but there is little doubt that the industry can, and in all equity should, carry the burden. There is no evidence that it has lowered the sale of cars. In fact, the industry was subsidized from 1900 to the 1920's by the use of special assessments, property taxes, and general funds to build streets and highways.

Taxing the Business Use of Highways

The allocation problem. The problem of the taxation of motor vehicles is complicated by the fact that highways are used for business as well as private purposes. This means that the users of the highways are competing with railroads. Railroads must keep their own roadbeds in condition, so in order to keep from giving the highway-user an unfair advantage he must be made to pay his fair share of the cost of the highways he uses.[12]

It is now generally recognized that the motor truck has become an essential agency for the transportation of freight, not only intracity and intercity, but also interstate. Merchants accustomed to the convenience of quick-replacements of inventories by motor truck no longer maintain large stocks of merchandise, and a cessation of truck operations in any community would quickly result in serious public inconvenience.[13] The railroads claim the trucker isn't paying his share of highway costs, and the trucker claims he is paying more than should be fairly allocated to him.

The whole issue is one of the allocation of costs of business users on the basis of the service enjoyed. By and large the degree of service enjoyed is best evidenced by (1) the miles traveled, and (2) the load carried. The fact that heavier roads must be built to carry the heavy trucks and buses must be considered. If 30 per cent is added to the cost of constructing a "heavier highway," that additional cost should be borne entirely by the trucks and buses. In addition, they should bear their fair share of the basic costs of highway construction. The whole allocation problem is further complicated by the fact that there are a number of different types of commercial users with different economic characteristics. Finally, if it were possible to work out a scientific allocation formula, it would still be necessary to find the type of tax which would carry out the formula.

[12] Groves, *Financing Government* (3rd ed.), pp. 311-312.

[13] *The Motor Truck Redbook.* New York: Traffic Publishing Company, New York: 1940, p. 5.

Types of carriers. Several basic types of commercial users exist, and each presents different types of allocation and tax administrative problems: (1) privately owned vehicles operated by individuals or companies in connection with their own businesses—these include 85 per cent of all trucks; (2) contract carriers—non-scheduled trucks and buses which operate only when hired; (3) common carriers—scheduled trucks and buses which carry goods or persons for hire and which operate over a fixed route, and between fixed termini.

1. *Private and contract carriers.* In the case of the great bulk of light, private delivery, and supply trucks, the allocation problem is relatively simple; the impact they place upon the highways is not very great. The share of the costs of service for this group can be adequately covered under (1) the gasoline tax, and (2) a license tax based upon gross weight with a special classification for light trucks up to a specified weight.

A real problem arises, however, in relation to the heavy trucks and trailers used by lumber, construction, chain store, industrial companies, and the vehicles of the non-scheduled contract carriers. The ideal policy here (over and above the gasoline tax) would be to take into consideration the volume carried and the distance traveled under a ton-mile tax. But there is a serious problem of administration and accounting for the miles and tonnage. There is practically no way of enforcing accurate results except at extremely high costs. The most feasible compromise here would be a license tax, classified according to the type of vehicle and graduated according to gross weight. The rates must be quite substantial.

2. *Common carriers.* In the case of the common carriers operating on regular schedules and routes, the opportunity for using the ton-mile approach seems to be better than for other commercial carriers. They are regulated as public utilities and make many reports in that capacity. They can be checked more easily than any other group. However, when common carriers are under the ton-mile tax, there is some discrimination against small businesses which cannot afford their own trucks.

These problems have not been easy to reconcile. Generally, the states now apply three different taxes to the various commercial users of the highways: (1) the gasoline taxes at the given per gallon rate for all highway users; (2) "license taxes" classified according to the type of commercial vehicle and graduated according to gross weight, with top rates running as high as $400 to $500 per vehicle per year and as high as $1,000 in a few cases; (3) "special taxes" of the gross receipts, ton-mile, passenger-mile or straight mileage type, or special fees based on weight.

It is under the latter group that effort is made to measure the actual use of the highways. In the "special tax" group California uses a 3 per cent gross receipts tax with a credit of 33⅓ per cent of the license fees allowed. Michigan uses a straight mileage tax—one to two mills per mile, depending

upon the weight of the vehicle. Colorado uses two mills per ton-mile and Washington uses weight fees based on maximum gross weight.

It is by the gasoline, license, and special taxes that the states attempt to make the "commercial users" pay their allocation of highway costs.

Miscellaneous Motor Vehicle Taxes

IN ADDITION to the gasoline tax, the license tax, and special commercial vehicle taxes, there exists in the several states a whole array of minor taxes that have their impact upon the purchase and use of motor vehicles. Beginning with the car as it comes off the production line, the federal government levies an 8 per cent manufacturer's excise tax from which $332 million was collected in 1949. When the car is sold to the user, it is again subjected to 2 and 3 per cent sales taxes in many states. Drivers' and chauffeurs' license fees are levied in practically all states. They are largely regulatory in purpose and do not produce much net revenue over costs of administration.

The personal property tax is also applied to automobiles either as part of the general property tax (as in Illinois) or as an adjunct of the license tax (as in California). Some states (such as Wisconsin) have seen fit to exempt automobiles from the personal property tax completely. The federal government has a 5 per cent excise tax on parts and accessories, and also comes in for 1½ cents of gasoline tax. In many cities auto use taxes are levied and parking meter fees are collected. In a few places throughout the country public bridge and road toll charges are applied. A close examination would reveal many other levies that affect automobiles from the manufacturer to the junk yard.

The Diversion of Motor Vehicle Tax Funds

DEVELOPMENT OF DIVERSION

When the gasoline tax was enacted in 1919 by the Oregon legislature, the proceeds were to be used for the construction and maintenance of a state highway system. As other state legislatures adopted this form of taxation, it was generally understood that the motorists would receive the benefit in the form of improved highways. The use of gasoline-tax money for purposes other than street or highway construction and maintenance has generally been termed "diversion."

The issue of whether or not motor vehicle tax money should or should not be diverted to other purposes was significant during the 1930's and in some states in our recent postwar era. During the depression the

collection of gasoline and license tax funds held up very well, with the result that there were always several million dollars in the "highway funds." State legislatures often diverted by direct legislative act or "borrowed" from such funds for relief, education, or for general purposes. Some states have diverted as much as 50 per cent or more to other purposes in given years. Even in 1940 about 15 per cent of such funds was directed to other services. In order to prevent such diversion, some states have placed anti-diversion clauses in their constitutions.

ANALYSIS OF THE ARGUMENT

Case for diversion. Some authorities on public finance do not admit that diversion constitutes a problem. Granting the historical background of gasoline tax legislation, they see the tax now as an accepted source of public revenue; and they feel that, if at a given time, relief, education, or mental institutions need more public financial support than new roads-construction, the state should be free to apply available revenues where the need is greatest. After all, they argue, bachelors and childless couples who own real property pay taxes for the support of schools, even though they derive no direct benefit therefrom.

This issue was argued before the Wisconsin legislature in May 1945. At that time Wisconsin had a substantial highway fund that was built up during the War. However, the condition of its mental, penal, and other correctional institutions was very poor. Governor Walter Goodland proposed to spend about $13 million to improve these institutions. The legislature opposed this measure and passed a bill requiring that motor vehicle taxes be used exclusively for highway purposes. The Governor vetoed the bill and delivered a strong veto message that evidenced a broad statesmanship on issues of public finance. He said in part,

> A segregated tax once set up becomes an "untouchable" and continues to hold its favorable position regardless of major difficulties confronting the lawmakers in financing general activities. The tendency of modern government is to eliminate special funds rather than creating new ones.

But the legislature passed the segregation measure over his veto. The highway construction pressure groups were too strong.

Case against diversion. Public campaigns against "diversion" of gas taxes have been common throughout the country. They are often inspired by business groups which stand to gain from more highways. Diversion, they say, implies stealing from motorists. It is maintained that these taxes are levied and paid on the theory that they are to be used for the benefit of the motorist in the construction and maintenance of highways. Automobile owners have a right to expect that the funds will be so used. To do otherwise involves a "breach of contract" with the payers of the gasoline tax.

Even the federal government in the Hayden-Cartwright Act of 1934 expressed opposition to diversion and looked upon it as unfair and unjust. Under the Act a state could lose up to one-third of its federal aid for highways if highway funds were set aside for other purposes.

There were those, however, who pointed out that the "net" diversion has not been great, because during the first quarter of the century, property taxes and special assessments played a major role in street and highway construction. They maintained that in our cities, until quite recently, the allocation of gas tax money was never very generous.

PRINCIPLES AND POLICIES

No single generalization can be made on the subject of diversion. A few guideposts of finance might be helpful, however.

(1) As a general proposition, motor vehicle tax money should be devoted (but not irrevocably) to street and highway purposes—especially during the period when the basic state highway system is being laid down.

(2) Once that highway system has been fairly well laid out and when highway funds are quite substantial, the assignment to highway purposes can become more flexible. Clearly, highways should not be maintained in luxury when other essential services are substandard. There should be sufficient flexibility so that the legislatures at their discretion can devote some of these funds to areas of "greater comparative need."

(3) In the midst of a depression, flexibility rather than rigidity should control the expenditure of these funds.

In the long run the great bulk of gasoline tax funds should be devoted to highway purposes, but they should not be frozen irrevocably so. The over-all fiscal and social needs of the state should enter into the judgment of the legislatures in allocating these resources.

Conclusions on Motor Vehicle Taxation

THE RAPID DEVELOPMENT of the motor vehicle in all its forms and its extensive use in our private and business lives has created such heavy needs for streets, highways, bridges, grade separations, freeways, traffic control and policing, and parking space, that the motor vehicle tax family must be a sturdy member of the tax system.

The gasoline and license taxes must serve as the backbone of this family structure. Under these two taxes is presented an opportunity to apply the benefits-received and cost-of-service principles with the greatest efficacy. The gasoline tax, if not carried too far, can be both a productive and popular tax. The license tax can overcome the weakness of the gasoline tax in relation to weight.

The taxation of the business use of the highways needs further improvement. By and large, the motor vehicle tax field should be reserved to the states. The injunction against diversion should not be too rigid. The exemption of one private passenger car per family from the personal property tax is worth considering. The development of the parking meter fee should go on. Miscellaneous minor automobile taxes should be kept at a minimum.

Part Seven

OTHER FORMS OF TAXATION AND REVENUE RAISING

XXIV. THE TAXATION OF NATURAL RESOURCES

XXV. TAXATION FOR SOCIAL SECURITY

XXVI. POLL TAXES

XXVII. REVENUES FROM NON-TAX SOURCES

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The Taxation of Natural Resources

IN CONCLUSION, *I desire to sound a note of warning against extravagant demands for forest tax relief and extravagant hopes of the benefits to flow therefrom... Now, there is no magic in taxation to make a profitable industry arise where profit is impossible... The utmost we can achieve is the elmination of one serious obstacle to the development of private forestry in America.*

—FRED R. FAIRCHILD.[1]

Overview

IN THE PAST our state tax systems have actually contributed to the accelerated exhaustion of many of our natural resources. The chief offender has been the general property tax. In the field of natural resources, taxation should have in it an element of conservation. Clearly, our tax system should at least not contribute to the accelerated consumption of our natural resources. Taxation can be made to contribute to the conservation of existing natural wealth, and it might even be made to stimulate the growth of certain reproducible resources, especially forests.

Some of the essential questions which must be considered in natural resource taxation are: (1) What are the economic characteristics of each type of natural resource? (2) What relevance do these characteristics have for the purposes of taxation and conservation? (3) How can taxation contribute to the conservation of natural resources? (4) How can taxation best reach "surplus elements" in the exploitation of natural resources? (5) What specific types of taxes are most desirable for each type of natural resource?

In this chapter we apply these questions to the taxation of (1) forests, (2) mines and minerals, and (3) petroleum resources. Some effort is also made to analyze the features of the income tax as they relate to natural resource taxation and conservation. The last section in the chapter

[1] Fred R. Fairchild, *Forest Taxation Inquiry*, Progress Report No. 4, April 15, 1929, pp. 4-5.

surveys special taxation of natural resources in land, reviews the theory of the "single tax," and appraises it as a tax instrument in a modern industrial society.

Economic Characteristics of Natural Resources

ECONOMISTS GENERALLY have tended to narrow the terms *nature* and *natural resources* to "all the materials and forces supplied without the aid of man and *used in the process of production.*" [2] This, although still very broad, specifically limits the margins of thought to economic considerations.

Of particular importance in the field of taxation are those elements of nature which are used extensively in the productive process. Among these are land, forests, minerals, and petroleum. They are significant not only because of their revenue-raising possibilities, but also because of the comparatively recent realization by the public that the abundant natural products at our disposal may be diminished to an irreplaceable level.

TYPES OF NATURAL RESOURCES

Natural resources (from the point of view of destructibility and reproducibility) can be classified into three broad categories: non-destructible and non-reproducible, destructible and non-reproducible, and destructible and reproducible. These categories should be analyzed on the basis of their economic characteristics, and then these characteristics should be appraised for their relevance to conservation and taxation.

Non-destructible, non-reproducible. The most important resources which come under this heading are land and land sites. Land sites are *non-destructible* in the broad sense that, for all practical purposes, the physical quantity of the resources does not diminish materially either by man's effort or "natural" processes over substantial periods of time.

Land is thought of as *non-reproducible* in the sense that neither man's efforts nor natural processes result in practical additions to the total quantity during a given period. No serious issues of conservation arise in relation to land sites and the supply of land because of taxation.

Destructible and non-reproducible. Under this category must be placed the vast wealth of materials such as coal, minerals, oils, and natural gases, which, because of their high degree of economic utility and productivity, are of great importance to our productive society.

Resources that are destructible and non-reproducible are those whose use in production requires a "total consumption" with no possibility of

[2] William H. Kiekhofer, *Economic Principles, Problems and Policies.* New York: D. Appleton-Century Co., 1946, p. 26.

re-creating the original product by man. They also may be considered *non-reproducible* in the sense that thousands of years are necessary for their formation by natural processes. An intelligent conservation program is most essential for the resources falling under the destructible and non-reproducible category. Taxation can make a contribution here—at least it can be so applied as not to encourage the accelerated extraction of our natural resources.

Destructible and reproducible. Destructible and reproducible resources, again, are those whose use in production requires a total consumption; but unlike the non-reproducible category, this type of resource is amenable to re-creative efforts. Here such elements as forests and soil fertility are of great importance.

Although both forests and soil fertility are reproducible, the processes of conservation and reclamation involve long periods of time and considerable financial outlays before profitable results can be expected. It is at this juncture that taxation can again make its contributions: first, in the conservation of existing resources by not forcing premature extraction, and second, by encouraging the replenishment of forests and soil fertility through tax inducements.

Taxation of Forest Resources

ECONOMIC SIGNIFICANCE OF FOREST RESOURCES

The economic importance of forest resources may be considered from a number of viewpoints. First, lumber and other forest products remain among the most important materials used in modern industry, despite the development of substitutes. Second, the lumber and forest product industries are the very staff of life for many communities in certain parts of the country. Third, the land-usage of forests often presents the most effective utilization for property that would be submarginal for other purposes. They thus offer a good deal of hope for submarginal agricultural communities that have no other means of support. They can also supply the setting for beautiful scenery, resorts and summer cottages, and recreational enjoyments. The economic significance of forests can also be seen from the conservation viewpoint. Here they are a major factor in preventing floods and soil erosion and in the protection of flora and fauna.

WANTON DESTRUCTION OF FOREST RESOURCES

Probably the most disheartening aspect of timber productivity in the United States has been the wanton ravaging of our original virgin forests. Substantially more timber is being depleted annually than it is possible to replace.

It is to be expected that with the tremendous growth of productive capacity in the United States, there would also be a concomitant decline of forest reserves; but what is appalling to conservation experts is the totally uncalled-for loss through wastage of one billion and a half cubic feet a year, chiefly through such practices as careless lumbering, wasteful methods of manufacture, and preventable forest fires.

SOCIAL AND ECONOMIC EFFECTS OF DEFORESTATION

The social and economic effects of deforestation have been tragic. In the stead of booming lumbering communities we find "sawdust towns" strewn throughout the United States—vivid testimony to the wanton exploitation of our virgin timber. We find, further, acres of "cut-over lands," now denuded of forest resources because of extensive "saw-farming." Much of this land is below the margin for agricultural uses and, therefore, does not lend itself well to other productive pursuits.

The greatest problem from the public finance viewpoint, however, is tax delinquency. This arises because more frequently than not, forest lands are assessed at a value based upon what they once produced, with only secondary consideration given to current market values. The high assessment spurs attempts upon the lumber companies to "cut from under the tax and get out," harvesting crops of timber in order to get the maximum short-run gain out of the land before abandoning it. With its productivity thus destroyed, the land is in no position to pay taxes. The above behavior was most common in northern Wisconsin, Michigan, and Minnesota forty to sixty years ago. However, the author was surprised to find that this still occurs on the West Coast.

But this is only the beginning of the problems, for the increase in the amount of tax delinquent land falls heavily upon local communities, counties, and states. Local revenue declines, while counties and states have tax delinquent property on their hands which they literally are unable to give away. Thus, a "new public domain" arises, but its economic value as far as productivity is concerned is nil; the new land is just so much dead weight upon the taxpayer, for it must be policed, it must be protected against fires, and conservation measures must be initiated if the land is ever to be made marketable for the public. It is at this juncture that taxation and positive conservation methods can make a contribution to the solution of these problems.

THE GENERAL PROPERTY TAX AND GROWING FORESTS

Property tax most common in past. Forest bearing lands have not always been taxed as forest land *per se*. Thus, there was no distinction made between forest lands and other property in general, and, as could be expected, the general property tax was applied indiscriminately to all types of land values. Although some innovations have been made in the

taxation of forest lands, the general property tax has remained, until quite recently, the chief method of forest taxation.

Disadvantages of property tax on forests. Probably the most vocal of all criticisms of the general property tax on forests is that it in no way conforms to an owner's ability to pay or to the time of harvesting the forests. This, of course, is because the tax is levied annually, whereas the income from forest property necessarily is deferred for many years on heavy timber and for shorter periods on pulpwood.

A second criticism of the general property tax is that it is based upon the estimated value of "future returns," which may in no way correspond to the actual value at which the timber is ultimately marketed.

A third criticism is that it encourages rapid and, therefore, wasteful cutting. Owners of forests, in order to escape additional taxes, tend to cut their timber before it reaches maximum growth; thus they deprive society of the full value of an important natural resource.

Last, the property tax is criticized on the ground that it does not make any provision for the peculiar risks of forestry. The hazards of fire are great to wooded areas, and the risk involved is practically all assumed by forest owners as far as the property tax is concerned. The federal income tax, however, recognizes capital losses in the above situation.

SIGNIFICANT FOREST TAX LEGISLATION

As the various states have seen their forest resources disappear, some of them have passed constructive forest tax legislation in an effort to conserve their remaining resources and to spur the rebuilding of their forest wealth. In framing their laws they have given consideration to: (1) making the tax burdens conform to the "time" of the receipt of income from the forests; (2) granting exemptions to immature timber; (3) giving tax incentives to encourage capital investment in forest property; and (4) making provision for some revenue to the local governments during the forest crop period. Oregon, Wisconsin, and Alabama have made notable efforts in the right direction. Other states have approached the problem less comprehensively.

The Oregon forest crop law. One of the earlier comprehensive forest crop and "yield tax" laws was that adopted in Oregon in 1929. It was of the "non-optional" type because in addition to defining the qualifications which make forest lands eligible under the law, it requires that the State Board of Forestry rather than the private owners of the forests shall classify lands for forest crop and tax purposes. Once the Board has classified and designated certain lands as forest crop lands, the private owners do not have the option of withdrawing their property from the operation of the law.

Those lands designated as forest crop lands are then exempt from the general property tax. To be eligible the lands must be without mature

timber in merchantable quantity and must be suitable for forestry. During the forest crop period, a very nominal tax of 5 cents per acre must be paid by the private owners to the local units of government. At the time the timber is cut, however, a 12½ per cent "yield" or "severance" tax is paid based upon the fair market value of the timber; thus the tax is geared to the time when the owner receives income from his forest lands.

The law was originally well supported by the forestry interests, and in the first few years after its enactment, there was a fairly rapid rate of classification. However, since 1933 the net gain in classified private forest area has been only about 100,000 acres, a gain which is insignificant in view of the very much larger increase in eligible area over the same period through removal of merchantable timber.[3]

This result may have been caused partly by the opposition which arose to the law. Where the property tax was so low that classification under the yield tax would result in increased taxes, the owners naturally opposed classification. On the other hand, if classification gave the owners a substantial reduction, county officials and other taxpayers opposed classification because it reduced local government revenues. Apparently the administrative authorities have deemed it wise to avoid forcing classification under the law where it was not wanted.

The Wisconsin forest crop law. The Wisconsin law was adopted in 1927. It also attempts to meet the requisites of a good forest crop law. It is of the "voluntary type" in that private forest landowners exercise the option of coming under the law or not as they see fit. If the owner decides to take his land under the law, the property is then exempt from the general property tax. In lieu thereof the private owners pay a low, flat rate of 10 cents per acre to the local units of government. The state government makes a like payment so that the local units of government may receive some revenue during the crop-growing period.[4]

Under the Wisconsin law, county units of government may also bring land under the law for forest crop purposes. Again the state makes a payment of 10 cents per acre to each county for such purposes. At the time the timber is cut, a "yield" or "severance" tax of 10 per cent is paid by the private owners and 50 per cent is paid by the county governments having land under the law. The tax is paid to the state.

The Wisconsin law is set up to promote commercial forestry by private owners and county governments. It specifies that land may be listed only in lots of at least forty acres and that it must be suitable for forestry. The Conservation Commission is empowered to examine the land within five years after entry and to reject all land not suited to forestry or which is

[3] R. Clifford Hall, "Appraisal of Special Forest Tax Legislation in Practice," *Proceedings*, National Tax Association, Vol. 34, 1941, p. 632.

[4] *Wisconsin Statutes, 1948*, Sec. 77.01-77.14.

not operated as forest crop land. Up to 1941, the Conservation Commission had canceled 112,000 acres of land entered by private operators.[5]

That the features of the law are conducive somewhat to private forest farming is demonstrated by the fact that over 152,000 acres were registered by 1942. This exceeds the amount registered under similar laws in other states. Most of it was registered by paper mill operators who are interested in small timber which can be grown in shorter periods. On the whole, however, the results have not been gratifying in regard to private owners, for compared to the 152,000 acres registered by them, over 1,884,000 acres of the listed land is owned by the counties.[6] Thus, the law is primarily applied to county-owned land, so that a substantial "public" forest crop program is developing in Wisconsin.

Though the Wisconsin forest crop law has not been a conspicuous success from the point of view of private participation, yet the combined program (private and county-owned) is contributing values which will be appreciated more as time goes on. Among these values are: (1) There is substantially more rural planning and better land-use than formerly. (2) A good deal of interest has been generated in forest-crop growing both at the private and county level. (3) Better care of the forests has resulted, with prospects for a reconstructed resource a generation or so hence. (4) Local units have been able to get sufficient revenues without the use of the general property tax. (5) In the long run the program will probably be both financially as well as socially self-liquidating for the state economy and the local communities.

MISCELLANEOUS FOREST TAXES IN OTHER STATES

Many states continue to tax their forests and forest resources under the general property tax. Some state constitutions permit classification for forest purposes and thus can give them separate treatment from other general property. But about half the states have special provisions in their tax codes in applying the property taxes to forests. Most of them make some kind of concession to growing forests and then time the tax to the cutting of the timber. Alabama levies an 8 per cent severance tax, Idaho 12½ per cent, and Louisiana 6 per cent and so on.

Some states, however, graduate the rate depending upon the number of years the forest land has been forest-classified for tax purposes. In Washington the rate is 1 per cent for each year that the land has been classified as forest land, and the severance tax rate becomes 12½ per cent after 12 years. Connecticut, Massachusetts, Michigan, Minnesota, and several other states use the graduated severance tax approach.[7] Most of

[5] George S. Wehrwein, "Appraisal of Special Forest Crop Taxation in Wisconsin," *Proceedings*, National Tax Association, Vol. 34, 1941, p. 631.

[6] Groves, *Financing Government*, (rev. ed.), p. 367.

[7] *Tax Systems*, (11th. ed.), 1948, pp. 156-157.

these states also levy a low acreage rate of 5 or 6 cents during the growing period.

Some states merely exempt forest lands meeting certain qualifications from the property tax for a stated period without any "yield or severance" tax feature. California is a good example of this approach. It exempts all immature forest trees which have been planted on lands not previously bearing merchantable timber, or planted or natural growth timber, upon lands from which 70 per cent of all trees sixteen inches in diameter have been removed. The exemption is good for forty years.[8]

It is to be noted, however, that most states continue to tax any original or virgin timber under the regular property tax; this encourages the practice of cutting from under the tax.

CONCLUSION ON FORESTRY TAXATION

The experience with rather well-conceived laws in Oregon and Wisconsin demonstrates quite clearly that not too much can be expected in the way of private forest farming as the result of favorable tax laws. This is so because the investment period is too long, the opportunity for profit is too remote, and the long-run risks involved are too great for any extensive participation by private enterprise in forest cultivation programs.

It leads logically to the conclusion that *governments* (local, state, and federal) must take the initiative in building forest crops if our economy is to have sufficient timber resources in the future.[9] Favorable forest tax laws can be helpful in conserving "existing timber" and in preventing "cutting from under the tax." They can perhaps aid in stimulating private owners in cultivating such short-run forest crops as Christmas trees, paper and pulp saplings, and local wood supplies. But not too much beyond that can be expected from private owners.

The Taxation of Mines and Minerals

PRINCIPLES OF MINE AND MINERAL TAXATION

Most of our mineral resources are destructible but non-reproducible. This means that tax and other economic policy should be directed to their conservation and should not contribute to their accelerated consumption. Taxation should not discourage risk-taking and investment, for there are few businesses as profoundly influenced by the amount of

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[8] *California Constitution*, Art. 13, Sec. 12¾.

[9] See Ralph W. Marquis, "Severance Taxes on Forest Products and their Relation to Forestry," *Land Economics*, Vol. 25, August 1949, pp. 315-319.

venture capital available as mining. The risks are great: "... surface bonanzas ... passed out with the buffalo herds." [10]

Therefore, in the taxation of mines and minerals the policy must be to avoid taxing "costs"—the activities of man and his use of labor, capital, and management in extracting the natural resources. Taxation should attempt to get at those elements which are essentially "surplus," or the bounty of nature. Such an approach would interfere least with the flow of venture capital into the mining industry.

TYPES AND FORMS OF MINE TAXATION

General property tax. The most common form of state and local taxation of mines in the past has been under the general property tax. It is essentially an *ad valorem* tax which attempts to place a value upon mineral property along with all other property in the community regardless of economic characteristics.

But the general property tax has deficiencies when applied to mines, just as it has when applied to forests. This is true both from the point of view of conservation and from the point of view of mine investment. Some of the more common objections raised to it are: (1) The accurate valuation of mineral property is too costly. (2) Some mines are almost impossible to appraise even reasonably well. Several states have placed mine assessment in the state tax commission in order to get more expert valuation. Shaft mines are very difficult to assess, whereas open-pit mines are relatively easy to appraise. (3) Developing and unprofitable mines are taxed even though they have no net income. (4) Conservation purposes may be defeated by rapid mining of the best ores and leaving the marginal ones in order to shorten the period of yearly tax payments. (5) By taxing the marginal mines, the development of such mines may be restrained. And (6) some local governments use the property tax to exploit nearby mines. It is well recognized by many state legislatures, however, that the general property tax does not contribute to the wise use of resources, nor is it a very scientific approach to mine taxation because it is not geared to get at surplus.

Tonnage severance taxes. Many states have attempted to adjust their mine and mineral taxes in such a way as to "take toll" at the time the mineral is extracted from the earth and about to be sold. There are, of course, several types of these "severance" taxes. One type is the tonnage tax—a tax of "so much" a ton is levied on the ore that is extracted. Sometimes no distinction is made concerning the quality of the ore (in which case the tax is regressive in relation to the poorer grades). Another disadvantage of the flat rate tonnage tax is that it

[10] Constantino Perez Duarte, "Mexican Mining Must Have Tax Relief," *Engineering and Mining Journal*, Vol. 146, December 1945, pp. 96-99.

is the same whether the ore is selling at a high price in prosperity or at a low price in depression. That means that the tax is much harder to bear in depression periods.

Montana takes some of the regressivity out of its tonnage tax on coal by exempting the first 50,000 tons for any one firm. North Dakota follows the same method. Alabama, Arkansas, Colorado, Louisiana, and Montana are the states which use tonnage taxes of varying rates for certain types of minerals.

Gross production taxes. A gross production tax is based upon the gross value of the product extracted. It is simple to administer and comes closest to the general property tax of any of the severance taxes. This tax ignores many factors in mine operation. It disregards costs—the very thing that should be considered in good mine taxation. Montana, New Mexico, Utah, and Wyoming use this approach for certain types of minerals.

Net product taxes. Net product taxes take into consideration the costs of extracting the ore, and the mining firm pays the tax on the net product. Minnesota uses the net value approach as one of the methods of taxing iron ore. As previously noted, Minnesota also taxes iron ore lands under the general property tax (with assessment by the state commission, however).

Various other state taxes affecting mines. Some states in order to avoid the task of mine valuation have merely taken the net income from the mine, doubled or tripled it, and used it as a property tax base. Some states use other forms of taxes to get at the surplus of mining activity. Occupation taxes make up one group. Among these are special license taxes, royalty taxes, and lease taxes. Then, too, mining companies as business entities are subject to state net income taxes.

CONCLUSIONS ON MINE TAXATION

Clearly, state and local governments should give consideration to the basic principles of mine taxation—that is, they should avoid taxing costs and attempt to get at surplus. As a general principle, the property tax should not be applied to mineral lands in an unclassified manner. If it is, then expert assessment by a central agency should contribute to the better administration of the tax.

Generally the use of some type of *severance tax* applied at the "time" and in relation to the "net value" severed would seem to come closest to the ideal theory of mine taxation. Under such a tax, costs would be considered, timing would be geared to the ability to pay, and surplus elements would be taxed. Incentives to risk and invest in the mining industry would be preserved. Both revenue and natural resources would flow into the economy in the desired amounts.

Taxation of Oil and Gas Wealth

PRINCIPLES OF OIL AND GAS TAXATION

Our gas and oil resources are clearly destructible and non-reproducible. Taxation, therefore, should contribute to the conservation of existing resources. Again the controlling principles should be those of avoiding the taxation of costs and a scientific effort to get at surplus.

The *ad valorem* approach of the general property tax does not conform to those principles. Furthermore, the difficulty of getting an accurate appraisal of the value of oil lands and resources is even greater than in the case of most minerals. These properties are unpredictable in relation to output and in many instances quite short-lived. Again the tax laws should avoid interfering with the flow of venture capital to the discovery and development of new wells. Proper allowance for exploration, drilling, and dry-well costs would make it possible to appraise the surplus elements and to tax them without repressive effects.

TYPES OF GAS AND OIL WEALTH TAXES

General property tax. Most of the direct taxation of gas and oil wells has been by state and local governments; this has meant that the early emphasis was upon the general property tax, with its attempt to appraise the value of gas and oil lands along with all other forms of property, without any consideration for economic characteristics. Some states, however, still use this approach, sometimes in combination with other taxes. California allows the local units to tax gas and oil lands on an *ad valorem* basis, and the assessment is performed by the county assessor with some technical assistance from state agencies. Texas also allows the local units to so tax. The objections to the general property tax as applied to gas and oil property are similar to those raised when the tax is applied to solid minerals generally.

Barrel severance taxes. A number of states use a given flat rate per barrel of oil extracted. This has the advantage of being easy to administer, and if the tax rate is low, this tax probably does no harm even when the price of oil drops to low levels. Texas levies a tax of 4⅛ cents per barrel, or 4⅛ per cent of the market value if the value exceeds $1 per barrel. In that way the state benefits when the price of oil goes up. In 1946 Texas collected about $40 million from this source, plus about $3½ million from natural gas. Arkansas imposes the low rate of 5 mills per barrel, but it charges a $50 permit fee for every well drilled and $15 for each abandoned well and dry hole. A number of other states levy very low rates per barrel, sometimes only a small fraction of a cent. This is true in those states where the oil resources are marginal in character.

Percentage production taxes. Oklahoma levies a 5 per cent tax on the gross value of the gas and oil extracted, but gas and oil lands are not taxed under the general property tax. Florida follows the same general approach with a 12½ per cent tax on the gross value of the production and "escaped" oil. For conservation purposes the state charges a fee of $50 per well drilled and $15 per dry hole abandoned. Indiana, Kentucky, Michigan, and New Mexico levy low percentage taxes—in all cases 2 per cent or less.

MINES AND OIL WELLS UNDER THE INCOME TAX

Percentage depletion. The mining and oil companies are, of course, subject to federal and in some instances state income tax laws. These industries are "wasting asset" industries—that is, they sell the very "core of capital" that makes them valuable, so that at the end of the extraction period there is nothing left but a hole in the ground. Therefore under the federal and state income tax laws they are allowed a deduction for depletion. However, the depletion is not granted on the basis of the cost of the mine or the oil well (which is the generally recognized method for granting both depreciation and depletion). Instead, however, and in recognition of the difficulty of correctly estimating the value of the natural resources to be depleted, the federal income tax laws permit the deduction of depletion as a percentage of the annual gross income from the oil and minerals.

Thus, the depletion allowed per year is 27½ per cent for gas and oil lands, 15 per cent for metal mines, 5 per cent for coal, 15 per cent for non-metallic minerals, and 23 per cent for sulphur. In any one year the depletion allowance may not exceed 50 per cent of the net income before depletion. The right to take these deductions goes on as long as any resources are extracted and without regard to the cost of the resources themselves.

Criticism of percentage depletion. The percentage depletion allowance has been criticized on the ground that the "rate" of depletion is overgenerous and that it is unsound in principle to take it as a "percentage" of *annual gross proceeds* year after year. Under this arrangement it is possible to take depletion beyond 100 per cent of the cost—an action not permitted other industries in relation to depreciation. The whole concept smacks of a special privilege extended to mineral and oil industries. It definitely makes it possible for them to earn higher rates and volumes of profit than comparable investment in other fields.

Conclusion on percentage depletion. There is little doubt but that the "wasting asset" industries should have the right to a depletion allowance in order to keep their capital intact.

The basic theory of both depreciation and depletion is simply that the enterpriser shall recover the impairment of his capital investment. In

general business, as well as in the regulated public utilities, that investment is calculated on the basis of cost. When the investor has recovered his cost, he is made whole; that is all that is required by the principle.

Therefore, the oil and mining companies should be required to calculate depletion based upon the cost of their oil and mineral lands. If, however, our natural resources become so heavily depleted that the opportunity for further discovery and extraction becomes quite small, then special consideration may be given under depletion and by other techniques to draw forth the necessary enterprise and risk capital.

Special Taxation of Land —the Single Tax

THE SOCIAL SIGNIFICANCE OF LAND

Broadly interpreted, land consists of all natural resources, including water, soil, wildlife, minerals, and sunshine. In a restricted sense, land means, however, that portion of the earth's surface which can either be inhabited or cultivated. It is in this latter sense that the word is used here.

Land is the original and basic natural resource of every economic system. It serves as the source and the cradle of most productive economic activity. Sir William Petty, writing in the seventeenth century about material wealth, maintained that "labor was its father and the earth its mother." In a modern industrial society land has lost none of its economic significance.

In a young economy such as the early United States, much land and its appurtenant resources were acquired practically by direct appropriation. Because much of what land gives off is "nature-granted," there are those who contend that land is a "fit subject" for taxation. Part of the analysis which claims land as especially fit for taxation arises from distinguishing that factor in production which is created by the efforts of man—capital—and that which is nature-granted—land. One of the major schools of thought which capitalizes on this distinction is that which advocates a "single tax" on land.

ECONOMIC DIFFERENCES BETWEEN LAND AND CAPITAL

In practical business affairs no serious distinction is drawn between land and capital. In our day and age both must be acquired in exchange. However, the advocates of special taxation of land claim that there are several basic economic differences between the two and that these differences are relevant for the purposes of taxation. Among the asserted differences are: (1) Land is provided by nature, whereas capital must be produced by man. A tax on land could not diminish the supply of land, but a tax on capital could restrain the production of capital and

improvements. (2) Land cannot be reproduced; capital can. The supply of land is relatively fixed. This is especially true of fertile land for cultivation and land well located for commercial and industrial activities. The value of improvements cannot advance above the cost of reproduction, but the value of land can advance indefinitely in the long run. The value of land which has risen above its acquisition cost provides a fit margin of surplus for taxation. (3) Land cannot migrate to a low tax area, but capital can. Therefore, land can stand a heavier burden of taxation without adverse economic consequences. A heavy tax on capital may cause a "flight of capital." (4) Taxation affects the value of land and capital differently. Taxes on land are not shifted forward; future anticipated taxes are capitalized and result in a decrease in the value of land. Thus taxes on land make it cheaper, whereas taxes on capital and consumer's goods make them more expensive.

EARLIER SINGLE TAX IDEAS: PHYSIOCRATS

The theory of the Physiocrats maintained that only land was the source of new wealth and "surplus" income. The Physiocrats, therefore, recommended an "impot unique" or a single tax upon the net product or the economic rent of land. Though this theory of taxation was advocated in France just before the French Revolution, it never gained sufficient political support to be enacted into legislation.

HENRY GEORGE'S SINGLE TAX

The modern single tax theory is associated with the name of Henry George and his famous work, *Progress and Poverty*, published in 1879. The book arose out of George's experiences in San Francisco—a booming, mushrooming town characterized by exorbitant increases in land values, the development of a wealthy, land-owning class, and the speculative withdrawal of much of the land from productive activity. Amidst all this George saw poverty and degradation of the laboring classes.

George believed he had discovered "the great cause of the inequality in the distribution of wealth in inequality in the ownership of land." He contended that the rent from land did not represent the reward for human exertion; rent was the price of monopoly of land and was determined by the excess of its produce over that which the same application could secure from the least productive land in use. Consequently, rent tended to increase as production increased and thus served to keep down wages and interest.

What to do about it? George was of the opinion that neither nationalization nor confiscation of land was advisable. Under his theory the legal title and possession to the land was to remain in the hands of private owners. Yet the full annual value of the land—that is, the *economic rent* of land—would be appropriated by taxation. Such a tax,

unshiftable, certain, and equitable, was according to his reasoning not only the most just of all taxes, but it also was the only one bound to stimulate industry, to open up new opportunities for capital and labor, and to increase the production of wealth.

THE SINGLE TAX ON THE ECONOMIC RENT OF LAND

The tax base under single tax theory is the *economic rent* of land. It is that part of the total product arising from the combined use of land, labor, and capital which is "specifically attributable" to the services of the bare land itself. It is the surplus element which land contributes to the total.

The single tax would not attempt to tax the "shares" of the other factors. Under the theory, labor would have the right to its wages, capital to its interest, and the entrepreneur to his profits. The income from improvements on land (such as fences, buildings, and the like) would be untouched.

To this economic rent tax base would be applied a 100 per cent rate each year, according to the more orthodox single tax concept; the full economic rent would be taken by taxation. When the theory was originally conceived, it was thought that the tax alone would be sufficient to meet all the costs of government—that is, it would be a "single" tax.

The case for the single tax. The single tax advocates present both a strong and consistent case for their theory and policy. They claim that the single tax would do away with many of the defects in both our present tax and economic systems: (1) It would exempt industry and improvements from tax burdens. (2) It would give us a just tax—one that cannot be evaded or shifted, and one that would not be a burden upon human resources and effort. (3) It would be simple because there would be but one object to be taxed; it would be adequate because the contribution of land and natural resources presents a huge annual fund from which to draw; it would be elastic because as the productivity and the economic rent of land increased, it would automatically become part of the tax base. (4) The condition of the laboring classes would be improved. (5) Land would be comparatively easy to acquire, and speculators would not be able to withhold it from use for higher prices. And (6) the farmer would be benefited because the products of his labor and capital would be exempt from taxation, and he would be able to acquire more land at reasonable market prices. All in all, it would minimize human poverty and stimulate social and economic progress.

Appraisal of the single tax—sound criticisms. The single tax as applied to a highly industrialized credit economy can be challenged on a number of valid grounds. Some of these are:[11]

[11] See Groves, *Financing Government*, pp. 379-380, for an analysis of the criticisms of the single tax.

(1) In our day and age the single tax would be inadequate as a revenue raiser. The gross product from all agricultural, mineral, and other extractive industries is probably somewhere in the vicinity of $80 billion per year; this includes the contributions of labor, capital, and entrepreneurship. Total taxes (local, state, and federal) now amount to about $80 billion per year. The remaining portion of the gross product (about $220 billion) comes from all other sources.

(2) It is unequal and too single. In our day and age other factors besides land receive surplus gains. There are times and circumstances when labor, capital, and risk-takers get returns well above what would draw forth their services.

(3) The great bulk of the land and natural resources held by individuals today was not acquired by appropriation or for a dollar and a quarter an acre. Most land must be bought at its full fair market value. Those who wish to acquire it must work, save, and accumulate, the same as must be done to acquire other types of assets.

(4) The single tax ignores ability-to-pay. In our day land does not constitute the predominant source of wealth and income. Income is acquired in many ways other than from the ownership of land. Other forms of property (such as buildings, stocks, bonds, and other intangibles) are big income-producers in a modern economy. Forcing less than 25 per cent of the national income to bear all of the tax burden is too arbitrary and would in effect discriminate against a particular form of wealth while all other forms were exempt.

Conclusions on the single tax. The single tax might have a good deal of validity in what is essentially an agricultural and extractive economy. Here in its early stages, at least, a good deal of the land may have been acquired by appropriation or at very low cost. Furthermore, in such an economy land would be the predominant form of wealth and source of income. But to endeavor to apply the single tax to a highly industrialized economy with its many forms of wealth, its innumerable ways of earning income, and its surplus elements flowing to all the factors of production is both unrealistic and impractical.

OTHER ADJUSTED TAXES ON LAND RESOURCES

The basic principle of the single tax theory is the appropriation of unearned income from land by taxation. Some countries, while not using the form of single tax, have applied the same fundamental principle in other connections and have levied other special taxes on land. One of the best known is the "land value increment tax" in Great Britain. It was adopted under the leadership of the Liberal Prime Minister, Lloyd George, in 1909. This concept, however, was advocated by John Stuart Mill in England in the 1870's. The theory of the tax was that *unearned increases* in the value of the land between the time of acquisition and

the time of sale should be subject to taxation. The British, however, did not attempt to appropriate the entire increase. While the law was in operation, a 20 per cent rate was applied to the increment above a reasonable exemption. Several years later the law was repealed because it was inadequate in yield and difficult to administer.

In the United States at present under the income tax, we tax increases in the value of all types of capital assets (including land) when they are sold or exchanged. All such increments are defined as income and are taxed under special schedules as capital gains, but at rates lower than for ordinary income.

In several parts of the world, adjustments or modifications of single tax theory have been applied to the taxation of land from time to time. Pittsburgh recognizes the advisability of taxing improvements more lightly than land sites. A number of cities in Western Canada have given special attention to the taxation of land values as a major source of revenues. A graduated land tax has been resorted to in New Zealand and Australia to break up large estates.

The City of Canberra, the capital of the Commonwealth of Australia, has perhaps come closest to the full application of the single tax theory. This city has had the advantage of "planning" things that way from the beginning. The city was built on bare land that cost the government very little. The city retains title to all land within its borders. All land is leased at about 5 per cent of its fair market value. Land is re-appraised periodically, and leases for various terms are granted again. In this way the city retains the right to the economic rent of the land site, whereas the private owners of the improvements earn their income from the use of labor, capital, and management upon the leased site.

A very common form of special taxation of land, of course, is the special assessment. It is based on the theory that certain services of government are essentially land services which benefit the use of the land and enhance its value. Special assessments will be treated briefly under the heading of nontax revenues.

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Taxation for Social Security

THE SOCIAL SECURITY ACT OF 1935 *introduced a new class of compulsory contributions commonly called social security payroll taxes.... They are usually regarded as special benefit taxes, since the revenue is used to finance social insurance.*

—DENZEL C. CLINE.[1]

Overview

A TYPE OF TAX which has come into public finance only recently is that group known as "social security taxes." These levies combine the characteristics of taxes with the purposes of social insurance. They are correlated reasonably well with the specific benefits that are ultimately paid to the beneficiaries.

The government is not so much a political agency as it is a trustee, collecting and administering a fund for specific social purposes. It is true that the payments are legally specified as taxes (an excise tax upon employers and an income tax on employees), and the taxing power is exercised to collect them; but this approach was resorted to in order to meet the technical requirements of the Federal Constitution.

The field of social security is very broad in its social and economic implications. Since this is a book on taxation, the scope of this chapter is limited largely to the financial aspects of social security: the collection of the contributions, the administration of the funds, and the place of social security in fiscal policy.

More specifically, the reader can here observe and analyze (1) the general theory of social security finance, (2) the methods of social security finance, (3) the revenue importance of social security taxes, (4) the shifting and incidence of these taxes, (5) the economics of social security reserves, and (6) the place of social security taxes and benefits in fiscal policy.

[1] Denzel C. Cline, "Pay-Roll Taxes and Social Security," *The Annals*, The American Academy of Political and Social Science, Vol. 266, November 1949, pp. 128-135.

The General Theory of Social Security Finance

RISKS AND LOSSES SOCIAL IN THEIR CAUSES

The concept that certain risks and costs in a modern industrial society are "social" in character was slow in achieving general acceptance. For a long time much of our thinking on poverty was strongly individualistic. Usually it was believed that people were poor largely because of their own conduct or misconduct. There can be little doubt that in some cases, hardship and distress in life are due to unwise spending, intemperate living, and inadequate saving by many who for long periods have the ability to do better. But for the great majority, a good proportion of the hardship from industrial accidents, unemployment, sickness, and old age is not necessarily due to any personal causes. Much of the hardship and distress, it is now realized, is due to the manner in which a modern industrial system functions. The hardship and distress may be "social" in their causes.

SOCIAL POLICY ON SOCIAL SECURITY

We have developed modern social security laws because we have come to recognize (1) that certain risks and losses are *social* in causation —not purely individual; (2) that these risks and losses are losses both to the individual and to society as a whole; (3) that society under the leadership of government must make provision for these contingencies; and (4) that by a combination of the insurance principle and taxation society can "save up" to meet some of its social and economic problems.

Methods of Social Security Finance

THE PROBLEM OF EFFECTIVE FINANCING

The problem of financing the risks and losses associated with old age, dependency, and unemployment for millions of people under a unified plan is not a simple one. We speak of this whole concept as social insurance. Underlying our social security laws is the theory that part of the risk should be borne by employers, part by employees, and perhaps part by the people as a whole (to the extent that contributions fall short and assistance must be had from the general revenues).

In strict principle, however, insurance is based upon the calculation of the average probability of the occurrence of the events insured against. This can be determined by the analysis of large numbers of independent cases of the same class. Once the probabilities have been determined, premiums can be calculated which (when accumulated with interest

over time) will result in building sufficient reserves to meet the cost of the loss incurred. This is the basic principle which underlies most forms of private insurance contracts.

To a limited extent this is the type of theory which lies back of our state and national efforts at social insurance. When it comes to applying the principle to social insurance, many special problems emerge. In relation to old age retirement and survivors' insurance, several "variables" and "unknowns" arise: [2] (1) the amount of wages the covered employee is likely to earn from the time of coverage to retirement or death, (2) his age at cessation of employment or death, the marital condition and number of dependents, and (3) his life expectancy and that of his wife after retirement.

Another basic problem is that of determining the amount of benefits to be paid when the contingency arises. To calculate contributions sufficient to build the reserves to pay the benefits becomes very difficult in the light of a large number of unknowns and variables. It must be admitted that perhaps it cannot be done with anything like actuarial precision. Nevertheless, some effort has been made to "approach" the insurance principle. Tax contributions have been calculated for both employers and employees. The concept of the reserve has been utilized. It is recognized that payroll taxes paid thus far fall short of being able to meet the "accrued" liabilities, although accumulated reserves are more than large enough to meet current liabilities. It is logical, therefore, to turn to a consideration of the *Social Security Act* itself.

METHODS OF FINANCING

Social Security taxes are levied and earmarked for Old Age and Survivors' Insurance and for Unemployment Compensation benefits. Three taxes are levied for these purposes by the federal government, two of them to finance Old Age and Survivors' Insurance and the third to finance Unemployment Compensation. Though both programs are based on insurance purposes, the tax instrument rather than the premium is used to secure the funds necessary to finance benefit payments. In general, both programs are based on the principle that the worker should be entitled to benefits as a matter of right rather than as a matter of relief based on a means test.

TAXES FOR OLD AGE INSURANCE

The Social Security Act of 1935. Both taxes levied to provide money for old age insurance are in effect levied on the payroll of the individual employer, though *one* is in the form of an "income tax" with the impact on the "wage of the individual employee" and the *other* in the form

[2] Shultz and Harriss, *American Public Finance*, p. 430.

of an "excise tax" with the impact on the "individual employer." The original Act of 1935 provided for a 1 per cent rate on both the employee "wage" and the "payroll" of the employer; it was to rise gradually to a top rate of 3 per cent in 1949. Subsequent acts of Congress have maintained the original rate of 1 per cent. An amendment in 1946 provided for a new schedule of rate increases so that there would be a rise to 1½ per cent for 1950 and 1951, an increase to 2 per cent for the year 1952 and thereafter.

The Social Security Act of 1950. The Social Security Act of 1950 continued the 1½ per cent rate for the calendar years 1951 through 1953, 2 per cent for 1954-59, 2½ per cent for 1960-64, 3 per cent for 1965-69 and 3¼ per cent for 1970 and after.[3]

Two types of exemptions were provided in the 1935 Act: (1) Any income earned by an individual above $3,000, was not subject to tax. If an employee worked for more than one employer and was taxed on a wage above $3,000, he was eligible upon application for a refund in the amount of the excess tax. (2) Several types of employment were excluded entirely from the tax and similarly, workers in these exempt industries were not eligible for insurance benefits. Exempt categories included agricultural workers, domestic servants, casual laborers, the self-employed, government employees, certain merchant seamen, employees of nonprofit organizations, and a few minor categories. It is estimated that 79.5 million persons have received wage credits for old age insurance during the period from 1936 through 1946.[4] In 1947 and 1948 another 2.7 million persons were given credits each year.

Both the tax base (amount of wages subject to tax) and the covered employment were modified by the 1950 Act. The new law provides that both the employer's and the employee's old age tax is to be calculated on the first $3,600 (rather than $3,000) paid to the employee during the calendar year beginning January 1, 1951.

The covered employment was expanded materially. Among those now protected are: (1) agricultural laborers, (2) non-farm domestics, (3) employees of nonprofit organizations, if two-thirds of the employees elect to be covered, (4) employees of federal government not covered by another retirement system, and (5) casual laborers. All must be "regularly employed" within the terms of the act. That usually means employed a certain number of days for the calendar quarter in which $50 or more is earned.

It should be noted that for the first time self-employed persons are included under the Old Age and Survivors' Insurance. The tax began

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[3] *The Social Security Act of 1950* (with explanation). New York: Prentice-Hall, Inc., 1950, p. 7.

[4] *Federal Security Agency, Annual Report, 1947.* Washington, D. C.: U. S. Government Printing Office, 1947, p. 30.

on January 1, 1951. The tax rate is 2¼ per cent of the individual's "self-employment net income" derived from his trade or business. The law excludes clergymen, physicians, lawyers, dentists, and other professional persons from the operation of the Act.

The *Social Security Act of 1935* provided insurance benefits ranging from $10 to $56 per month to the individual worker. The $56 was on an average wage of $250 and 40 years of coverage. In 1939 benefit payments were readjusted to include such dependents of the worker as the wife and children living with the recipient, or in event of his death payments were to continue to these dependents. Since there was no increase in the tax rate, the general effect of the 1939 amendment was to insure several family members at the same tax rate previously established to insure one person. At the time of the passage of the Act of 1950 it was possible for the individual cited above (but with one dependent) to receive $84 per month old age retirement pay.

The *Social Security Act of 1950* increased the retirement pay somewhat. Again based upon an average wage of $250 per month and 40 years of coverage, the individual worker may draw $80 per month. One worker with a wife over 65 years of age, or a widow with one child (survivor's benefit) would receive $120 per month.[5] For lower average wages and shorter periods of coverage the benefits are proportionately less.

UNEMPLOYMENT COMPENSATION TAXES

The Social Security Act of 1935. Under the tax provisions inaugurated by the *Social Security Act of 1935 all employers of eight or more persons* in nonexempt employments were subjected to a 1 per cent tax of the wage paid in 1936. According to schedule, this rate rose to 2 per cent in 1937 and reached the top level of 3 per cent in 1938, where it remains today. Exempt industries are practically the same as for Old Age and Survivor's Insurance taxes, and the tax applies only to the first $3,000 earned by an employee during the year. The *Social Security Act of 1950* made no material changes in unemployment compensation taxes or benefits.

Two significant differences exist between the taxes levied for *Unemployment Compensation* and those levied for *Old Age and Survivors' Insurance.* In the first place, the impact of the unemployment tax falls *only on the employer,* so that it might seem that the intent of the Act was to have industry assume full responsibility for unemployment as a "cost of production." In the second place, this tax has a strong nonfiscal objective in that the law is so framed as to encourage uniformity of unemployment compensation laws enacted in the various states.

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[5] *The Social Security Act of 1950* (with explanation). Prentice-Hall, Inc., pp. 34-40.

States permitted to pass unemployment acts. The *Social Security Act* neither restricts nor makes provision for the states to levy a similar tax for unemployment compensation benefits upon the employee. Consequently, a number of states (including Alabama, New Jersey, and California) levy an unemployment tax over and above the federal tax *on the employees.* California's tax rate is set at 1 per cent, but it contains the provision that the rate may not exceed one-half the rate paid by the employer. This provision extends to the employee the benefit of any tax credit that his employer might obtain.[6]

Previous to the enactment of the *Social Security Act,* the individual states had been hesitant about adopting unemployment compensation laws, for the states feared that to tax business might drive industries to other states. With the establishment of a national law, this fear was removed and all of the states immediately enacted compensation insurance laws. The *Social Security Act* permits an individual employer to credit against the federal tax of 3 per cent the amount of tax paid into the state fund as long as the credit does not exceed 90 per cent of the federal levy. Many state laws simply provide for a tax rate of 2.7 per cent, which is sufficient to keep the full revenue permitted to the state in the state account.

Unemployment compensation and merit rating. One other tax provision of the Act deserves consideration because of its regulatory nature and its relation to fiscal policy. States are permitted and encouraged to incorporate "merit ratings" with tax rate deductions as an incentive to employers to maintain good records of continuous employment. The state tax rate for individual industries varies in relation to the employment record within a given industry. If the merit plan of the state has been established in accordance with federal requirements, the federal government accepts the resulting tax rate reductions to individual industries, and in calculating the federal credit the government considers the merit-reduced state taxes as if they had been paid at the standard rate.

How effective "experience" or "merit rating" has been as an incentive to more stable employment is difficult to say. Nevertheless, the controversy on this issue is still active. It is maintained in favor of this practice that there are certain types of unemployment within the control of employers. They should, therefore, be given some inducement to minimize it. Against experience rating it is argued that the heavy cyclical unemployment is beyond the control of individual employers, and granting the tax reductions in good times simply means smaller funds to care for unemployment in depression periods. Furthermore, it is claimed that some interstate competition has crept into merit rating.[7]

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[6] *Deering's California Laws, Unemployment Insurance Act,* Act 8780d, Sec. 44.

[7] For a more thorough analysis, see Charles A. Myers, "Experience Rating in Unemployment," *American Economic Review,* Vol. 35, June 1945, pp. 337-354.

Some uniformity exists in the various state insurance plans. Benefits are based on the length of time employed and the amount of wages earned in covered employment. Duration of benefits is usually dependent on the wages earned or the number of weeks employed during a specified period of time. A waiting period of short duration usually occurs before the first compensation benefit is paid out. The maximum number of weeks of benefit payments in any one year set by law varies from twelve to twenty-six weeks in the various states, the most common being twenty weeks.

The Revenue Significance of Social Security Levies

ANNUAL REVENUES

An accurate picture of the total revenue secured through tax measures enacted to carry out the insurance provisions of the *Social Security Act* can only be obtained by considering the yield from each group of payroll taxes. Revenues received through payroll taxes for these different purposes for the fiscal year 1950 are as follows: [8]

Total Collections	$3,938.1 million
Old Age and Survivors' Insurance Tax	2,106.4 million
Federal Unemployment Tax	226.3
Railroad Retirement Tax	550.2
Railroad Unemployment Tax	9.1
Credited to State Accounts	1,146.1

The revenue for social insurance thus provided the third largest source of income during the fiscal year 1950. The figure of $3,938.1 million was surpassed only by the proceeds from the personal income and the corporate net income tax. Revenues from the social insurance taxes in 1950 represent the highest yield yet recorded for these taxes. The proceeds in the early 1950's will be even greater because of increased employment and because of the changes wrought by the *Social Security Act of 1950.*

CUMULATIVE COLLECTIONS

"Cumulative" figures for the first ten years of operation, 1936-46, reveal a total of $8.4 billion for OASI, $10.5 billion accredited to state accounts for unemployment compensation benefits, and $1.2 billion collected by the federal government to defray costs of administering unemployment compensation. The cumulative deposits in the Unemployment Trust Fund through June 30, 1950 amounted to $14.532 billion.

[8] *Annual Report of the Secretary of the Treasury*, 1950, pp. 53 and 463.

An Appraisal of Social Security Levies

CRITICS OF THE financing aspects of the social security program base their opposition on the grounds that: (1) the tax provisions remove money from the lower-income wage earner that he can ill-afford to lose and similarly have an equally adverse affect on the small or marginal business; (2) the provisions introduce a large element of regressivity into the tax structure of both the national and state governments; (3) they tend to have a deflationary effect on purchasing power; and (4) they are likely to increase unemployment, the very thing for which they are designed to compensate.

REGRESSIVITY OF SOCIAL SECURITY TAXES

On the employee. As the tax falls on the gross wage of the employee earning under $3,600, it cuts into the low incomes. The tax is proportional up to $3,600 and it consequently bears no relation to the worker's ability to pay. Actually, the tax is not strictly proportional in that all wages earned over $3,600 are totally exempt. This would indicate a new type of tax rate, even though it can be classified properly as regressive in effect.

On business. Unquestionably a small and marginal business will find the "cost of compliance" much larger in proportion to that paid by larger concerns. In addition, weak firms will encounter difficulties in attempting to shift the excise tax forward to the consumer or backward to the worker. If marginal businesses are forced to assume the tax as part of the cost of production, this may be in effect "the straw that breaks the camel's back," and such companies may be forced to cease operations.

On the tax structure. Because of the size of the revenue produced by the three payroll taxes, a large element of regressivity is introduced into the entire tax system of the country, both national and state. This, of course, may increase the need to adjust the total tax structure by increasing revenue from the progressive taxes lying in the income and death tax fields.

UNEMPLOYMENT

Up to the present it has been impossible to evaluate the effectiveness of the social security program for unemployment. Certainly, in the period of transition from war to peace, the weekly benefits to workers who were unable to secure immediate re-employment did a great deal to maintain purchasing power. The unemployment insurance program has been called the most vulnerable part of the social security structure,

for there is serious doubt whether the unemployment compensation program will play an effective role in the depressed swing of the business cycle.[9] Proponents of the program maintain that unemployment benefits will tend to cushion the workers against the loss of income incident to normal shifts of employment, and at times of downward trends in economic activity the benefits will serve to retard the downward process of the economic cycle.

A more serious criticism of the taxes for unemployment is made by those who maintain that employers will tend to escape the tax by substituting machinery for labor. Replacing labor by machinery would tend to create unemployment; and if universally practiced, the replacement would lead to severe unemployment in the short run and thus create a situation which would soon exhaust unemployment compensation funds.

The Shifting and Incidence of Social Security Taxes

KNOWLEDGE OF THE shifting and incidence of a tax levy is of primary importance in determining the location, the weight of the tax burden, and the social and economic effects of the tax. These principles become peculiarly significant when considering the payroll taxes for social security because of the "social objectives" incorporated directly into the tax measure. Three distinct taxes warrant consideration; the impact of one falling directly on the employee and the impact of the other two falling directly on the employer.

INCIDENCE OF TAX ON EMPLOYEE

Discussion will center first on the income tax levied on the wage of the employee. Three alternatives suggest themselves as indicating the possible incidence of the tax, namely: (1) tax remains on the employee, (2) tax is borne by the employer, or (3) tax is shifted backward in reduced costs of one or more of the factors of production. Most of the information available about the process of shifting of taxes leads to the conclusion that this tax rests finally at the point of impact—the worker.

In the first place, the tax is still small—only 1½ per cent. That rate even on a small wage provides little incentive to the worker to shift the tax. In the second place, the tax is in effect a means of compulsory saving which will result in ultimate benefit to the taxpayer. Many workers will receive benefits larger than the accumulated tax so that this, too, acts as a restriction on the desire to shift the burden elsewhere. Even if the rate is increased to 2 per cent in 1954, benefits to be received will probably

[9] "Social Security," Tax Foundation, New York, 1944, p. 3.

still outweigh the tax burden. In the third place, the tax on the employee is becoming more universal as the coverage is extended, so that migration to other employment is not likely. Though there are a number of exempt industries, these do not represent a serious competitive threat to the non-exempt employments. These factors lend validity to the theory that the tax rests on the employee, and they also illustrate the difficulties of shifting the tax either forward or backward.

INCIDENCE OF TAX ON EMPLOYER

Since the other two payroll taxes fall directly on the employer, these will be considered together. These taxes can also have as their final incidence the *employer*, the *consumer* with the tax shifted forward in higher prices, or the *employee* with the tax shifted backward in lower wages. Opinions among authorities concerning the incidence of these two taxes are divided. Professor Withers feels that "the major weight of the taxes, however, is on consumption since most of the burden is undoubtedly transferred to the consumer." [10] On the other hand, Professor Taylor presents strong arguments to support the theory that the "major part of the incidence of the excises is upon labor in the long run." [11] Sufficient confusion exists to warrant the conclusion that the incidence of these taxes cannot be predicted with any great degree of assurance. On the whole, a safe conclusion would seem to be that it is "divided among employers, labor, and consumer, but in what proportion cannot be definitely said." [12]

Certain observations regarding the incidence of the employer's excise taxes are definitely in order. There is little question that the employer will attempt to shift the tax rather than pay it himself. The total rate of the two payroll taxes paid by employers at the present time is 4½ per cent. If, of course, the employer is entitled to merit rating credit, this rate is somewhat reduced. However, the total amount of tax paid still represents a substantial amount of money to be allocated to taxes each month. For example, assume that an employer of eight in a covered industry pays each worker an annual wage of $3,000. At the 4½ per cent rate his total tax for the year would be $1,080, which would amount to $90 a month. This represents a relatively high fixed cost that the employer will attempt to shift if at all possible.

In general, the arguments favoring a shifting of the tax to the worker in lower wages are the same as those employed to substantiate the conclusion that he bears the impact of the tax levied on him for old age

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[10] William Withers, *Public Finance*. New York: American Book Company, 1948, p. 217.

[11] Philip E. Taylor, *The Economics of Public Finance*. New York: The Macmillan Co., 1948, p. 560.

[12] Groves, *Financing Government*, (rev. ed.), p. 148.

benefits. In recapitulation: the tax represents a special benefit to the worker over and beyond what he contributes; he cannot migrate easily to escape the tax; and wages are susceptible to tax shifting. However, the strength of organized labor in many of the nonexempt industries could very well prevent this shift to the worker in lower wages.

There are a number of reasons for believing that payroll taxes are shifted forward to the consumer in higher prices. These taxes have many of the characteristics of "consumption taxes" and also of "business taxes" and tend to be considered as "costs of production." As "costs of production," the consumer can be expected to pay them in the purchase price of the commodity. As these taxes are levied on gross income, they have some of the characteristics of a "unit tax." This would tend to work a distinct hardship on the marginal producers, possibly forcing some of them out of business. If these producers withdraw from the market, the supply will be lessened and prices will tend to rise.

The Economics of Social Security Reserves

INTRODUCTION: TWO APPROACHES

One of the most serious controversies relating to social insurance taxation has arisen over the matter of the social security reserves. Actually, there are two opposing points of view. *First*, many authorities favored the principle of "reserves" so that sufficient funds could be built up to cover benefits later disbursed to the original, contributing wage earner. This recommendation was based on many of the features utilized by private insurance companies and governmental retirement systems. *Second*, an equally strong group of authorities favored the "pay-as-you-go" or the "current-cost" basis for financing insurance benefits. In this way each generation of workers would support the retired employees of the preceding generation. After considerable debate on the matter, the reserve program was incorporated into the original *Social Security Act.*

TWO RESERVE TRUST FUNDS CREATED

Two trust funds were created by the Act of 1935. One was to hold in trust the money received by the national government from taxes levied on the employee and employer for old age benefits; this was known as the Federal Old Age and Survivors' Insurance Trust Fund. The other was to hold the money from taxes levied on the employers for unemployment in a fund known as the Unemployment Trust Fund.[13] Bookkeeping in the latter system was set up in such a way as to credit the money

[13] A third fund was set up and administered separately for railroad old age retirement and survivors.

received from each state to the account of that state. The national government would disburse the benefit claims directly to the aged, and it would release money from the Unemployment Trust Fund to the states upon request for the payment of unemployment benefits. The reserve method, of course, proved to be cumbersome and involved a program of costly bookkeeping. Investment of the money from the trust funds not needed to meet current withdrawals was made the responsibility of the Secretary of the Treasury.

Amendments to the *Social Security Act* in 1939 reduced the reserve fund for old age benefits to a contingency basis. Increased benefits were provided to the worker, and dependent members of his family were extended insurance coverage. Since the tax rate was not raised the estimated size of the reserve fund was considerably reduced over initial predictions.

CRITICISM OF RESERVE FUND PRINCIPLE

As money from the trust fund can only be invested in interest-bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States, the money not needed to cover anticipated benefit payments is in effect used to pay for the general expenses of government. Objections to this are raised on the ground that as federal taxes will have to be levied to amortize the bonds as well as to pay the interest on them, a second tax levy would eventually become necessary to provide money for future Social Security benefits. Such a process would increase general taxes in order to support the old age security program.[14] Another criticism attacks the reserve on the basis that money for benefit payments will become particularly acute in times of depressed business conditions. Government bonds will have to be sold at this time to provide the money for benefit payments. Since other investors are seeking to dispose of securities at the same time, this will tend to further deflate prices. Another argument is advanced which maintains that the goods and services to be consumed by old age pensioners are not produced by building cash reserves.

ARGUMENTS IN FAVOR OF RESERVE PRINCIPLE

The reserve system is advocated for a number of reasons. First, costs of government are spread over a longer period of time. Second, long-term planning in terms of future needs is mandatory. And third, the principles inherent in financing by reserve funds re-enforces the contributory aspect of old age benefits. As a result of this, a larger element of "right" as against "relief" is injected into the entire social security program than would be true if the program were financed entirely on a current-

[14] *Social Security*, Tax Foundation, New York, 1944, and J. S. Parker, *Social Security Reserves*. Washington, D. C.: American Council on Public Affairs, 1942, pp. 9-10.

cost basis. Then, too, it is claimed that under the reserve principle social security taxes could be reduced in the long run. Finally, the taxes required to finance reserves would serve as a check upon voting large benefits.

The Place of Social Security Taxes in Fiscal Policy

THE PLACE OF THE SOCIAL SECURITY PROGRAM in fiscal policy deserves careful consideration because of (1) the revenue secured each year from the tax provisions, (2) the proportion of the population affected by the taxes and the subsequent disbursement of benefits, and (3) the general economic level of our national economy that the social insurance program covers.

SOCIAL SECURITY, TAXATION, AND CONSUMPTION

Most authorities agree that the incidence of the payroll taxes on those workers least able to pay exerts, over the long run, a persistent downward pressure on the current annual level of consumption. When the available amount of money cannot keep up with the supply of consumers goods, large annual deductions mean a piling up of merchandise and a resultant loss of income to the producer. To this extent the general net effect of the payroll taxes is deflationary and will remain so as long as revenues secured from taxation exceed benefit payments.

At the point, however, when disbursements in the form of benefit payments to insured workers begin to equal and subsequently exceed tax collections, these payments, diffused as they are throughout the lower-income groups, will tend to preserve and sustain purchasing power. Since this money is primarily spent for essentials, it passes quickly into the stream of income and produces a salutary effect upon investment spending. Such counter-cycle operation is an inherent part of the social security financing plan. Most students of the fiscal aspects of social security doubt whether this automatic feature is sufficient to play an important role in maintaining and stabilizing the nation's economy. The better thinking on the subject indicates that although this lays a good foundation, additional policies are necessary.

SOCIAL SECURITY TAXES LACK FLEXIBILITY

There is another obstacle that prevents the present social security program from playing as effective a role as it might in fiscal policy. The social security tax system tends to be rigid. The tax rates are fixed by statutory enactment, and similarly there is incorporated into the Act a fixed scale of benefits regardless of price levels, individuals' problems, and family needs. Ideally, taxes should far exceed benefits during periods of prosperity; thus taxes would retard inflation and at the same time accu-

mulate insurance funds. Rates should be lowered and the size of disbursements increased during periods of depression and early recovery. If this flexibility were made possible under the law, the payroll taxes could be regarded as devices to "expand or curtail" purchasing power according to the needs of the economic system.

MERIT RATING AND FISCAL POLICY

The merit rating principle in the unemployment insurance program has stimulated considerable discussion about its effectiveness as a device for sustaining full employment. There are many who contend that this feature achieves just the opposite effect. Viewed objectively, the basic provisions of the *Unemployment Compensation Act* would seem to run counter to accepted tax policy. In periods of full employment, (under merit rating) the tax rate is low because of few layoffs and a sustained high level of employment.

When business conditions are depressed and industry finds profit-making difficult, the tax will automatically rise. At such a point, too, marginal concerns will find it difficult to shift the tax; this condition will probably result in some business failures, and thus will add to unemployment. The unemployment compensation plan has operated admirably in the shift from wartime production to high peacetime production. The effectiveness of the program is yet to be tested in cushioning a real business recession. We also do not know from experience whether the statutory excise tax on employers and the merit principle basic to the current unemployment plan can withstand prolonged depressed conditions.

NEED FOR RE-APPRAISAL OF SOCIAL SECURITY PROGRAM

These considerations of the role of social security financing in fiscal policy have led to an almost universal request for complete re-appraisal of the social security program. The Hoover Commission succinctly summarized the general consensus in Recommendation No. 4 of its pamphlet on Social Security:

> The Eighth Annual Report of the Board of Trustees of the Federal Old-Age and Survivors' Insurance Trust Fund has stated: "... There is need for a review of the old-age and survivors' insurance program covering not only the benefit formula, the coverage of the system, and the scope of protection afforded, but also contributions and financial policy." We recommend that such a review be made.[15]

Throughout current literature the same concern is expressed for the various fiscal aspects of unemployment compensation. Undoubtedly the next few years will see steps taken in the indicated direction.

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[15] "Social Security, Education, Indian Affairs," *The Commission on Organization of the Executive Branch of the Government.* Washington, D. C.: U. S. Government Printing Office, 1949, p. 22.

SOCIAL SECURITY AND ECONOMIC MORALE

One aspect of social security financing defies specific, clear-cut analysis —the psychological effect on the benefiting wage earner. Insofar as the members of the wage-earning population are free from fear of total income stoppage, they can continue as productive units in the nation's economy. This is, after all, the basic principle which led to the adoption of the *Social Security Act.* Even though the benefit scales are not as yet substantial, the benefit does represent a "kernel" to which the individual is entitled as a matter of right because of his own contributions. It is true, of course, that he in fact receives more than he contributed. Such factors which contribute to the bolstering and sustaining of morale when business conditions become difficult are bound to reduce the mental hazards which tend to augment the disorganization of our economic structure.

Conclusions

SOCIAL SECURITY has become an accepted part of American social responsibility. The broad social objectives inherent in social insurance are compatible with the general welfare clause of our Constitution.

In the area of the broad social security purposes themselves, three major issues arise: (1) Should other types of individual and social risks be included in the program? This is still a highly controversial issue which the American people will have to decide in the long run. (2) The other issue relates to coverage: What types of employment should be included within the scope of social security? The Act of 1950 has made forward strides on this issue, and it is estimated that about 10 million additional persons were brought under its provisions. Other workers may merit consideration. Their entry into the system will depend upon the social policy of our people and the administrative feasibility of applying social security to these miscellaneous groups. (3) It is claimed that the social security benefits are inadequate to meet the needs of a reasonable standard of living, especially in periods of rapidly rising prices. The Act of 1950 made gains in the right direction. In the long run our ability to expand benefits will depend upon our capacity to increase our productivity and raise the national income.

It must be concluded that the broad objectives of the social security program can become an integral and vital part of the economic and social functioning of our economy. There is widespread realization of the gaps and inadequacies in the present system of social insurance. Re-evaluation and modification of the provisions of the present *Social Security Act* will undoubtedly occur within the next decade.

26

Poll Taxes

OLDER THAN THE TAXES *that we have been engaged in considering, but now of little importance, are the capitation or poll taxes.... Their origin is evidently found in the idea that persons as such should contribute to the wants of public power.... No modern State could employ a capitation tax as a substantial source of revenue. Its inequality and directness make it unpopular.*

—C. F. BASTABLE.[1]

Overview

SOME TYPES OF TAX are more closely associated with the individual person than are others. At the one extreme the person himself may be the base of the tax; at the other, taxes may be so hidden in the price of a commodity that the purchaser is entirely unaware of paying any tax at all. The one tax that qualifies perfectly as a personal tax is the poll tax. It is also called a "head" or "capitation" tax. The latter names bring out more vividly the "personal" character of the tax.

In the United States the poll tax is unimportant as a revenue raiser. In some states in the South, however, the poll tax in the past has yielded more revenue than the income tax. During the period between the two World Wars and throughout the 1940's, the poll tax became somewhat more commonly used.

By far the more significant aspects of the poll tax are nonfiscal in character. In some states it is used primarily as a means to disfranchise large numbers of poor people and as a basis for racial discrimination.

It is the purpose of this chapter: (1) to analyze the nature and theory of poll taxes; (2) to appraise the arguments for and against the poll tax; (3) to analyze the present status of the poll tax; (4) to appraise the revenue importance of the tax; and (5) to analyze and appraise the use of the tax for nonfiscal purposes.

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[1] C. F. Bastable, *Public Finance*. New York: The Macmillan Co., 1922, p. 465.

The Poll Tax in Theory

THE GENERAL CONCEPT of a poll tax is a money payment, usually at a flat, low rate (and sometimes with slight graduation) levied upon all members of a community. It is a tax upon the right of a person to live in a society and to receive protection as well as all the other benefits of such a status.

All taxes must be paid by some person or a group of persons some way or another. Nevertheless, some taxes are "more attached" to the individual taxpayer than others. The property and sales taxes are taxes upon non-personal concepts. The income tax and the poll tax, on the other hand, are "personal taxes," with the latter as the only tax that qualifies perfectly as a "pure" personal tax. It is a tax upon the person himself, and with certain exemptions it considers all individuals as its *base*. It is sometimes called the "capitation tax" or the "head tax." (The latter epithet brings out more strongly the "personal" character of the tax.)

ARGUMENTS FOR AND AGAINST THE POLL TAX

Arguments for. The most powerful arguments in favor of the poll tax are the "non-fiscal" arguments. The poll tax, as will be proved later, cannot be depended upon as a revenue raiser, but for the sake of inclusiveness, all arguments will be analyzed here.

1. *Benefits received.* Since all persons receive some benefits at the hands of government, so all persons ought to contribute to that government. This argument, although granting the different degrees of benefits received, is in favor of a "fixed sum" of money, equal to the least marginal portion of benefits received by the poorest citizen, to be levied as a general tax upon everyone. Under this theory the tax has to be extremely small, and it obviously cannot be depended upon as a source of revenue.

2. *Ability-to-pay.* The proponents of the poll tax argue that every person possesses "some ability" to make payment to government, however small the payment may be in some cases. Here again, unless the tax is graduated, the tax will be too small to be of any fiscal value. There is some question also whether every person has "some ability" to pay taxes. It would be very difficult to prove even "any ability" in the case of those who exist at the margin of bare subsistence.

3. *Supplement to the personal income tax.* The chief significance of the poll tax at present is its possible use as a direct personal impost to supplement the personal income tax and to place some responsibilities on the classes which are exempt from that tax. This may serve several purposes: (1) to arouse interest in sound government, (2) to check un-

wise demands for spending by voters who do not pay direct taxes; and (3) to raise additional revenue for the taxing unit of government.

4. *General participation in cost of government.* With the use of the poll tax as a supplement to the personal income tax, the chief argument in favor of a poll tax is that it makes everyone participate in the "concern" for the cost of government. It is often argued that because poll and income taxes are paid directly to the government, they help to make the public tax-conscious. These taxes should be paid by all classes as constant reminders of governmental spending.

Arguments against. In the thinking of most fiscal experts and democratically-minded people, the weight of the argument seems to be against poll taxes. This is so from both the fiscal and social point of view.

1. *Regressivity through uniformity.* If a poll tax is used as a main item in the tax system, then the uniformity of the rate will prove to be regressive. The extreme regressivity of such a tax at once condemns it from the standpoint of ability-to-pay. That is why in colonial days, when this tax was relied upon for revenue, uniformity of levy was soon abandoned for a graduated tax based upon ownership of property or size of income (faculty).

2. *Problems in administration.* The poll tax may seem to be an easy tax to collect because all that seems to be necessary is a list of all the persons residing in the community. But the problem of reaching those with low incomes and those who do not pay other taxes has proved to be so difficult and expensive that those political units which continue to use the poll tax generally make no attempt to collect it from any but those who pay some other tax. The result has been that it has become an adjunct to the payment of some other levy and that it raises little revenue.

3. *Objections to nonfiscal uses.* The main argument against the poll tax is the nonfiscal role which it has come to play. The motive behind this tax has not always been revenue, for at times it is levied primarily for the regulation of some function. This is now illustrated by the requirement of several southern states that the right of suffrage be predicated upon the payment of the poll tax. The motive is to discriminate against Negroes and poor white citizens by levying the burden and then making no attempt to collect the tax from them. The failure to pay the tax is then utilized to bar these citizens from voting. An additional abuse creeps in when the politicians make a practice of paying the tax for those who support a given candidate.

4. *No justification on "ability" or "benefits."* Arbitrarily assessed poll taxes measure neither ability-to-pay nor benefits received. The opponents of the tax (while granting the benefits received by poor folks, and doubting that they have any ability to pay) *conclude* that the low-income groups already pay regressive commodity and property taxes which are shifted to them through the price mechanism.

The Present Status of the Poll Tax

THERE SEEMS TO BE a general misunderstanding among American laymen to the effect that the poll tax as it exists in the United States is primarily a political measure with undemocratic, nonfiscal purposes. In actual practice, however, two main types are used: one is clearly a "revenue" tax with no conditions attached, and the other is the "nonfiscal" tax, payment of which is necessary as a condition to voting. In recent years the "revenue" type of poll tax has been gaining ground in our cities, counties, and school districts in various parts of the country.

THE LEGAL BASIS OF THE POLL TAX

At the federal level poll taxes have never been levied and for a very good reason. Article I, Section 9, Clause 4 of the Constitution provides that "No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken."

There exists no direct federal constitutional limitation upon the states and local units to levy a poll tax. However, in legal theory it might be possible to invoke the "equal protection of the laws" provision and claim improper discrimination. But the amounts involved in poll tax cases are so minor that they very seldom are carried into the higher courts. Therefore, there are no leading decisions testing the applicability of the "equal protection" clause to poll taxes.[2]

The poll tax is completely forbidden by the constitutions of four states: Maryland, Ohio, Oregon, and Utah. In two states, Alabama and Mississippi, the poll tax is "levied directly" by the state constitution. It is "required to be levied" by the constitutions of ten states: Arkansas, California, Delaware, Nevada, North Carolina, Rhode Island, South Carolina, Virginia, West Virginia, and Wyoming. It is not in the constitution but is "permitted" by statutory provision in seven states: Connecticut, Indiana, Iowa, Kansas, Minnesota, New Jersey, and South Dakota, and it is "permitted" by the constitutions of all other states with the exception of Wisconsin (in which the poll tax is mentioned neither by constitutional nor statutory provision).[3]

POLL TAX BASE, RATES, AND EXEMPTIONS

The poll tax is usually limited to adults over twenty-one years of age. (There is one exception, Louisiana, which applies the tax to persons eighteen years of age.) Most states use maximum age limits ranging from 45 (in Alabama and Arkansas) to 70 years (in New Hampshire and Ver-

[2] Shultz, *American Public Finance*, (3rd ed.), p. 420.
[3] *Constitutions* and *Statutes* of the several states.

mont). Women are included in the base of the poll tax in some states and excluded in others.

The poll tax is usually levied as a flat charge without graduation. The rate is usually one or two dollars for each governmental unit. The common gross rate ranges from $1 to $5 except in Louisiana, where it may amount to $12 in parishes, with the privilege of commuting the tax by working on the roads. In sixteen other states, this alternative of paying cash or performing services a given number of days is the rule.[4]

Special exemptions are frequent in the imposition of the poll tax, and they differ with different states. Commonly exempted are war veterans, paupers, the mentally and physically disabled, and those who already pay other specified taxes.

The Fiscal Significance of the Poll Tax

SOME DIFFICULTIES ARISE in attempting to get a complete and accurate picture of the revenue importance of poll taxes. The data are quite incomplete for several reasons: (1) The volume collected is considered quite minor and therefore is lumped together under "miscellaneous receipts." (2) Many local units fail to report the revenues collected from this source.

Of the states actually using the poll tax in some form, only about a dozen report their revenues from this source reliably well. Various studies and reports made in the past give some indication of the fiscal significance and trends in collections over the last twenty years.

By 1940 the states were collecting $7.7 million from this source; by 1945 $9 million, and by 1946 $9.5 million. The figure for 1946 increased in spite of the fact that Georgia repealed her poll tax in 1945.[5] Assuming that state collections run about 20 per cent of total poll tax revenue, it is reasonable to infer that total collections from this source now run between $45 and $50 million, of which about $10 million goes to the states, $10 million to the counties, and about $30 million to other local units. This is not an unreasonable inference, partly because in recent years the poll tax for revenue purposes has been adopted by local governments. In 1947 Pennsylvania authorized certain classes of local government to levy any taxes which the state has the power to levy but does not now levy. It raised the maximum poll tax in third class cities from $1 to $5. A poll tax of $1 to $5 was authorized for the Pittsburgh School District.[6]

In 1948 about thirty-six local units (school districts, cities, and boroughs)

[4] H. L. Lutz, *Public Finance*. New York: D. Appleton-Century Co., 1947, p. 360.
[5] The above figures are derived from *Tax Systems*, 1936-1948.
[6] "City Tax Legislation in 1947," *Tax Policy*, December 1947, p. 5.

in Pennsylvania adopted poll taxes ranging from $1 to $12.50 per year.[7] Movements to have cities and school districts levy poll taxes are under way in other parts of the country. It is true that the desire to remove the payment of poll taxes as a condition precedent to voting is getting stronger, but on the other hand, poll taxes "for revenue" are also gaining new momentum. South Carolina in 1950 is the most recent state to repeal its poll tax as a condition to voting; Arkansas, North Carolina and Georgia preceded South Carolina by several years. Nevertheless, the total poll tax collections are probably more than two and one-half times greater than they were in 1930. As local governments become harder pressed for revenue, there is reason to believe that they will follow the example set in Pennsylvania. Poll taxes for "revenue only" are quite likely to expand in the years ahead.

The Nonfiscal Use of the Poll Tax

THOUGH THE POLL TAX had been in use in a number of states for many years before the Civil War, it was not re-adopted and made a condition to the right to vote until after 1875. Most southern states had made the change by 1903. At the time the adjustment was advocated it was claimed that the purpose was (1) to raise the standard of the voting masses and (2) to eliminate corruption in elections.

EXPANSION OF NONFISCAL USE

During the Civil War the Negro slaves were emancipated by executive proclamation. That freedom was confirmed and guaranteed by the Thirteenth Amendment to the Constitution, ratified in 1865. Certain civil rights were protected under the Fourteenth Amendment, and the right of the Negro citizen to vote was guaranteed by the Fifteenth Amendment, ratified in 1870. In the meantime, the South endured a period of Negro domination (under carpetbagger leaders from the North) that lasted well into the 1870's. It was a period during which many southern white voters were disenfranchised; the carpetbaggers and Negroes abused their newly-won power and many wrongs were perpetrated. The ill-feeling and hostile reaction created in the South became deep-seated and quite enduring.

When the carpetbaggers were finally driven out and the southern whites recovered influence in the government, they were reluctant to admit the Negroes to full voting rights. During the first few years most of the methods of restraint were "outside the law." Legal methods were curbed

[7] "City Tax Legislation in 1948," *Tax Policy*, October 1948, p. 11.

by a clause in the Fourteenth Amendment, which provided that if a state denied male citizens the right to vote, its representation in Congress would be reduced.[8] This clause was not strictly enforced. However, by 1890 one southern state after another gained sufficient confidence and popular support to make payment of the poll tax a condition precedent to voting. By 1903 all of the southern states had done just that.

EFFECTIVENESS OF NONFISCAL PURPOSES

To appreciate the preventive effect of the nonfiscal aspects of the poll tax, it is well to review the volume of total and Negro voting "before" and "after" the adoption of the voting poll tax laws in the various states. In Virginia in the last presidential election before the imposition of the poll tax, 266,000 persons voted. After the imposition of the tax, the number was cut to 136,000, a reduction of 49 per cent. In Mississippi, 117,000 persons voted before the tax and 52,000 after its imposition, a reduction of 56 per cent.[9] In Louisiana, for the 1896 elections, the last before the imposition of the tax, there were registered in the state 133,344 Negroes, constituting a majority in 26 parishes. For the 1900 national elections, the number of Negroes registered fell to 5,320, and no parish showed a majority of Negroes.[10] There were similar immediate reductions in other states.

In the congressional election of 1946, in the states where free elections were held an average of 47 per cent of the potential voters cast their ballots. In the poll tax states an average of less than 10 per cent of the potential voters balloted.[11]

In 1951, six southern states continued to require the payment of the poll tax as a condition of voting. Vermont required payment as a condition precedent to voting in the town elections, and Philadelphia required payment as a prerequisite to voting in city elections. In the South the effectiveness of the poll tax statutes is enhanced by the policy of not attempting to enforce the tax law.

PROBLEMS INVOLVED IN NONFISCAL USE

Racial discrimination. There is little doubt that the passage of poll taxes as a condition to voting has substantially reduced the number of persons voting in southern elections. This is true in spite of the fact that the present poll tax rates in these states are relatively nominal.

Those who oppose the poll tax on the ground of race discrimination often overlook the fact that many poor whites are also disfranchised by it.

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[8] Art. XIV, Cl. 2.

[9] G. H. Bender, "Poll Tax Disgrace," *Christian Century*, Vol. 64, July 23, 1947, pp. 900-901.

[10] Groves, *Financing Government*, (rev. ed.), p. 349.

[11] Bender, *op. cit.*, pp. 900-901.

This does not destroy the basic argument, however. Those whose ideals are toward the expansion of true democracy see in the poll tax a serious barrier to democratic expression, a barrier that is contrary to the whole spirit of American governmental philosophy and institutions. This is an attitude that is difficult to refute.

On the other hand, there are those who do not see any serious harm in poll tax voting requirements. They point out that there are many other points in our tax system where failure to pay taxes results in penalties. If a person does not buy an automobile license, he cannot drive his car. If the income tax return is not filed on time, a penalty attaches. If the property tax is not paid, it becomes a lien upon the property, and ultimately the property can be sold. Many of those who do not pay their poll taxes do not have enough interest in civic affairs to make a nominal sacrifice. Many of them will not fail to pay the automobile license tax because they do not want to give up driving a car. Their attitude toward the right to vote is somewhat less devoted.[12] It is also pointed out that there are such other means of disfranchisement as failure to register.

However, those who favor the poll tax often overlook the fact that the failure to pay may be a matter of the lack of the ability to pay rather than indifference. In the recent past, large numbers of Negroes and poor whites in the South have had incomes of only $200 to $300 per year, and often part of that was not in cash. The "marginal one, two or three dollars" has an extremely "high utility" to these people for standard-of-living purposes. If these dollars are paid out in poll taxes, the payment definitely entails a maximum sacrifice.

Those who oppose the tax can point to a serious abuse associated with the poll tax—the practice of buying votes by paying the tax. Some states attempt to safeguard against this by making it a penal offense to pay the tax for another. Some states attempt to reduce the risk of corruption by requiring that all poll taxes be paid a given number of months before an election. However, no matter how careful the safeguards, the threat of bribery and corruption is always present.

Even in a democracy certain types of conduct warrant the loss of rights and privileges, but it seems rather "harsh democracy" that a man should lose his right to vote because of the inability or failure to pay a one- or two-dollar poll tax. There are more valid tests of the ability to vote. There are logical grounds upon which to deny the voting privilege, such as a serious crime, insanity, ignorance, and failure to register. Let there be tests but they should bear a logical relationship to the exercise of the voting power. The mere payment of money does not meet that test.

State versus federal legislation. In recent years, partly as a reaction to existing poll tax laws in the South, bills have been introduced in Congress

[12] H. L. Lutz, *op. cit.*, pp. 361-362.

seeking to invoke any possible powers Congress might have under the Constitution to control elections—especially the election of federal officials.

Whether or not Congress has such powers depends upon the interpretation of a clause in the Constitution which prescribes, "The times, places and manner of holding elections for Senators and Representatives shall be prescribed in each State by the legislature thereof; but the Congress may at any time by law make or alter such regulations, except as to the places of choosing Senators." [13]

In 1937 the Supreme Court decided in the case of *Breedlove v. Suttles* [14] that the levy of a poll tax was not unconstitutional and that the authority on such questions rested wholly with the state legislatures. The decision was handed down in a situation in which Congress had not passed any law on the subject. There is strong opinion to the effect that a poll tax as a condition to voting in federal elections can be abolished by an act of Congress under powers granted to it by the Constitution.[15]

Attempts at the abolition of poll taxes. In the last ten years four major attempts have been made in Congress to abolish the poll tax requirement for voting in federal elections in the southern states. The first anti-poll tax bill appeared in the House of Representatives in 1942. It passed by a vote of 252 to 84, or by a ratio of three to one. In the Senate, however, the bill was reported out favorably by the Judiciary Committee, but a ten-day filibuster by the poll tax Senators prevented it from coming to vote.

The second measure was introduced in May 1943. A third attempt was made in 1945 and the fourth in 1947; all suffered the same fate.[16] From these experiences with the strongly favorable votes in the House, it is reasonable to conclude that most Americans are opposed to the poll tax requirement in national elections.

Conclusions

A POLL TAX is probably not very unjust in a simple society where the difference in wealth and income are not too striking, but in a modern industrial society this principle of equal taxation clearly becomes inequitable and unworkable. It has lost favor over the years because it does not conform to modern concepts of justice in taxation.

It is difficult to justify the poll tax on logical grounds for the way in

[13] Art. I, Sec. 4, Cl. 1.

[14] 302 U. S. 277 (1937).

[15] G. H. Bender, "Poll Tax Disgrace," *Christian Century*, Vol. 64, July 23, 1947, p. 900-901. (Mr. Bender was a member of Congress from Cleveland, Ohio, at the time.)

[16] C. V. Gray, "Poll Tax Situation," *Sociology and Social Research*, Vol. 29, May 1945, pp. 382-387.

which it disfranchises particular groups of citizens. The standards for allowing or disallowing the right to vote should be proximately and logically related to the exercise of the franchise. The payment or nonpayment of a few dollars is not so related.

Insofar as the low-income people should contribute something to the cost of government, other taxes can be more equitably adjusted to that objective and can be more effectively administered and collected.

The poll tax as a nonfiscal instrument will probably "fade away" in the next generation. As a revenue raiser for small and medium units of local government, however, the poll tax has been gaining ground and raising some revenue in recent years. It seems that our state governments could readjust local taxing powers in such a way as to avoid a flat rate, undifferentiated burden upon all. Local units render many special services to particular persons some of which are still paid for out of general revenues. Here is an area where these units could equitably acquire some of the needed revenue. Then, too, even local units should have some opportunity to use "ability" taxes. Fiscal adequacy should not become the all-controlling distribution principle for cities, villages, towns, and counties.

27

Revenue from Non-Tax Sources

WHILE TAXATION *yields the greater part of governmental revenue, there are many other sources of income which produce substantial sums. Governments may obtain revenue from such non-tax sources as public domain, the operation of public industries, and administrative income from fines, fees, licenses, special assessments, and excess condemnation.*

—ORVAL BENNETT AND ISAAC LIPPINCOTT.[1]

Overview

THE RESOURCEFULNESS of all levels of government has been challenged to provide revenues to meet their public expenditures. As a result, a great variety of taxes and other forms of income have been developed. Taxes are by far the most important of these forms of public income, but the use of non-tax revenues is becoming noticeably more significant. These revenues are distinguishable from tax levies on the basis of several criteria (particularly their special benefit and voluntary character), but occasionally the differences are primarily those of degree.

The greater part of the non-tax revenues is received at the village, city, county, and (to a lesser extent) state levels. For a time after the great bulk of the public lands had been sold, non-tax revenues were practically insignificant at the federal level. Today the trend in dollar volume collections from non-tax sources by the central unit is perceptibly upward. The percentage, nevertheless, remains relatively small.

In our analysis of non-tax revenues, an effort is made to achieve several objectives: (1) to establish a workable classification of non-tax revenues, (2) to distinguish non-tax from tax revenues, (3) to analyze particular non-tax sources according to their nature and purpose, (4) to appraise individual non-tax elements on the basis of their fiscal significance, advisability of given governmental units participating in the source, and principles pursued in procuring these funds.

[1] Orval Bennett and Isaac Lippincott, *Public Finance.* Cincinnati: South-Western Publishing Co., 1949, p. 671.

Classification of Non-Tax Revenues

NON-TAX REVENUES may be classified into a number of different categories. The following economic classification, an adaptation from that promulgated by Professor William Withers,[2] lists the revenues as nearly as possible in order of their importance from the standpoint of volume.

1. Revenue from public enterprise. .
   a. Profits from the sale of goods and services.
   b. Fees from services.
   c. Rentals from goods and equipment.
2. Revenues from administrative functions or services.
   a. Fees.
   b. Licenses.
   c. Fines.
   d. Special Assessments.
   e. Excess Condemnation.
3. Revenues from Interest.
   a. Interest on deposits.
   b. Interest on loans.
4. Revenues from the public domain.
   a. Sales of land, mineral, and property rights.
   b. Rentals from land.
   c. Royalties from mineral or property rights.
5. Revenues from expropriation.
   a. Expropriate Revenues.
   b. Escheats.
6. Revenue from gifts and grants.
   a. Gifts from individuals.
   b. Grants-in-aid.

Tax and Non-Tax Revenues Distinguished

CHARACTERISTICS OF TAX REVENUES

Tax revenues differ in several respects from non-tax revenues. A tax is a compulsory contribution. It is an obligation paid by all individuals who come within the jurisdiction of the taxing unit and within the scope of the particular tax law. Taxes are levied and the revenue spent for the general welfare without regard to particular benefits to particular individuals.

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[2] William Withers, *Public Finance*. New York: American Book Co., 1948, p. 261.

CHARACTERISTICS OF NON-TAX REVENUES

Non-tax revenues are characterized by the more or less "voluntary choice" on the part of the individual whether or not he will receive the benefit and pay for it. There is not necessarily a close relationship between the "amount" of the payment and the "value" of the benefit to the individual (or the "cost" of providing that benefit), although there usually is a reasonable relationship. Another characteristic of non-tax revenues is that they generally appear as the result of some administrative service or control activity of government.

Some charges are denoted as non-tax revenues because of their legal basis. For example, fines are usually classed as a form of administrative revenue (and levied as a means of "enforcing regulations") rather than as an income-raising technique.

Many non-tax revenues are more irregular in time of payment than most basic taxes. Payments are made usually at the time of receipt of the special benefit, and they may not be paid again; in contrast, many taxes are recurring and are usually paid annually or at specified times.

It can be considered, therefore, that the principal distinction between non-tax revenues and taxes lies in the degree of *general benefit* as contrasted with *special benefits*. The charges may be called taxes when the general benefit is the outstanding feature, and they may be referred to as non-tax revenues when the special benefit is most significant.

Fiscal Significance of Non-Tax Revenues

IN THE UNITED STATES, total receipts from the various non-tax sources seldom constitute more than 10 per cent of the total income of all units of government, local, state, and federal. At the federal level, the dollar volume from non-tax revenues is a noticeable item, although as a proportion of total federal revenues it represents less than 2 per cent of the total. On the other hand, some cities get as much as 12 to 15 per cent of their revenues from non-tax sources, whereas about 20 per cent of the revenues of some states come from such means.

It has never been a major purpose of our units of government to conduct enterprise operations for a profit. However, in recent years more of that type of activity prevails at all three levels—at the federal level in the credit and public power fields, at the state level in the alcoholic beverage area, and at the local level in the ownership of municipal utilities. Licenses, fines, and fees have never been considered as a prime source of revenue, although their use has been quite extensive at most levels of government. They are relatively insignificant at the federal level, but they bulk larger

for the state and local units. As time goes on, it is reasonable to assume that the fiscal importance of non-tax revenues will increase.

Revenues from Public Enterprises

REVENUES FROM PUBLIC INDUSTRIES are received by governments in the form of prices paid by individuals for goods and services produced by government-owned enterprises. These commercial enterprises provide goods and services of specific benefit to the consuming public. These enterprises are not incidental to general governmental functions (as is the case of administrative revenues), but they are independent undertakings designed to supply goods and services which are ordinarily furnished by private enterprise.

PUBLIC PRICING POLICIES

The decision to sell rather than to donate the goods and services that are provided by government arises from the fact that their benefit is readily identified with the individuals using them. However, the price may show little correlation between the amount of benefit conferred and the cost of providing the service. The price is determined in some degree by the *purpose* for which the government undertakes the function. A deficit may be deliberate in order to promote some activity beneficial to general community welfare (as in the case of the postal service). Most publicly-owned utilities charge prices about equal to those charged by private utilities, except that rates are usually reduced when the public utility earns more than a modest profit.

COMMERCIAL ENTERPRISES OF THE FEDERAL GOVERNMENT

The public corporation is most commonly used at the federal level to facilitate public administration of these enterprises. It has operated in five major fields, as established by the Government Corporation Control Act, December 6, 1945.[3] The fields are those engaged in aids: (1) to industry (RFC and others), (2) to housing (FHA, HOLC), (3) to agriculture (Commodity Credit Corporation and others), (4) to international relations and trade (Export-Import Bank), and (5) to regional development (TVA).

Other sources of non-tax revenue of the commercial variety for the federal government (often administered by a political department) are postal receipts, canal tolls, receipts to the government printing office, land rentals, park fees, sale of personal supplies to service men and women, and

[3] *Public Law 248*, 79th Congress, 1945.

others. It is not our purpose here to analyze all these in detail; rather our purpose is to recognize as many as possible in perspective.

In addition, after conflicts such as World War II, the federal government finds itself with great stocks of surplus or obsolete equipment which has a sale value. The sale of this material yields some *recovery* of the original cost and contributes to the revenues for the periods of sale.

The book value of all the assets used by the various federal credit corporations and business-type activities amounted to $23.4 billion as of June 30, 1948. The gross income from the sales of goods, supplies, services, interest received, and gains on the sale of fixed assets amounted to over $3.5 billion for the fiscal year 1948.[4] The largest sales were those of the War Assets Corporation and the Commodity Credit Corporation.

COMMERCIAL ENTERPRISES OF STATE GOVERNMENTS

On the whole the states have been slower than the local and federal units in entering public enterprises of various kinds. As late as 1932 revenues from state-operated enterprises amounted to less than $10 million and a very small percentage of their total revenues. The depression years and the repeal of prohibition have stimulated state activity in public-service and liquor-sale enterprises.

The heaviest expansion has come in the latter activity. In 1948 sixteen states operated liquor monopolies, the gross sales from which amounted to $877 million and the net income from which was about $167 million.[5] This represented the great bulk of the income from all state-operated enterprises.

COMMERCIAL ENTERPRISE OF LOCAL GOVERNMENTS

Public enterprise provides an important source of revenue for many city governments. The three fields most heavily occupied by municipal units are water supply, the generation and distribution of electricity, and local transit lines. In recent years they have operated airports, set up special "authorities" to render port and wharfage services, and engaged in housing activities more than ever before. In 1947, for cities with populations over 25,000, the operating revenues from all forms of local enterprise amounted to over $811 million, of which $346 million came from water-suppy systems, $165 million from electric light and power systems, $234 million from transit systems, and the remainder of $66 million was derived from all other forms of municipal enterprise such as transit systems, port facilities, airports, and so on.[6]

[4] *Annual Report of the Secretary of the Treasury*, 1948, pp. 580 and 584.
[5] *Statistical Abstract of the United States*, 1949, p. 410.
[6] Ibid., p. 411.

Revenues from Administrative Services

IN THE PERFORMANCE of such governmental functions as the provision of facilities for the convenience of society, the protection of property and persons, and the establishment of regulations for commerce and industry, units of government have occasion to collect revenues from the individuals who benefit directly from these services. These revenues may be a result of benefit received, cost of service, or a penalty, but they are not necessarily in proportion to the benefit or to the cost of service. Primarily, however, these revenues are derived from fees, licenses, fines, special assessments, and excess condemnation.

REVENUES FROM FEES

A fee is a charge imposed as the result of the performance of a "special service" on the part of a governmental agency and the receipt of a special benefit on the part of an individual or group. Considerable sums are received from tuition fees, passport fees, court fees arising out of judicial procedure, and many others. One advantage of the fee system is that these revenues are easily collected at the time the special service is rendered. The payment of fees emphasizes the benefit of the service for the individual, and also prevents the wasteful use of public resources and public services which might occur if they were offered without charge.

Under some state laws, certain public officials are permitted to retain the fees collected in lieu of salary. This practice results in serious abuses, especially in the case of county sheriffs, constables, justices of the peace, and others. There is a tendency to put the emphasis upon the accumulation of fees rather than upon the fair and objective performance of the functions of the office. Unbiased and competent public service requires that officials be paid salaries and that fees be turned over to the public treasurer.

Recently, with the urgency for revenue at the local level, the fee system has been advocated as a supplement to the ordinary sources of revenue. Since many local services are of direct benefit to certain individuals, businesses, and property, fees are considered an equitable method of financing. Another development in fee revenues at the state level has come in connection with those industries which require regulation in the public interest. Wisconsin and a few other states now charge the public utilities fees for the administrative costs which they create.

REVENUES FROM LICENSE GRANTS

The fees discussed above are the type charged in exchange for some "specific service." Fees are also charged in connection with the granting

of a "privilege" which is of a personal and business advantage to the grantee. These are usually spoken of as "license fees." The license fee is more likely to be used in connection with some form of regulative control than is the ordinary fee. It is more definitely an expression of the police power. The permission to operate a pool and billiard hall, or to hunt, fish, or to conduct a pawn shop, involves payment of a license fee.

License fees vs. license taxes. There has been considerable difficulty in distinguishing between the "license" as a charge made incidental to an "administrative function," usually that of supervision and regulation, and the "license as a form of taxation." Some charges are imposed under the guise of license fees, but these charges are actually in the form of license taxes. The ease with which applicants for motor vehicle licenses, for example, may register false or temporary addresses or even alias names indicates that this charge, originally for regulatory purposes, has lost some of its effective regulative character and has become a kind of motor vehicle taxation.

The truth which the judges have vaguely seen (and which they have attempted to realize in their decisions) is simply this: A fee is a payment for a service or privilege from which a special measurable benefit is derived, and normally it does not exceed the cost of the service; a tax is a payment where the special benefit is merged in the common benefit or is converted into a burden. A fee remains a fee, whether levied under the taxing power or the police licensing power; and a tax is no less a tax when classified under the police power than when put under the taxing power.

Revenues from license fees and taxes. The best records available on these revenues are for state governments. Preliminary figures for the fiscal year ending June 30, 1950 reveal that total license and privilege taxes (including motor vehicle) collected by all states amounted to $1.2 billion.

The statistics on license fees and taxes collected in our cities are quite incomplete, but some general conclusions may be drawn. Business license fees constitute a leading source of revenue in many southern and Pacific Coast cities. Some larger cities collect more than a million dollars per year from this source. In the South, Richmond, Birmingham, Louisville, Montgomery, Mobile, and Little Rock are a few of the cities which derive substantial revenue from license sources. The business license in this region has been used to supplement property taxes.

Wider usage of business and occupational license taxes by Pacific Coast cities is a newer development accelerated by World War II. Seattle has made good use of such taxes. One small city in Oregon (Veronia, population 1,500) levied no property taxes one year because its water revenues and business license revenues were sufficient to meet all municipal expenses.

REVENUES FROM FINES AND FORFEITURES

A fine is a charge levied upon individuals in the process of enforcing the laws, as a penalty for their infraction. It is levied with regard to the severity of the offense rather than with regard to the offender's ability to pay, although judges and other officials responsible for enforcing the law frequently have the option of remitting or suspending the fine, or of varying the actual amount imposed within limits indicated by the statute. This charge is an exception to the statement made about non-tax revenues having an element of "benefits received." Furthermore, fines and penalties bear no logical relation to the cost of administering the protection and justice functions of government.

Forfeitures of bail or bond are comparable to fines in that they are penalties for the failure to appear in court and to meet other special obligations associated with the administration of justice. Neither the fines nor the forfeitures are levied with the intent of filling the public treasury. They are basically "by-products" of the administration of justice and the enforcement of the law. It must not be overlooked that as a practical matter in many of our large cities the traffic and police courts do bring in substantial revenue.

SPECIAL ASSESSMENTS

Special assessments are compulsory levies against a piece of property to meet the costs of specific improvements to the property. Their distinguishing characteristic is that a specific benefit is involved, although this does not preclude the possibility of a general benefit. Most special assessments are in payment for services which make property more desirable to own. They resemble property taxes in that they are levied on the property values and are a claim on the property, not on the property owner. These assessments are levied on church, educational, lodge, and other property usually exempt from other forms of regular property taxes. The greatest value of special assessments is that they facilitate extensive improvements needed in a rapidly developing community. The disadvantages of special assessments are that they may become excessive because of the fact that they are usually exempt from debt limitations. These faults should be corrected. Unscrupulous speculators often force improvements which are not needed and which overburden property with debt.

In practice, projects are usually proposed by the governmental unit. Property owners are then given some power of rejection after a public hearing. However, since the interests of the general welfare are paramount, the veto cannot be exercised except by a majority of the property owners. The principal difficulty in the use of special assessments is in the measurement of the benefit. This measurement may involve the fol-

lowing questions: (1) What portion of the improvement is of general benefit and should be paid for from general tax funds? And what portion is of special benefit and should be paid for by special assessment? (2) What territory is to be included in the special assessment district? (3) What method—frontage, area, or depth curve—should be used to distribute the cost among properties in the district? The most equitable means is the depth curve (or percentage of depth value to the frontage), otherwise a lot with a 60 foot frontage and an 80 foot depth would pay as much as one with a 140 foot depth.

Improvements which are ultimately paid for by the special assessments upon the property owners may be financed in the first instance by a number of different methods: (1) special assessment warrants, which force the contractor to collect the assessment installments when they fall due; (2) special assessment bonds issued by the governmental unit involved; and (3) a revolving fund involving the sale of bonds to create the fund. These funds reduce the cost of financing by eliminating the high interest rates payable on special assessment bonds.

Prior to 1929 special assessments were used very extensively to pay for streets, roads, and highways. With the development of gasoline taxes, they are no longer used to finance state highways. They are still significant in financing the construction of city streets. But even here, since the cities now acquire a larger share of the gasoline tax revenues, the burden of financing city streets by special assessments is being lessened.

REVENUE FROM EXCESS CONDEMNATION

There is, however, an alternative method for the financing of limited local improvements. This is by excess condemnation. It is defined as the practice by governments of taking by "right of eminent domain" more property than is needed for the specific public project and then profiting by its later sale or lease. The proceeds from the sale or lease of the surplus property may be directed to payment of the cost of the improvement or for other public purposes, in case such receipts exceed the cost.

This technique has not been extensively used in the United States; in fact in most states there are legal barriers to its use, and the courts have had the tendency to construe "taking for a public purpose" somewhat narrowly. Some states have modified their state constitutions to permit limited excess condemnation. Among these are California, New York, Massachusetts, Ohio, and Wisconsin. In California the state and cities may condemn property a distance not to exceed 150 feet from the boundaries of the recognized public improvement, and they may "zone" the excess property to protect and preserve the view, appearance, air, and usefulness of the public works.[7]

[7] *California Constitution*, Art. I, Sec. 14½.

Even from the point of view of the cities, excess condemnation and the sale of the excess may not be all profit. The condemnation price may be too high; other "damages" to private owners may have to be paid for the loss of good will and established trade advantages; the sale of the excess may be slow and at low prices. Then there is the matter of the "interest charge" on the money used to buy the surplus land.[8] All these can add up to some risks and burdens for municipal governments.

Revenues from Interest

INTEREST ON DEPOSITS

There is seldom a perfect coincidence between revenue receipts and disbursements by our various units of government. The result is that for certain periods of time over the fiscal year there may be surplus funds on hand. Cash balances of any size are not merely kept in a vault. Usually they are deposited in commercial banks. During the 1920's the state and local governments were able to get interest on their deposits, and it was not uncommon for them to collect sizeable earnings that way. Even the federal government received 2 per cent interest on its deposits with the Federal Reserve banks and large numbers of commercial banks that served as depositories. The Banking Act of 1933 enjoined member banks from paying interest on demand deposits both public and private (unless agreements to pay were in effect when the Act was passed), with the result that very few units of government receive interest on their demand deposits today.

INTEREST ON LOANS

In recent years new sources of interest-revenue have arisen for the federal government as the result of the credit activities of many special federal corporations such as the RFC, HOLC, FHA, and as the result of loans to farmers, veterans, and others. In 1948 this ran into appreciable dollar figures—$269.8 million for a large number of federal credit and non-credit agencies.

With some exceptions, the state governments have few "direct loans" on which they may receive interest. Most state constitutions forbid the extension of public credit to outside enterprises. But most of these governments maintain sinking funds and trusts funds which are invested in interest-yielding securities. A common procedure is to invest such funds in the bond issues of the governmental unit that maintains the fund. However, at the present time state and local governments own over $6 billion in United States Government bonds on which they draw interest in the same manner as private holders.

[8] Lutz, *Public Finance*, p. 240.

Revenues from the Public Domain

FEDERAL GOVERNMENT LANDS

Under the feudal system, the king as the chief lord received revenue from the "lands" of the country. As constitutional governments were established, these estates of the kings became public property. In modern times, governments have usually disposed of large portions of their land holdings to private owners.

Article IV of the Federal Constitution grants Congress the right to determine the disposition of the public domain including forests, mineral lands, waste lands, public parks and game preserves, and other lands reserved from ordinary use.

The income from the sale of public lands has not been of any great importance as a source of revenue for a number of years. During the first half of the nineteenth century, however, customs duties and proceeds from the sale of public lands were the major sources of revenue for the federal government. The heaviest sale occurred during Andrew Jackson's second administration when 12 million acres were sold in 1835 and 20 million acres in 1836. The dollar sales amounted to about $25 million in the latter year. Between 1800 and 1860 the land was sold for $1.00 to $2.50 per acre. Even in the period from 1880 to 1900 the proceeds ran from $2 million to $13 million per year. More recently (1900-45) receipts of the general land office have ranged from $4 million to $14 million per year—the latter figure being for 1945.[9] These figures are now a minor proportion of total federal revenues.

Today the flow of lands is in the opposite direction. Federal, state, and local governments are looking toward the acquisition of land for conservation measures and to provide outdoor recreational facilities, both activities, which, incidentally, are destined to provide increased revenues through the use of royalties, fees, and licenses.

STATE AND LOCAL LANDS

Large areas of land reverted to control of the various states during the 1929-33 depression period through tax delinquencies. In a number of states, legislation is such that the state has clear title to these lands. All states are not so fortunate, for they are required to go through a rather lengthy procedure to obtain title. State governments usually have very small amounts of rentable property. However, there are some states which act as landlords of farms operated by tenants.

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[9] *Historical Statistics of the United States, 1789-1945*, Bureau of the Census, Department of Commerce, Washington, D. C., 1949, pp. 119-120.

Revenues from Expropriation

EXPROPRIATE REVENUES

In ancient times it was a common practice for the "victor to take the spoils"—that is, to confiscate the property of enemy aliens. Today, the governments seize all enemy alien property found "within their boundaries" immediately upon the declaration of war. Thus, in two world wars the federal government has confiscated hundreds of millions of dollars worth of enemy ships, factories, patents, bank deposits, and other property.

After the close of wars, the modern version of expropriate revenues are *reparations* in money, goods, and capital assets. Equipment, coal and other natural resources, rolling stock, and gold have been removed from "occupied countries" to aid in reconstructing the war-damaged areas of the victorious nations and to support armies of occupation. However, our own federal government made no claim to reparations after World War I. Since the close of World War II, France and Soviet Russia have removed equipment, coal, and other natural resources from Germany for reconstruction purposes at home and to support armies of occupation. Great Britain and the United States have made withdrawals, but these were largely to cover part of the costs of occupation.

REVENUE FROM ESCHEATS

State governments acquire some revenue by mere chance. The ultimate title to all property, real and personal, resides in the individual state as a sovereign power. State governments under their laws of conveyancing during life and by their laws of wills and inheritance at death regulate the transfer of property. If a person dies intestate and without any known heirs, his estate "escheats" or reverts to the state. Usually intangible personal property reverts to the state of the decedent's domicile, whereas the real and tangible personal property go to the state in which they are located at death. This type of state income is entirely fortuitous and of no real revenue significance.

Revenues from Gifts and Grants

GIFTS FROM CITIZENS

On occasion, all units of government receive gifts from private citizens, either *inter vivos* or at death. Generally these contributions are designated for some special purpose such as the establishment of libraries, museums, public parks, hospitals, athletic fields, and other public purposes. Usually they take the form of real or personal property rather than money.

The gifts are characterized by the absence of a claim of direct benefit to the donor, except the personal satisfaction enjoyed in knowing that some worth-while activity has been encouraged. Gifts are rarely given for the purpose of carrying on the current and ordinary activities of government. They usually involve the presentation of fixed assets to be used and enjoyed in the long run and are, therefore, no contribution to current revenue.

GRANTS-IN-AID

Another form of grant that has expanded on the American fiscal scene since World War I is the grant-in-aid from a higher to a lower unit of government. Such grants are not "new" and "net" revenues, for they have their source in the "taxes" or "borrowings" of the upper unit. They are primarily a *transfer* of a pre-existing revenue. To the unit that receives such a grant, it does give a greater ability to perform certain public services in greater quantity and of a better quality.

In 1949 local governments in the United States received over $3.5 billion in aids from state governments. Recent years have seen a major expansion in such aids. In 1915 only $110 million in such grants were transferred from the state units. The amount has more than doubled since 1940. At present, the great bulk of these aids are expended for education, welfare services, highways, and other purposes often left to the discretion of the local units. Federal aids to state and local units amounted to $1.8 billion in 1949.

Conclusions

THOUGH TAXES are the basic source of public revenue, they are by no means the only one. A family of revenues designated as non-tax sources, though they do not bulk large in the the total collections, at times and for some units of government *are* fiscally quite significant. Non-tax revenues constitute a miscellaneous array of relatively minor individual sources that arise out of the performance of many administrative and proprietary functions. They include revenues from (1) public enterprises, (2) administrative functions, (3) investments, (4) public domain, (5) expropriation, and (6) gifts and grants.

Some non-tax instruments are difficult to justify. Some of them are poorly adjusted to costs and benefits, and others disregard the ability to pay. Some raise issues of how far units of government should go in the performance of essentially "proprietary functions." Water, electricity, and local transit charges can be justified on the theory that they are strongly "affected with a public interest," and these charges have been subject to regulation for many generations. Several pitfalls in the

use of certain non-tax revenues must be avoided: (1) Care must be taken to avoid a system of special privileges for those who can pay them. (2) Non-tax revenues should not be used for those services which are substantially of a general welfare character. (3) Revenues from these special sources should be accurately accounted for and husbanded to the use of the unit of government and not the officers and collectors themselves.

There is little doubt that non-tax revenues of selected types should be expanded by municipal governments to get at those who receive many special and general benefits without contributing to the revenues under the general property tax.

Part Eight

TAXATION AND THE FUNCTIONING OF THE ECONOMIC SYSTEM

XXVIII. THE RELATION OF TAXATION TO ECONOMIC AND BUSINESS LIFE

XXIX. TAXATION AND TAX POLICY IN WARTIME

XXX. TAXATION AND TAX POLICY IN PROSPERITY

XXXI. TAXATION AND TAX POLICY IN DEPRESSION

XXXII. TAXATION AND A BALANCED FISCAL POLICY

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The Relation of Taxation to Business and Economic Life

MORE AND MORE, *taxation is being related to the problems of the economy—to such objectives as increasing the national income, stablizing the economy, maintaining high-level employment, encouraging investment, and increasing the flow of consumer purchasing.*

—ALFRED G. BUEHLER.[1]

Overview

AN ECONOMIC SYSTEM functioning effectively has a high volume of employment of both capital and labor, high production of the most beneficial kinds of goods and services, a minimum wastage of human and material resources, a wide diffusion of income among the people, and a reasonable degree of economic stability. That most Americans believe that a private-enterprise system in the matrix of a democratic way of life is a requisite for enjoying these economic objectives can hardly be doubted.

The problem of employment has especially taken the fore in recent social thought. As one economist notes, adequate and stable job opportunity depends upon two conditions: first, an adequate and stable, actual or potential demand for goods, and second, a system that will respond to this demand with increased production and employment rather than with increased wages and prices.[2] Tax policy is clearly relevant to both conditions.

Within this chapter the author examines the strategic relevance of taxation and tax policy to America's private enterprise system. A general view is presented of the relation of taxation to over-all fiscal and economic policy. The specific junctures at which taxation affects the operation of

[1] Alfred G. Buehler, "Taxation and the Economy," *National Tax Journal*, Vol. 3, June 1950, p. 121-133.

[2] John Maurice Clark, *Guideposts in Time of Change*. New York: Harper & Brothers, 1949, pp. 79-80.

a private enterprise system are analyzed and appraised. Therefore, there is explored the relation of (1) taxation and work incentives, (2) taxation, risk-taking, and investment, (3) taxation, private demand, and consumption, (4) taxation and the total income stream, inflation, and the "direction" of production, consumption, and distribution, and (5) taxation and the form and conduct of business activity.

Tax Policy Needs Greater Inductive Verification

THE RELEVANCE OF TAX AND ECONOMIC POLICY

Taxation is but one of several aspects of governmental fiscal policy in particular and of economic policy in general which can have noticeable influences upon the economic system and private business activity. The amount, timing, and incidence of taxation can never be separated from such other aspects of fiscal policy as the amount, timing, and direction of governmental expenditures, and the amount, timing, and distribution of changes in the public debt. An effective program for aiding business activity requires careful co-ordination of all three, together with other types of economic policy, both public and private.

PRINCIPLES PARTLY HYPOTHETICAL

Principles developed concerning the relation between taxation and private business activity range from the largely hypothetical to a smaller portion which is inductively confirmed enough to gain reasonable acceptance. On a more firm foundation, for example, are the principles relating to the effects of taxes on saving, consumption, incentives to invest, and the distribution of income.

CONFLICT IN ECONOMIC IDEOLOGY

When the problem becomes one, however, of relating these factors to the functioning of the economy at high and increasing levels of production and employment, the economic chorus becomes more dissonant. Such lack of harmony rests most frequently on the split which has occurred in economic thinking between the Neoclassical school of economics and that which was developed by John Maynard Keynes–the aggregate income or purchasing power school.[3] The Neoclassical school has been predominant in this century up to the present day, but it has

[3] Literature on Keynesian economics is increasingly abundant today. The first development of the new theory may be found in John Maynard Keynes, *The General Theory of Employment Interest and Money*. New York: Harcourt, Brace and Co., 1936. For a more elementary exposition of the new theory see Dudley Dillard, *The Economics of John Maynard Keynes*. New York: Prentice-Hall, Inc., 1948.

been increasingly challenged by both Keynes and the American, Alvin Hansen. Specific points of disagreement most generally concern the economic significance of savings and consumption.

NEED FOR INDUCTIVE VERIFICATION

Much of the disagreement concerning tax effects could be reduced through improved quantitative knowledge. Not enough is known, for example, of the short- and long-run elasticities of desire for income and leisure, for savings and consumption, nor of the importance of non-monetary incentives to business activity. Even the more firmly-held principles concerning the effects of taxation upon savings, consumption, and incentives to invest have not been adequately verified. As a result, tax decisions and tax principles must be based in large measure upon the most reasonable assumptions. Although workable policy can in most cases be found, the assurance of more concrete data would be welcome.

Taxation and Work Incentives

INCENTIVES TO WORK NECESSARY IN OUR SYSTEM

There is little doubt that the incentive to invest time and energy in productive work is essential to the proper functioning of a private-enterprise economy. Our country has 3.8 million business enterprises and 6 million agricultural enterprises, which altogether make up 10 million centers of initiative.[4] These centers of initiative must be kept functioning healthily, competing with each other for new and better products at lower costs, abundantly encouraged with incentives to innovate, invent, expand, and provide employment.

TAXATION CAN AFFECT INCENTIVES

The tax system by influencing the net income received by individuals and by permitting public satisfaction of wants to supplement private satisfactions, can substantially affect such incentives. It may be found, for example, that increasing a withholding tax will stifle a worker's interest in larger productivity through improved technology. Even the social security system can undermine the ambition and thrift of an individual insofar as it makes his future welfare appear independent of his productive effort.

EFFECTS OF TAXATION NOT CRYSTAL-CLEAR

Nevertheless, the net effect of such taxes as the income tax upon private initiative is in doubt. First of all, there are other incentives to work

[4] Sumner H. Slichter, *The American Economy*. New York: Alfred A. Knopf, 1948, p. 18.

and effort besides the economic. These incentives may include enjoyment of the job, desire for power, social approval, moral compulsion, and other psychological and ethical considerations. This is especially true in the managerial and professional classes. Second, the effect of taxation upon economic incentives does not always result in less effort for less pay. This may be seen in the case of an individual who has already committed himself to a given standard of material comforts. If the income of such an individual is reduced by taxation, he may desire to work even longer and harder to maintain his standard of living. There has been observed some tendency to want to maximize the "take-home-pay" after taxes.

Whether individuals will work less and retire early, or whether there will be an actual increase in initiative and effort as a result of additional taxation depends in economic terminology upon the "elasticity of the demand for income in terms of effort." If the elasticity of demand for income in terms of effort is greater than unity, then the effects of a tax will be a diminution of work done. If it is less than unity, a tax will result in an increase in work done. After an intensive study of the various arguments, one economist concludes that "... any attempt to predict the effect of a change in the terms on which income is earned must proceed by inductive investigation of elasticities. The attempt to narrow the limit of possible elasticities by *a priori* reasoning must be held to have broken down." [5] Statistical investigations have not yet afforded sufficient information to make an absolute calculation one way or another concerning the net effect of taxation upon work incentives.

TAX POLICIES TO STIMULATE INCENTIVES TO WORK

Whatever the net effect of taxation upon initiative and effort, certain types of tax policies may tend to minimize the adverse effects during the productive period. Among the more relevant policies in this connection are: (1) avoidance of high marginal rates on personally created income (whenever fiscally possible), (2) adequate recognition of losses, (3) provision for averaging income, and (4) allowance of an "earned-income credit." Adjustments of the above character could encourage the driving forces of economic initiative that are necessary in our kind of economic system.

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[5] Lionel Robbins, "On the Elasticity of Demand for Income in Terms of Effort," *Readings in the Theory of Income Distribution*, Blakiston Series of Republished Articles on Economics, Vol. 3. Philadelphia: The Blakiston Company, 1946, p. 244. As reprinted from *Economica*, Vol. 10, June 1930, pp. 123-129.

Taxation, Venture Capital, and Investment

SIGNIFICANCE OF PRIVATE INVESTMENT IN THE ECONOMY

Private investment plays a dominant role in the operation of a private economy. There is a close relation between enterprise, progress, and innovation. First, progress comes largely from the innovation of private enterprisers, and second, the private enterprise system is better able to weather the flood of innovations than any other social system.[6] The tax system must not place a brake upon the enterpriser's propensity to innovate and to expand.

Maintaining the flow of "venture" or "risk" capital has long been of concern to economists, taxation experts, businessmen, and others interested in the functioning of the economic system. The strategic significance of private investment is revealed in a variety of ways.

Private investment maintains and raises the productivity of the nation and the standard of living of the people. It helps prevent economic "stagnation," [7] determines the severity of business cycles, helps determine the long- and short-run levels of employment, and when funneled into large and small business (both old and new), it helps maintain the vigor and growth of our economic system.

ECONOMIC DETERMINANTS OF PRIVATE INVESTMENT

Insofar as taxation can influence the determinants of investment, it can influence investment itself and thus the attainment of the economic objectives. But the economic determinants of investment become subject to dispute by the orthodox and Keynesian analysts. Controversy flares over the strategic significance of savings and consumption.

Orthodox theory. The more orthodox economists generally have assumed a tendency for full employment to exist in a free-enterprise system. Business cycles tend to swing around this full employment level. Economists base this assumption on what have come to be known as Say's Law of Markets and Marshall's Law of Substitution.[8] Say's law asserted that there will always be a sufficient rate of spending to maintain full employment, since the supply of goods creates its own demand for

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[6] Clare E. Griffin, *Enterprise in a Free Society.* Chicago: Richard D. Irwin, Inc., 1949, pp. 318-319.

[7] The name of Alvin Hansen has been most closely associated with the theory of "secular stagnation." See especially his *Fiscal Policy and Business Cycles.* New York: W. W. Norton and Co., 1941, and his *Full Recovery or Stagnation?* New York: W. W. Norton and Co., 1939.

[8] Jean Baptiste Say was an early nineteenth-century French classical economist. Alfred Marshall founded the Neoclassical school of economics at the turn of the twentieth century.

goods. Marshall, in addition, said that there is always some wage at which all labor will be employed, if competition is permitted to force it to the appropriate level. Under such conditions, everything an individual saves also tends to be spent. Savings are spent for producers' goods (investment). This equality between savings and investment tends to be brought into adjustment by means of flexibility in the interest rate. Business cycles are due largely to price-cost maladjustments, monetary and banking factors, and the like.

The major way to increase investment, then, according to orthodox theory, is to increase savings. Investment would increase, even though consumption is decreasing, because the additional savings are a potential future demand for goods. To the practical businessman this implies the type of *tax policy* which would not cut heavily into savings and therefore the propensity and capacity to risk and to invest. More specifically, this would mean more moderate rates in the middle and upper brackets of the personal income tax and lower corporate net income tax rates. It would also involve avoiding the use of an excess profits tax.

The new economics. Some new economic analysis stimulated by Keynes' work has postulated a closer relation between present consumption and investment than the more orthodox economists have assumed. This body of thought has also denied the necessity for savings to equal investment at a full employment level of income.

In a "mature and wealthy" economy, the new economists claim, chronic unemployment tends to persist. This is because a wealthy economy has a high "propensity to save" and a low "propensity to consume." Saving, they say, is detrimental to investment and full employment, because saving is merely an act of removing money from consumption.

Without an offsetting inducement for the businessman to invest, an increase in saving tends to reduce the national income and thus reduce the "effective demand" for the products of industry. The interest rate tends to be insensitive to the volume of savings, especially in a depression. Therefore the interest rate does not fall sufficiently to induce the businessman to borrow the added savings and invest them.

The new economists attribute these "oversavings" largely to inequalities of income. One way to increase national income (and thus the volume of employment, production, and investment) is to redistribute the income from higher- to lower-income groups. This would tend to increase the volume of consumption and absorb the oversavings. Progressive taxation to redistribute income is therefore encouraged by these economists.

In the practical arena of political economy the low-income people and their labor leaders attempt by tax policy to conserve purchasing power in the hands of millions of consumers. They favor fostering consumption and demand by steeply progressive personal income taxes, high exemptions and low rates in the bottom brackets, substantial corporate net income

taxes, and excess profits taxes. They would also refrain from the resort to sales and some excise taxes.

The more orthodox economists and business groups, on the other hand, seek to encourage full employment by creating wage and price flexibility, by regulating monetary and banking policy, and the like. Then investment would be increased by increasing saving, not by decreasing it, and by increasing incentives to invest. This would require encouraging thrift on the part of the people and avoiding greater equalization of income.

SOURCES AND OWNERSHIP OF RISK CAPITAL

Knowledge of the sources of risk capital and of who owns and uses it is essential for its preservation. In general, risk capital comes from two sources; first, the savings of individuals, and second, the earnings of business ventures which are retained for expansion purposes rather than distributed to the individuals who have supplied the capital. After a survey of the ownership of old and new venture capital, one study reaches the following conclusions.[9]

1. There is no particular income group primarily responsible for having made the risk investments in the past. The dispersion of profits and dividends extends far up and down the income scale.

2. Tax adjustments must not be limited to corporations. Sole proprietorships and partnerships have owned and used more than half as much venture capital as corporations reporting net income since 1924.

3. A large number of small investors, having a relatively small stake individually in the country's business, have in the aggregate contributed a substantial proportion of venture capital in the past.

4. The reinvestment of earnings is an important source of funds for the expansion of both corporate and non-corporate concerns. In the aggregate, small firms contribute a substantial proportion of the total.

5. As individuals accumulate personal fortunes and as their estates grow, they tend to provide venture capital by investing in corporation equities.

A recent study by the National Bureau of Economic Research showed that between 1919 and 1938 the top 1 per cent of the population received on the average 65 per cent of the total dividends from stock, and the top 5 per cent received 77 per cent. However, it must be observed that in distinguishing the top 1 and 5 per cent groups, the study reached well down the income scale. The lowest units of the top 1 per cent received incomes which ranged from $8,000 to over $16,000 for a family of four. And the lowest units in the top 5 per cent group ranged from $5,000 to

[9] *A Tax Program for a Solvent America* (Committee on Postwar Tax Policy). New York: The Ronald Press, pp. 81-82.

$8,000 for a family of four. The shares of income for the upper-income groups remained about the same from 1919 to 1938. However, they declined materially from 1939 to 1945 and by 1948 had recovered but little.[10]

THE STRATEGIC ROLE OF PROFITS

Profits play a particularly strategic part in determining the amount of new investment and economic progress to be maintained by a private-enterprise society. Their role is a triple one. First of all, profits and the prospect for profits provide the incentive to invest—an incentive that is sensitive to attack by social and economic influences. Without prospects for profits, none of the other motivations for investment (such as social approval, moral compulsion, and desire for power and prestige) could long exist, for without profits a firm would die or would not even be born. Second, in our system profits supply one of the major sources from which new investment comes. High taxation of profits tends to absorb a large fraction of private investible funds. Third, differentials in profits direct investment into the most productive channels. These three roles make profits one of the most "dynamic elements" in a private-enterprise economy. The many careless attacks upon the concept of profits today imply that the functions of profits in our system are only imperfectly understood.

Only when profits are left idle—that is, neither invested nor distributed—can they be said to be detrimental to the successful operation of the economic system. Even then their anticipation still is a primary motive for investment, and their holding may give employment at a future date when a loss would ordinarily force the firm to reduce employment or fold up completely. Before an attack upon profits is made through the tax system, the particular use to which such profits are put must be carefully investigated.

INFLUENCE OF TAXATION UPON INVESTMENT

Influence upon basic economic determinants. The main emphasis of the purchasing-power school for preserving a high degree of investment (and thus employment and income) has been upon the redistribution of national income from the savers to the spenders to take advantage of a high marginal propensity to consume. Keynes himself emphasized the need for a steeply progressive personal income tax.

Many economists, on the other hand, put greater emphasis upon maintaining the "supply of savings" through taxing high incomes less rather than more, since they view savings as one of the strong causal influences

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[10] Simon Kuznets, *Shares of Upper Income Groups in Income and Savings.* New York: National Bureau of Economic Research, Inc., 1950, pp. 2-4.

in maintaining investment. The ability to keep larger portions of earned income creates incentive to offer funds for investment.[11]

Influence on motives to risk and initiate. Besides affecting the basic economic determinants of the quantity of investment, taxation may perhaps even more forcefully influence the specific motivations of the businessman and saver to invest and risk his capital and to initiate new enterprise.

The motives for risk-taking are very sensitive to attack. This is because they are not only economic but also psychological. The primary motive for risk-taking is the hope of profit. The "jackpot" rewards especially offer the greatest hope for economic progress, because these are the incentives for major industrial innovations. High marginal income tax rates are prone to discourage new businesses which are particularly risky. Quite often it is these high-risk rewards which are penalized most by our tax system, for there is little opportunity for offsetting losses.

Very few undertakings guarantee a profit. There is usually an element of risk in every enterprise, especially at its inception. When the hand of taxation distorts the balance between the decision to risk or not to risk, its economic impact may be adverse to going forward with investment. The extra effort, worry, chance of loss, and additional managerial responsibility that go with new investment may make it unattractive if taxation loads the dice against the chance of compensating gain. Tax devices must be very carefully hewn.

That does not mean, however, that high taxes inhibit all new risk-investment. Our World War II experience with the excess profits tax demonstrates that when taxes are very high, business firms may take risks which they would not normally assume, because the risk expenditures are comparatively costless. They are costless in the sense that they would be income subject to high taxation—the money that is risked is income that would otherwise go to the government. This is a special case—one which can also be subject to abuse. It does not mean that high taxes *per se* stimulate risk investment.

The motives of men in risking their savings and abilities are neither easily classified nor measured. These include prestige, desire for power, and moral compulsion, as well as the expectation of profits. Nevertheless, some hypotheses on the effects of taxation upon motives to risk are generally accepted.[12]

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[11] One of the strongest protagonists for a less progressive personal income tax is Harley L. Lutz. See especially his *Guideposts to a Free Economy*. New York: McGraw-Hill Book Co., 1945.

[12] An excellent discussion of these factors will be found in Groves, *Postwar Taxation and Economic Progress*, pp. 8-11; see also Lewis H. Kimmel, *Taxes and Economic Incentives*. Washington, D. C.: The Brookings Institution, 1950.

1. The higher the "degree" of taxation, the more likely it is to affect economic propensity to risk, venture, and invest.

2. The tax rate on the "marginal part" (the top bracket) is of greater strategic significance as far as new risk-taking is concerned than the average effective rate. This is true under either personal income or business taxes.

3. The "form" as well as the "degree" of the tax is significant in risk motivation. A balanced arrangement can lessen the burden.

4. The fear of losses may be as significant as the hope for gain. This would suggest proper allowance for losses.

5. Taxes placed immediately upon business firms as such are more likely to curb investment than comparable levies on private individuals. This is because an increasing proportion of investment decisions are being made by management within organized, largely corporate, business.

6. The propensity to risk and venture is relatively sensitive to attack. The relatively secure investments compete strongly with the more risky undertakings.

7. Expectations of tax reductions or increases may be as stimulating or depressing as the taxes themselves. This is because incentives for business expansion depend upon anticipating the future.

8. Uncertainty and frequent changes in tax laws are detrimental to business investment and production. Retroactive changes are particularly unfair because they prevent adjustment of the business activity to the tax.

9. A tax program which places reasonable emphasis upon neutrality will facilitate business expansion and production more than one which makes the consideration of tax consequences enter into every business decision.

10. The "timing" of taxes is important in influencing business activity and investment. Heavier levies only after the creative economic activity of an individual has almost ceased (as in the application of the death tax) will have the least deterrent effect.

Tax adjustments to spur investment. Based upon the preceding principles, there are a number of tax adjustments which appear useful in encouraging the flow of venture capital. Insofar as any of these particular adjustments force greater reliance upon taxes striking consumer purchasing power, some economists would undoubtedly feel that their value for stimulating greater investment is annulled. Here the loss in purchasing power would have to be weighed against the stimulative effect upon investment in order to determine its usefulness. Among the various tax adjustments that are "usually recommended" as least disruptive of investment incentives or positively stimulative to risk-taking are:

1. Avoidance or downward adjustment of any excess profits tax.
2. Removal of "double" taxation of corporate profits.

3. Reduction of the corporation income tax is a possible substitute for the removal of "double" taxation (where the latter is not politically feasible).

4. Removal of nuisance and high-cost-of-compliance taxes.

5. Emphasis on the personal income tax rather than taxes directly levied against business–corporate, individual, or partnership.

6. Reducing rates in the middle and upper brackets of the income tax. It is from these brackets that most investment funds originate.

7. Allowing carry-back and carry-over of business losses in calculating the corporation and the individual income tax. Due consideration must be given losses to make the investment worth the risk.

8. Granting accelerated depreciation. Depreciation of capital equipment over a period shorter than the service life for tax purposes will, in time of investment slump, give added incentive for risking capital in new investment.

9. Current deductions for research and development. Such deductions will help stimulate the research that opens up fields for new investment.

10. Removal of tax-exempt features from public securities. By the elimination of intergovernmental exemption of state, local, and federal securities from income taxation there may be some incentive to invest in higher-yielding, venture-capital securities.

11. Resort to sales and consumption taxes. This would shift the tax burden to the lower-income groups rather than to the savers and investors.

12. Special treatment of reinvested earnings through the capital gains tax. The taxation of reinvested earnings of corporations only when realized as capital gains (either upon sale of the stock or upon death) would encourage reinvestment of earnings by the corporation. This would probably require that capital gains be taxed at or near the regular income tax rates to help compensate for tax postponement.

13. Greater stability in tax laws appears desirable as an incentive to investment, although the use of taxation as an instrument of fiscal policy may prevent stability in specific rates and taxes.

14. A general progressive tax on spending would be the most extreme consumption-penalizing measure in the name of aiding investment. Some economists would consider it as hindering both consumption and investment, but of strategic value in preventing inflation.

Taxation, Private Demand, and Consumption

SIGNIFICANCE OF PRIVATE DEMAND AND CONSUMPTION IN THE ECONOMY

The effect of private consumers' purchasing power upon employment, production, and investment has frequently been overlooked by businessmen and others, especially in their tax thinking. As a result, tax programs advocated by such groups often would bite deeply into private demand for goods and services in the hope of conserving incentives and investment. As noted, the purchasing-power school of economics has in contrast laid great stress upon the strategic relation between private demand and investment, especially during periods of less than full employment. Tax programs of labor economists and other groups have reflected this new emphasis.

In their business analysis, in frequent contradiction to their tax policy, businessmen and bankers recognize the importance of private demand. They keep their attention fastened on the upward or downward trend of sales as a guide to the expansion or contraction of production and investment. This is natural because the level of demand for goods and services determines cost-price relationships, profits, and expectations of profits. It is the expectation of profits which stimulates investment in new capital.

TAX ADJUSTMENTS TO SPUR CONSUMPTION AND DEMAND

A number of tax policies are advanced as conducive to the maintenance of high levels of consumer purchasing power. Those taxes are detrimental to consumption which fall heavily on the individuals with small and moderate incomes. These groups consume almost all their income, and any savings they may have are usually meticulously guarded. Tax policies to aid consumption must, therefore, it is argued, reduce the tax burden on the lower- and moderate-income groups and thus release purchasing power for private goods. Among the policies usually suggested are:

1. Increasing exemptions for lower-income groups under the income tax. The income released would be spent almost entirely for consumption.
2. Lowering the income tax rates in the lower brackets. The effects should be similar to the effects from increased exemptions.
3. Avoiding sales taxes. Although sales taxes may reduce savings of the higher-income groups, their net effect is to reduce consumption more than savings. Such taxes are especially noticeable on state and local levels.
4. Reducing or removing certain excise taxes. Although excise taxes on luxury items largely consumed by the higher-income groups probably

reduce savings more than consumption, those excises on products consumed largely by the lower-income groups (such as on movie entertainment, beer, and tobacco) tend to reduce consumer purchasing power more than savings. Moderating such excises would tend to increase consumer purchasing power for other private goods.

5. Retention of the excess profits tax, corporation income tax, and high rates in the upper brackets of the income tax. This would permit less reliance on taxes which cut more deeply into consuming power. The income taxes, however, could cut into incentives for investment and if they are shifted, into capacity to consume.

6. Strengthening the death and gift taxes. Death and gift taxes per dollar collected probably reduce economic incentives and purchasing power less than any other tax in wide use today. The taxation of wealth at death is less a deterrent to economic activity than taxation of similar amounts during the active, productive lifetime of an individual. The effect upon the supply of investible funds depends upon the amount of redistribution of income such taxes entail. It clearly appears that the strengthening of such taxes to prevent evasion and avoidance is one of the most desirable of possible alternatives for preserving consumption.

7. Taxation of capital gains at death. Taxation at death should help preserve consumption with the least deterrent effect upon business activity. Consumption is preserved because capital gains largely accrue to the upper- and middle-income classes and because any revenue raised from this source could make consumption taxes less necessary.

BALANCING THE INTERESTS OF CONSUMPTION AND INVESTMENT

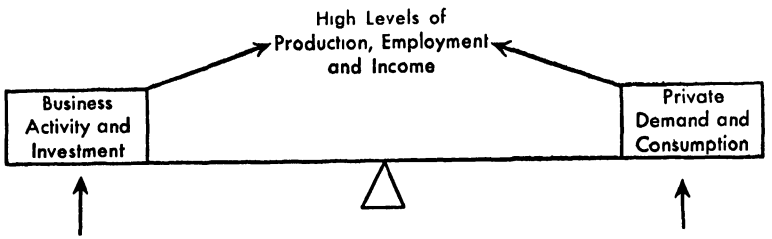
The taxes promoting investment and consumption are the tools to be used in the application of fiscal policy. But it is also necessary to know how to use these tools correctly. Different situations require different remedies and thus different uses of the tax devices.

Creating the desirable economic stability and high levels of production, employment, and income requires *balancing* the needs of business investment against those of private demand and consumption. In periods of full employment, for example, if there is a tendency to invest more than is voluntarily saved, tax deterrents to both investment and consumption appear advisable. During periods of wartime inflation, if new investment is needed, tax incentives to investment and deterrents to consumption may be the best policy. Tax policy in recession and depression would require a different emphasis.

The correct use of the tax devices depends, therefore, upon a better knowledge of the facts of the economy. It depends upon co-ordination with other fiscal policy techniques (such as debt and expenditure policy) as well as with other monetary and economic devices. It depends upon

an accurate timing of all such devices. All this requires careful economic analysis and scientific tax planning.

Figure 21 illustrates the general approach that should be taken in *balancing* the interests of consumption and investment by tax adjustments. The various tax adjustments cited on each side of the scale are in the nature of "possibilities" for encouraging one or the other. The more exact balancing and proportioning is something which can be achieved only after careful economic analysis in the economic period under consideration and by the exercise of fair and accurate fiscal judgment.



Encourage Investment By:

1. Avoidance or downward adjustment of any excess profits tax.
2. Removal of double taxation of corporate profits, or
3. Reduction of the corporation income tax.
4. Avoidance of nuisance and high cost of compliance taxes.
5. Emphasis on the personal income tax rather than many minor taxes
6. Reducing rates in the middle and upper brackets of the income tax.
7. Allowing carry-back and carry-over of losses
8. Granting accelerated depreciation
9. Current deductions for research and development.
10. Abolish tax-exempt securities.
11. Resort to sales and consumption taxes
12. Special treatment of reinvested earnings through capital gains tax
13. Greater stability in tax laws.
14. General progressive tax on spending.

Encourage Consumption By:

1. Increasing exemptions for lower-income groups under the income tax.
2. Lowering normal and surtax rates in lower brackets.
3. Avoiding all sales taxes.
4. Reducing or removing certain excise taxes
5. Retaining excess profits tax, corporation income tax, high rates in upper brackets of income tax
6. Strengthening death and gift taxes.
7. Tax capital gains at death

(Note that these tax adjustments—on either side—are "possible adjustments." They need not all be applied at one time The type of adjustment, the degree of application, and the timing are all matters to be determined by the economic conditions existing at the time they are to be applied.)

It must be noted that the author does not advocate the adoption of the respective policies on each side. He has merely summarized the policies which are usually suggested by those who would encourage investment on one hand or consumption on the other. The major task of tax policy is that of striking the correct balance between the two objectives

FIGURE 21. *Balancing the Interests of Investment and Consumption by "Tax Adjustments."*

Other Economic Aspects of Taxation

TAX POLICIES have other important economic implications besides those for work incentives, consumption, and investment. The mere process of taxation and expenditure of the tax receipts, some say, may by itself

substantially influence the total income stream. Furthermore, certain specific taxes have a greater deterrent effect upon inflation than others. Taxation may affect the *direction* of production, consumption, and distribution, and also the *form* of business activity, and business conduct. All these aspects of taxation are closely relevant to obtaining the kind of private economic society the American people desire.

TAXATION AND THE TOTAL INCOME STREAM

Some assert that the mere process of taxation and expenditure can by itself increase the total of national income, even if it does not redistribute income either among profits, wages, and other factor incomes, or among personal incomes of various sizes. The claim is made that even with no redistribution of income, equal increases of taxes and government expenditure on goods and services will tend to increase the national income by the value of the governmental goods and services. This does not hold true for transfer payments.[13]

A less extreme interpretation holds that even with regressive taxation some expansion in national income would result if money were taxed away and spent which would otherwise be hoarded.[14] But this would be much less than the total value of the taxes. And the *real* national income would not be increased unless employment were increased. The increase in income would be further enhanced (according to Keynesian reasoning) if the income were redistributed through progressive taxation. The proposition can then be supported that an equal increase in taxation and public expenditure will increase the *real* national income in the *short run* by the amount of the expenditure of funds which would otherwise be privately hoarded under conditions of less than full employment.

Taxation and equal governmental expenditures (balanced budget) can increase *real* national income in the long run insofar as it develops human and material resources which augment the future productive capacity of

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[13] For mathematical support of this point of view see Arthur Smithies, "Federal Budgeting and Fiscal Policy," *A Survey of Contemporary Economics* (Published for the American Economic Association) Howard S. Ellis, editor. Philadelphia: The Blakiston Co., 1948, pp. 187-188. For another view see George J. Stigler, "A Survey of Contemporary Economics," *Journal of Political Economy*, Vol. 57, April 1949, (A Review); section devoted to Smithies' article, pp. 97-98. Stigler reviews the many qualifications which may vitiate the working out of the assumptions in applying "aggregative" fiscal policy. This includes the fact that it makes a difference who pays taxes and who receives the payments; that the extent and nature of public expenditures affect private expenditures; that public investment may directly affect private investment; that relative prices can affect private investment; that the "expectation" of inflation can have adverse effects. Stigler doubts that predictions using Keynesian analysis are any more accurate than those employing the quantity theory of money and the more recent Neoclassical techniques.

[14] See Alvin H. Hansen, *Monetary Theory and Fiscal Policy*. New York: McGraw-Hill Book Co., 1949, pp. 167-168, together with the literature there cited.

the nation, and insofar as this does not merely replace capital expenditure which would be made by private enterprise.

More recently, there has been developed an economic analysis which places positive emphasis upon the income-creating powers of taxation.[15] This view holds that the "method of taxation" might be preferable to continuous "deficit spending" as a technique for lifting the levels of income in an underemployment situation.[16] The income created per dollar of tax expenditure may be larger in the *long run* than the per dollar of deficit expenditure plus interest. This analysis applies the multiplier to the theory of tax incidence.

Income-creation by the use of taxation functions through both determinants of national income—consumption and investment. According to this analysis, the levy of the tax causes taxpayers to consume a larger proportion of their "disposable income" (unless they are consuming it all before the tax). When the tax revenues are spent for consumption by the nation as a whole, total consumption increases. "When the receipts are spent to expand private investment, consumption may decline at the outset; but this is more than offset by the increase in investment. The national income begins to rise, and after only a few income periods consumption is larger than before the imposition of the tax."[17] In this manner taxation is thought to contribute to lifting both determinants of national income and thereby national income itself.

Income-creation by taxation may be the "missing instrument" in a balanced fiscal policy which may relegate deficit financing to a correlative position in over-all fiscal policy and de-emphasize it as the sole income-creating instrument in the hands of government. However, the whole concept of income-creation by taxation requires further study and verification before it is accepted in full as an instrument of public policy.

TAXATION AND THE FORM AND CONDUCT OF BUSINESS ACTIVITY

When firms decide whether to become corporate or partnership in form, tax criteria play a prominent role in the decisions. This was illustrated during the last war when many smaller firms disincorporated to avoid the high corporation income and excess profits taxes. Taxes may have many other strong influences on the form and conduct of business activity. The unemployment compensation tax under the provisions of the *Social Security Act* is lowered in most states to firms with smaller worker turnover. This creates incentive to stabilize employment. The profitability of holding companies may be seriously affected by provisions under the corporation income tax concerning consolidation of returns and

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[15] Joshua C. Hubbard, *Creation of Income by Taxation.* Cambridge: Harvard University Press, 1950.

[16] *Ibid.*, p. vii.

[17] *Ibid.*, p. 6.

taxation of intercorporate dividends. Undistributed profits taxes of the type levied in this country from 1936 to 1939 can influence business policy concerning reinvesting or distributing dividends. Variations in state taxes affect the location of various types of business firms. Other instances can be cited where government either purposefully or unintentionally has influenced business *form* and *conduct* through taxation. More devices will no doubt still be developed if the need arises. Taxes which do *not* alter business decisions have been called "neutral." By and large, taxation should be as neutral as possible in relation to the form and conduct of business. These business policies are best determined on economic and business grounds. Taxation should not become the most significant factor in business decisions.

TAXATION AND THE DIRECTION OF PRODUCTION, DISTRIBUTION, AND CONSUMPTION

Various types of regulatory taxation affect the *direction* of production, distribution, and consumption of goods and services. The legal and individual economic aspects of regulatory and nonfiscal taxation have been discussed early in this book. The purpose here is merely to draw attention to the over-all effects of taxation upon certain basic functions in economic life. Taxation can affect what is produced and how much, how goods and services are distributed, and what and how much is consumed. This is accomplished by special taxes, sumptuary taxes, and licensing and exempting both producers and their commodities. Some examples of this type of legislation are the exemptions of educational, charitable, and other nonprofit institutions from taxation, the lower property tax rate applied to improvements than to land in some cities, protective tariffs, chain store taxation, the taxation of state bank notes by the federal government, the federal phosphorous match, opium, marijuana, and firearms taxes, excises on liquor and tobacco, and exemption of food from sales taxes. There are, no doubt, others.

Some of these tax controls (such as many protective tariffs, oleomargarine taxes, and chain store taxes) are distorted to serve selfish group interests rather than the national welfare. Even some of the more general taxes may sometimes affect what and how goods are produced, distributed, and consumed.

Conclusions

IT IS NOW RECOGNIZED that there exists a strong relation between taxation and our economic and business life. Few would doubt, however, that as a minimum requirement, taxes should be levied in a manner least detrimental to the operation of America's private economy. In our day with

its increased responsibilities of government on many fronts and the heavy need for revenue, the task of adjusting the tax load to the economy in the most bearable manner has become more and more difficult. If we wish to preserve our private-enterprise system and democratic institutions, we cannot be blind to the limits of taxable capacity. We all realize, of course, that a costly and a destructive World War III could force a substantial modification of our economic and political institutions and force us to overlook taxable capacity. However, that possibility should not prevent us from seeking out the best tax instruments and policies to meet the responsibilities already upon us.

Our legislatures must make an honest and scientific effort to strike a reasonable balance between the interests of "consumption" and "investment." We need not wreck our tax and fiscal policy by quibbling over which came first, the "hen or the egg."

There is little doubt but that more empirical knowledge on the functioning of our economic system would be helpful. This includes the development of "statistical gauges" of the condition of the economy and "economic ratios" to serve as warnings when economic relationships get out of line. But a nucleus of workable knowledge does exist upon which it is possible to apply taxation in a way most favorable to the successful operation of our private-enterprise system.

One thing must be borne clearly in mind, however, when discussing what the government should do to facilitate the functioning of the American private-enterprise system: that is, *government cannot do it all.* The initiative and drive must come from within. The government can "permit" and "encourage" the system to function, but it takes the combined ideals and actions of private business, labor, and agriculture to insure its success. Business, however, must recognize its own responsibilities: to the public, to employees, to government, to consumers, to stockholders, and to the world.[18] Only through the energy and resourcefulness of millions of businessmen and workers can a private-enterprise economy realize its full potentialities.

The following chapters apply the principles and take cognizance of the relations here studied in the formulation of tax programs for meeting the challenges of wartime, prosperity, recession, and depression.

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[18] On this point, see especially the series of essays in Harwood F. Merrill, (ed.), *The Responsibilities of Business Leadership.* Cambridge: Harvard University Press, 1948.

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Taxation and Tax Policy in Wartime

> WE CANNOT EXPECT *that the realities of war finance will exactly approach the theoretical. No scheme of war finance can take the profit out of war or equalize the sacrifices of war. No scheme of war finance can preserve the continuity of culture or the way of life that would have developed had there been no war. No scheme of war finance can prevent the eventual transition from war economy to peace economy from being difficult and painful. But well-reasoned schemes of war finance can prevent flagrant profiteering; they can avoid wanton, careless, or subversive destruction within the way of life; and they can mitigate the hardships of the postwar period.*
>
> —ROBERT WARREN.[1]

Overview

THE APPLICATION of strong and effective tax policies in wartime is absolutely necessary in a modern economy attempting to meet the demands of total war. As we shall see, the responsibilities of war finance are much greater than those of merely "paying for the war." On the other hand, the possibilities of carrying through the right kind of fiscal program are greater than during any of the phases of the business cycle in peacetime. Under appropriate leadership, psychological forces exist which can be harnessed into a great co-operative and all-out effort that cannot begin to be approached in peacetime.

War finance, however, is not something that a nation can rush into pell-mell, carried largely on the psychological wave of patriotism and willingness to sacrifice. Adequate tax policy requires a careful economic analysis of the problems and needs of a war economy. This must be followed by careful planning for those needs.

This chapter, therefore, has the task of: (1) analyzing the economic conditions and the attendant problems that exist in a war economy; (2) setting forth the basic social and economic objectives of wartime tax and

[1] Robert Warren, "Function and Scope of War Finance," in Symposium: *Financing the War*. New York: Tax Institute, 1942, p. 24.

fiscal policy; (3) laying down some broad principles for financing wars; (4) appraising the limitations of tax policy in wartime; and (5) delineating the specific tax measures which will be helpful in carrying out the objectives and principles of war finance.

The Economic Conditions and Problems in Wartime

BEFORE those (Congress, The President, and Treasury) who help to shape tax and fiscal policy in wartime can proceed to formulate a tax policy, they must make an analysis of the economic conditions and problems which prevail in a war economy, with a view to determining how tax and fiscal policy can aid in meeting those problems. Some of the conditions and problems which exist in a war economy are: (1) the problem of shifting from civilian to war production, (2) the shortage of goods and rapid rise in prices, (3) the increased demand for labor, (4) the opportunities for high profits, (5) the increased total purchasing power and the dangers of inflation, and (6) the problems of those in the armed services who lose opportunities for high incomes. Each of these conditions will be analyzed briefly.

SHIFTING FROM CIVILIAN TO WAR PRODUCTION

In modern warfare thousands of items of war equipment ranging from rifles, uniforms, and bullets to tanks, artillery, airplanes, battleships, submarines, and now atomic bombs are required. A large part of the plant, equipment, and manpower of the economy must be converted to the production of these goods as soon as possible. This means that manufacturers must be induced to utilize existing equipment and to expand the facilities needed for war production. In the latter instance accelerated depreciation under income taxes can be helpful. The production of certain civilian goods must be stopped or curtailed. All of this will contribute to shortages of various types of civilian goods. The whole concept of "business as usual" must go out the window. The problem becomes that of balancing the interests of "guns versus butter." The economy cannot supply all of both.

The task becomes that of industrial mobilization for war. That means the marshaling and utilization of the materials, civilian manpower, production plant and equipment, capital, and services to support both the military effort and the civilian population.

At the time of Pearl Harbor, the United States was devoting about 15 per cent of its industrial production to war purposes. The President in January 1942 called for the production of 60,000 planes, 45,000 tanks, 20,000 anti-aircraft guns and 8,000,000 deadweight tons of merchant ships.

Between July 1, 1940, and July 1, 1945, the American economy produced about 300,000 airplanes, 71,000 naval ships and 86,000 tanks.[2] In the same period about $60 billion was invested in construction and equipment for industrial purposes of all kinds. About $13 billion was applied to non-manufacturing facilities. This was 94 per cent privately financed. Manufacturing facilities absorbed about $25.5 billion. Of this, about $22 billion went into war production industries—75 per cent of which was publicly financed.[3]

On the over-all production side the index number (1935-39 average=100) for durable manufacturers rose from 139 in 1940 to 360 in 1943, 353 in 1944 and dropped to 274 in 1945. The general manufacturing index (both durable and non-durable goods) rose from 126 in 1940 to 258 in 1943 and tapered off during 1944 and 1945.[4]

The task of the conversion and expansion of an industrial economy to all-out war purposes is an immense one. To the achievement of this task, taxation and methods of financing should make constructive contributions and avoid those policies which might be a hindrance.

THE RISE IN PRICES

When the people realize the meaning of wartime events, they often become frightened for fear that they will not be able to buy the goods to which they have been accustomed. They, therefore, rush out and buy various civilian goods in quantities large enough to take care of their needs well into the future; sometimes they even borrow money to pay for such purchases. They thereby create shortages and put an upward pressure on prices. Many goods are curtailed in production, a move that also produces an inflationary lift on prices. Those who hold the scarce goods exploit the operation of the law of supply and demand to its utmost. "Black markets" develop in which scarce goods are sold at high prices to those who want them badly enough and possess the purchasing power to command them. In many respects, the price system breaks down as the instrument for the equitable distribution of goods and services in the economy.[5] All along the line both in consumers' and producers' goods prices tend to rise quite noticeably.

In World War II most prices rose quite rapidly between January 1941 and early in 1943. The wholesale price index (1926 average=100) jumped from 78.6 in 1940 to 103.1 in 1943. Retail food prices (1935-39 average=100) advanced from 96.6 in 1940 to 138 in 1943. The con-

[2] George A. Lincoln, William S. Stone and Thomas H. Harvey, *Economics of National Security*. New York: Prentice-Hall, Inc., 1950, pp. 206, 209.

[3] *Ibid.*, p. 219.

[4] *Statistical Abstract of the United States—1949*, p. 928.

[5] For an excellent chapter on "The Price System Under the Impact of War," see Henry W. Spiegel, *The Economics of Total War*. New York: Appleton-Century, 1942, pp. 108-144.

sumers' price index (1935-39 average=100) rose from 100.2 in 1940 to 123.6 in 1943.[6] All of the price-spiraling tendencies were gaining momentum when the application of direct controls and tax policies began to hold the line. Again, in this area taxation and tax policy can contribute some curbing effects upon price increases.

INCREASED DEMAND FOR LABOR

As soon as production for war begins in earnest, the demand for labor —especially for skilled and semi-skilled labor—rises very rapidly. Men and women flock to war production industries. Large numbers are taken for the armed services, and even the civilian industries attract many workers. Before long, critical shortages develop in certain types of labor. Wage rates rise. The total volume of employment increases. Unemployed labor resources are put to work at rising wages. All of this adds to the total purchasing power in the hands of workers. Many of those who have been unemployed have strong needs for consumers' goods which they are now able to demand with their new buying power.

The United States had a large pool of unemployed manpower to draw upon in the period before Pearl Harbor. The total number of unemployed stood at 8.7 million in May 1940. It dropped rapidly during the following year and amounted to about 4 million in May 1941. It receded even more rapidly during the remainder of that year. By 1943 there were about 1 million unemployed. The low point was about 670,000 in 1944. However, although the employed civilian labor force expanded rapidly in 1940 and 1941, because of the heavy drain of manpower into the armed services, it actually declined in 1944 and 1945.

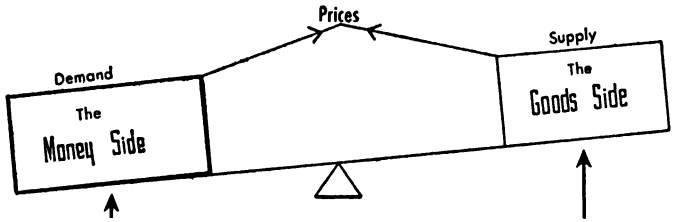
In spite of the fact that the total production task to be performed increased several times from 1940 to 1943, the employed labor force increased only about 14 per cent during the same period. This necessitated working longer hours during the regular work week and overtime on Sundays and holidays. The average weekly hours for production workers in manufacturing increased from 38.1 in 1940 to 45.2 hours in 1945. In the same period the average hourly earnings increased from 66 cents to $1.02. The average weekly earnings for these same production workers increased from $24.56 in 1940 to $47.50 in 1945. The net result for the economy as a whole was a greatly expanded pool of worker purchasing power.

INCREASED TOTAL PURCHASING POWER AND INFLATION

As a natural consequence of increased employment, higher wage rates, rising profits, and increased rents, there develops a substantial expansion of total purchasing power in relation to the supply of available consump-

[6] *Statistical Abstract of the United States—1949*, pp. 301 and 308.

tion goods. In a peacetime economy the logical step would be to increase productivity and the volume of goods. However, that is not possible in wartime, because a good fraction of plant and equipment must be devoted to war production. This imbalance between the volume of purchasing power and supply of civilian goods tends to drive prices upward. During World War II economists talked a good deal about the "inflationary gap" —the difference between the actual supply of purchasing power and the supply which would be sufficient to take the stock of consumer goods off the market at non-inflated prices. They argued that this inflationary surplus would have to be absorbed in other ways if continued price rises were to be prevented.



Factors Increasing Purchasing Power:

1. Increased wage rates.
2. Full employment.
3. Overtime at higher rates.
4. Higher profits.
5. Heavy government expenditures.
6. Borrowing from banking system.

Factors Affecting Goods Available:

1. Elimination of production of some civilian goods
2. Decreased production of other civilian goods.
3. Hoarding.
4. Reduction in imports.
5. Many civilian goods needed for armed forces
6. Goods exported to aid allies.

FIGURE 22. *Inflationary Tendencies in Wartime.*

World War II experience demonstrates quite well the expansion of income and purchasing power in a wartime economy. The gross national product increased from $100 billion in 1940 to $213 billion in 1945. The net national income on the other hand increased from $81.3 billion to $181.7 billion in the same period. As a result of this expanded income, personal consumption expenditures increased from $72 billion in 1940 to $122.8 billion in 1945. Personal savings grew from $3.6 billion per year to $26.6 billion over the five-year period.

OPPORTUNITIES FOR HIGH PROFITS

In the atmosphere of shortages of consumer goods and the high demand for war goods, the opportunities for high profits become extensive. In the organized commodity markets, high speculative gains become everyday occurrences. In the manufacturing, wholesale, and retail fields for consumers' goods, sellers' markets develop and the tendency to charge "all that the traffic will bear" becomes general. Government cost-plus and other contracts for war goods needed in a hurry give rise to further opportunities for high profits. Those who hold the scarce and strategic

materials can cash in on their advantages. And so all along the line those who have anything to sell stand in the strategic position of charging high prices and reaping unusual returns. This process has not inappropriately been termed "profiteering."

Again World War II experience illustrates clearly what occurs to business profits under wartime conditions. Income from unincorporated business increased from $12.6 billion in 1940 to $29 billion in 1945. The rise in corporate profits was somewhat comparable. They expanded from $9.3 billion in 1940 to $24.5 billion in 1943. From a figure of $24.3 billion in 1944, they dropped to $20 billion in 1945.

THOSE IN ARMED SERVICES LOSE OPPORTUNITIES

A final set of conditions which prevails in a wartime economy and which is relevant to tax and fiscal policy is the fact that millions of men and women are drawn out of the civilian economy into the armed services. These people lose the opportunity for high wages and profits which are available to those who remain at home. In addition, they receive relatively lower compensation, their careers and economic progress are interrupted, and they run the risk of losing their very lives. Many of those who remain at home are actually better off than ever before—in fact, many of them are able to earn incomes and accumulate wealth that ordinarily would have taken many years to achieve. This set of conditions must necessarily be recognized under wartime tax and fiscal policy.

Objectives and Requirements of War Taxation

ECONOMIC REQUIREMENTS FOR FULL-SCALE WAR EFFORT

Taxation is but a part, although admittedly an important part, of all-out economic mobilization for war. In a plea for total mobilization of the American economy in 1950, Bernard Baruch spoke of the many fingers of the "two hands" needed to do the mobilization job. He said, there is needed

> ... priorities ... allocations ... the elimination of profiteering; higher taxes; effective price, wage, and rent controls; power to ration scarce civilian essentials where necessary; the postponement of all less essential works; a reduction of unnecessary public and private expenditures; every effort to increase production; the development of substitutes for things in short supply; control of all exports and imports; conservation of what is scarce; and an organized self-restraint among the people—the enlightened self-discipline to accept the denials which winning the peace entails.[7]

[7] Bernard M. Baruch, statement to the Senate Banking and Currency Committee, July 26, 1950.

Although taxation cannot do the task alone, it can make the attainment of the other goals easier. Indeed, it might be said that in the absence of a strong wartime tax program, the successful prosecution of a war without disastrous results to the economic system and the individuals in it would be extremely difficult.

If a careful analysis of the conditions that prevail in a wartime economy is made, the task of assigning objectives to tax and fiscal policy becomes somewhat obvious. Among those objectives are: (1) to facilitate war production and the total war effort; (2) to provide revenues for the prosecution of the war; (3) to combat inflation; (4) to distribute the burdens and sacrifices equitably; (5) to prevent undue accumulation of wealth; (6) to aid and supplement other wartime controls; and (7) to transmit as a postwar legacy as little burden and disorder as possible.

FACILITATE WAR PRODUCTION

A primary purpose of tax policy must necessarily be to facilitate rather than to impede the transition to and development of high levels of war production. In the early stages of a war effort, tax rates, especially on the personal income tax, corporate income tax, and the excess profits tax should not be made too severe. The risk lies in curbing the expansion of plant and equipment and in discouraging personal effort. However, if the economy is well-equipped with plant and machinery and is functioning at high levels at the outbreak of the war, not so much concern need be shown toward tax burdens. Stiffer taxes can be applied sooner. For instance, heavier tax burdens could be laid with less risk in 1951 or 1952 than was the case in 1940 or 1941.

The tax system can make a positive contribution to the expansion of war production by granting accelerated depreciation on new plant and equipment installed for war purposes. If the normal estimated service-life given machinery is 10 years, then permission can be granted to depreciate it over 5 years instead of 10, or the duration of war, whichever was shorter. Such incentives were granted to those who installed "war production" facilities in World War II to the advantage of both the war effort and the taxpayer.

PROVIDE REVENUES TO FINANCE THE WAR

Definitely, war taxation should make a maximum contribution to the financing of the war effort. There are other alternative methods such as heavy borrowing and the issuance of paper money. Both have serious short-term as well as long-run consequences. The larger the proportion of war costs financed by taxes, the less will be the inflationary effects during the war and the economic burdens in the long run.

Since it is the heavy expenditures by government which result in the rise in the national income, it is only proper that government recover part

of those expenditures out of the increased income. Payment of war costs by taxes results in lower long-run costs and less burden for the government and the taxpayers. Wars have to be paid for; current payment by taxes out of current income represents the soundest approach to war finance.

TAXATION TO COMBAT INFLATION

One of the most useful functions that a well-designed war tax system can perform is that of serving as a brake on inflation. Not that taxation can do the whole job effectively; it cannot. But indirectly it can mop up part of the surplus purchasing power, take it out of the buying stream, and apply it directly to the costs of war in a way that is non-inflationary.

The risks and consequences of inflation in wartime can be serious. Inflation substantially increases the costs of the war to the national government. It embezzles away the limited purchasing power of the low-income groups. It cuts into the standard of living of the people living on fixed-incomes. It disorganizes markets and economic processes. It distributes the burdens of war inequitably. Finally, it leaves a more disordered legacy of burdens and problems for the postwar period and later generations.

Taxation, therefore, can and must make its contribution to curbing inflation by absorbing part of the "inflationary surplus," by taking some of the loose purchasing power out of the hands of the people and thus sterilizing it as a force affecting the prices of civilian goods.

DISTRIBUTE BURDENS EQUITABLY

Taxation can make other contributions to wartime finance which are extremely important. First is that of assisting in a more equitable distribution of the sacrifices and burdens of war, as between the low- and fixed-income groups, and those whose incomes have expanded during the emergency. Here by proper graduation and perhaps by special excess income taxes (to be discussed later), the burdens can be made to fall on those who have profited most by the war.

Second, taxation can assist as between those who have gone into the armed services and those who have stayed at home. By exemption of those in the armed services and by graduated income taxes and excess income taxes on those at home, the tax system can provide partial monetary compensation for war burdens. This is highly necessary for the morale of those in the armed services as well as for the "cause" itself.

PREVENT UNDUE ACCUMULATION

In World War I about 50,000 American service men were killed and about 250,000 wounded. At the same time, however, the war effort produced about 20,000 millionaires and many thousands of other "war rich."

For some years after the war, our wartime financial policy was severely criticized because it permitted heavy profiteering and high incomes which were not properly adjusted downward by taxation. The general principle was developed that individuals and business should not be permitted to profit and accumulate in extra measure out of the emergency of the nation at war, and especially at the expense of those who made heavy sacrifices of their lives, their time, their opportunities, and families. It seems only equitable that the tax system take specific measures against heavy accumulation of wealth in a war emergency.



FIGURE 23. *Running Up Prices.*

SUPPLEMENT OTHER CONTROLS

Tax policy cannot perform all the fiscal and control functions that are necessary to operate a war economy wisely, but it can supplement and strengthen other direct and indirect controls. When co-ordinated with monetary and banking policy, rationing and price control, and other types of fiscal policy, taxation can be a strong auxiliary weapon against inflation. It can aid in making price control and rationing effective. If billions of dollars of surplus purchasing power are available for purchasing civilian goods, the dikes of price control and rationing might not be strong enough to "hold the line." In addition, the tendencies toward evasion and black markets would be strengthened, and civilian morale could be seriously injured. Taxation can tap the inflationary surplus, shunt it away from consumers' markets and into the direct financing of the war effort where it is apt to be less inflationary.

TRANSMIT A MINIMUM POSTWAR BURDEN

Tax policy in wartime, however, must look beyond the period of the war itself, for quite often some of the most severe social and economic consequences arise in the years after the war. Therefore, war tax and fiscal policy should be of such a character as to leave a minimum legacy of burdens and disruptions. The greater the proportion of the war financed by taxes, the lesser the debt burden to be borne in the postwar era. The more effectively inflation is controlled during the war proper, the less likely are the dangers of a postwar inflation. The more fair and equitable the distribution of income in the war economy, the more stable will be the postwar economy. And so on down the line on other issues of economic significance. Firm and correct tax policy in war can have a carry-over of worth-while social and economic values in peace.

The Limitations of Tax Policy in Wartime

THERE ARE SOME LIMITATIONS in respect to taxation that should be observed in wartime. These limitations, however, can be overcome by the exercise of discretion and by adjustments. On balance, the advantages of taxation as an instrument of wartime finance far outweigh its limitations.

Harsh tax rates at the beginning of a war effort would tend to cripple industrial incentive and ability to remobilize into war production. Enlargement of plant and expansion of output of war goods requires both money and initiative (which are reduced by excessive levies on business and personal incomes).

Drastic taxation could conceivably damage civilian morale. In the

early part of the war, tolerance of the public for a given scale of rates is closely related to the scale in force. But here it should be remembered that in the early part of the war psychological acceptance of sacrifice is strong.

The objection that taxation has a deterrent effect upon industry at a time when it needs all possible encouragement is probably valid in the early stages of mobilization. Nevertheless, severe rates may be applied to soak up war-created income when war production is well advanced without any serious repercussions on national output. This is true because once volume production is achieved, decreasing costs and increased profits arise. At that time taxes may even serve as a stimulus to greater effort in order to secure a larger differential margin after their payment.

Broad Guideposts for Financing Wars

ONE OF THE BASIC QUESTIONS concerning war finance which keeps cropping up is: What proportion of war costs should be financed by taxes? What proportion by borrowing? It is now well agreed that taxation must play a major role in financing modern wars. None, however, would go so far as to advocate that the total costs should be borne by taxation. It is recognized that taxation possesses some limitations as an all-out instrument. The majority concedes that some balance between taxes and loans adjusted to the taxable and psychological capacity of the economy is the most ideal guiding principle.

TAXATION VS. BORROWING IN WARTIME

Curtailment of private spending and financing of government in war may be either voluntary or compulsory. If the government relies upon borrowing, it is voluntary. If the government relies upon taxation, it is compulsory. The two methods may be used jointly. Borrowing may be either from the banking system, in which case it is most inflationary, or from the public, which is least inflationary. Taxation on the other hand may be progressive or regressive. Progressive taxation strikes income that might be saved, whereas regressive taxation restricts consumption and thus tends to be more deflationary.

ADVANTAGES OF TAXATION IN WARTIME

Almost all fiscal experts recognize that taxation must play a dominant part in financing government during war. Many arguments are offered for this view.

(1) Taxation, along with other wartime devices, is useful for checking inflation, strengthening direct controls, and creating greater price stability.

One alternative is borrowing, but necessarily a large part of borrowed funds must come from newly created bank credit which releases a flood of new purchasing power into the economic system. (2) Taxation can help control profiteering. Together with renegotiation of contracts it is an effective device. (3) It produces revenue at the time the people's ability to pay is the highest. During wartime the expansion of incomes and values creates a larger tax base from which to derive revenue. (4) By helping prevent inflation, taxation assists in keeping down the costs of the war. (5) It is desirable to distribute the burdens of war during the war itself as equitably as possible between those who stay at home and those who go into the services. The people at home can never equal the sacrifices of those in the front lines. Taxation, however, enables them to bear a larger share of the financial burden, at least. (6) After the war, the burdens should not be permitted to fall on the veterans when they return. Borrowing merely postpones money costs to future taxpayers. (7) During wartime there is much better psychological acceptance of heavy tax burdens than there would be during a peacetime period of comparable business activity. (8) Taxation is apt to be far more effective than borrowing for actually curtailing private consumption. (9) Taxation can facilitate the transfer of workers from industries producing civilian goods to those producing war supplies. Prohibitive taxation on nonessential production would increase prices for the civilian product. This would free workers for more important industry. Luxury excises have such an effect. The limitations of taxation have already been discussed in a previous section.

ADVANTAGES OF BORROWING IN WARTIME

As an alternative to taxation, borrowing, too, has its advantages and drawbacks. (1) Borrowing diverts large amounts of "current savings" to the use of government more quickly and effectively than does taxation. It taps depreciation, depletion, replacement, and other accumulated funds that cannot be reached easily or equitably by taxation. (2) Borrowing is more flexible as between individuals and as between enterprises than taxation for it avoids hardships for those with heavy responsibilities or urgent business needs for funds and yet it permits those who can spare most to contribute most to the war effort. It consequently creates minimum disturbance to the financial programs of individuals and enterprises per unit of revenue obtained. (3) Borrowing is far less likely to impair incentives to production and to injure public morale than taxation, for the contribution is only a loan which will be paid back eventually. (4) Politically, borrowing is less controversial than taxation because it results in no immediate change in the relative distribution of incomes, even though it postpones the problem of distributing some of the money costs of the war until later.

LIMITATIONS OF BORROWING

The drawbacks of borrowing, however, limit its desirability in a wartime finance program. Besides lacking the advantages of taxation, Treasury bonds do not represent an addition to a country's real wealth. The goods they represent are largely shot up, used up, or are of negligible value in peacetime. The burden of the debt upon the future is therefore dead weight.

Borrowing is not quite as efficient as taxation in fighting inflation. Generally, the purchase of bonds is voluntary. Too often, many with surplus funds prefer to spend a good part of them rather than purchase bonds. This can be overcome to some extent by enthusiastic bond campaigns or by the process of "forced loans" in which case the funds are "taxed" away, but bonds are given in return for part of the taxes paid.

Borrowing by means of bonds, furthermore, tends to make the future distribution of income more unequal than if taxation were used. During a war period individuals with larger incomes are able to buy a larger proportion of the bonds than are persons with lower incomes. The former thus have a greater than proportional lien on future tax receipts. To avoid redistribution of income from this cause after the war, the tax system would have to be made sufficiently progressive to take the same additional amount of taxes from the wealthy as they receive in interest and in return of capital on the bonds. Furthermore, borrowing increases the money cost of the war by the amount of interest which must be paid on the bonds.

CONCLUSIONS ON TAXES VS. BORROWING

Both taxation and borrowing have a role to play in financing modern wars. In the past, the tendency has been to rely too heavily upon borrowing. That was clearly so in World War I, and although we did somewhat better on that score in World War II, we did not do as well as we should have. Whereas both Great Britain and Canada paid about 50 per cent of the cost of the war by taxation as they fought, the United States averaged only about 41 per cent by taxation from 1942 to 1945. It is common knowledge that we did not approach either our psychological or taxable capacity under war conditions.

It probably would be safe to generalize that the American economy in World War II could have paid at least 50 per cent of the current costs of the War by taxation. It may be that in the future the character of war itself and the needs of survival may require that a much larger proportion be covered by taxes. This generalization is re-enforced by a large pre-existing national debt and the huge aftermath costs from World War II.

Specific Tax Measures in Wartime

HAVING ANALYZED the economic conditions which exist in wartime and having formulated the objectives to be sought in financing a war, the next task is that of selecting the specific tax measures which will best carry out those objectives. Fiscal experience has demonstrated that the following types of taxes can best achieve those ends: (1) the personal income tax, possibly including an excess income tax; (2) the corporate net income tax; (3) the corporate excess profits tax; (4) selective excise taxes; and (5) social security payroll taxes. Other taxes are valuable as revenue instruments. If they exist as part of the tax system at the beginning of the war, they should be retained; if they do not, some of them should be added in wartime. Among these are estate and gift taxes, customs duties, capital stock taxes, sales taxes, and perhaps a few others.

THE PERSONAL INCOME TAX

The income tax made a sizeable contribution to revenues in World War II. The combined income and profits (corporate net and excess) taxes yield in the fiscal year 1945 was over $35 billion, or about three-fourths of the total revenues raised. The personal income tax alone brought in $19.7 billion in 1944 and $19.1 billion in 1945. This was as it should have been. Income taxes (both personal and business) must necessarily bear the brunt of war financing for it is income (as a result of heavy government expenditure) which expands enormously in a war economy.

As a general principle, personal income taxes ought to bring in about half the federal revenues required in wartime. In order to accomplish this, the first bracket rate must be relatively high (probably 25 per cent). The graduation must necessarily be highly progressive. The middle brackets could bear somewhat heavier rates than in World War II. The top rates on the *marginal part* above $200,000 could well be 95 per cent in a war emergency.

The personal income tax also makes valuable contributions to other war finance objectives. It is a strong device for transferring to the Treasury expanded civilian incomes. With current collection at the source, it can serve as a brake on consumer spending and inflation. Furthermore, it can distribute the burdens and the sacrifices among the taxpayers in a more scientific and equitable manner than other taxes. It also makes the taxpayer more conscious of his sacrifice.[8]

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[8] W. L. Crum, J. F. Fennelly, and L. H. Seltzer, *Fiscal Planning for Total War*. New York: National Bureau of Economic Research, 1942, p. 245.

AN EXCESS PERSONAL INCOME TAX

Not only corporations but many individuals as well receive increased incomes under the impact of a war economy. In many instances the increases are several times the income of the previous peacetime period. Some evidence that this is true appears from an examination of federal income tax returns. In 1938 net income (individual and fiduciary) amounted to $8.8 billion; in 1940, $36.5 billion; in 1943, $99.5 billion; and in 1945, $120.3 billion. A substantial part of this increase was due to increased employment, but a good measure was contributed by increased wage and salary rates and increased profits to individuals.

Since some individuals receive materially increased income growing out of war activity, it was suggested during World War II that some effort be made to tap such excess incomes. An excess income tax was attempted during World War I, but it failed. Such a tax would have to allow a basic exemption of $5,000 or $6,000. A comparison of average income for the three years preceding the war and the annual war income would serve as the basis for determining the increased income. Such a tax would require the allowance of a credit for regular personal income taxes paid in applying the excess income tax rates.

Such a tax could be justified on the ground that it would equalize the burdens of contributing to the war effort, it would minimize the growth of the "war rich," and it would add materially to revenue.

Table XI

FEDERAL INCOME AND PROFITS TAX COLLECTIONS, 1939-1950 *

(*in millions of dollars*)

Fiscal Year	*Individual Income Tax*	*Corporation Profits Tax*	*Total*	*Per Cent of Ordinary Revenues*
1939	$ 1,029	$ 1,149	$ 2,178	39
1940	982	1,139	2,121	40
1941	1,416	2,504	3,470	46
1942	3,216	4,744	7,960	62
1943	6,505	9,589	16,094	72
1944	19,779	14,876	34,655	78
1945	19,145	16,027	35,173	76
1946	18,704	12,554	31,258	73
1947	19,343	9,676	29,019	67
1948	20,996	10,174	31,170	67
1949	18,051	11,559	29,610	73
1950	17,153	10,854	28,007	72

* The data are compiled from the Secretary of the Treasury, *Annual Reports; Tax Systems*, (12th ed.), 1950, pp. 2-3, and Supplement to 12th ed., 1951, pp. 4-5.

THE CORPORATE NET INCOME TAX

The corporate net income tax must also bear its share of war finance burdens. Corporate incomes generally expand rapidly in wartime and therefore constitute a substantial base from which to extract war revenues with some measure of ease. The corporate net income tax yielded about $3 billion in 1942 and about $5 billion in 1944 and 1945, or about 11 per cent of total war revenues in the latter two years. In a war economy it may be necessary to raise the rates to 40 per cent or better. This can be done without serious injury under wartime circumstances. This tax has some measure of anti-inflationary influence in that it absorbs income that might be paid out in increased wages, salaries, and dividends, and thus exert additional pressure on prices. The corporate net income tax should bring in about 12 per cent of the federal revenue under wartime conditions.

THE EXCESS PROFITS TAX

The excess profits tax was used as a wartime emergency measure in both world wars. In a highly industrialized war economy, it is now an absolute "must" in war finance. Under wartime conditions it is an even stronger revenue raiser than the corporate income tax. During three out of the four years between 1942 and 1945 it raised more revenue than did the corporate income tax. In 1945 it produced more than twice as much, or $11.1 billion as compared with $4.8 billion for the corporate net income levy. Under wartime conditions a well-designed excess profits tax should yield somewhat more than 25 per cent of total federal revenues. If the tax has to be used for war purposes again, the base should be strengthened, although it might be wise to avoid the 95 per cent rate. This high rate frightens corporate accountants and lawyers, with the result that many devices are utilized to cut down the impact of the high rate. A stronger base with a lower rate might in fact raise more revenue.

The excess profits tax, however, performs other functions in war finance besides raising revenue. It directly contributes to anti-inflation measures in that it "mops up" funds that might otherwise be paid out in higher wages and dividends. It is psychologically necessary to justify in the public mind such direct measures as price control, rationing, and a strong personal income tax. It also makes a worth-while contribution to a better distribution of income during the war period and after. It possesses some drawbacks, however, in that it stimulates waste and inefficiency and weakens resistance to wage demands.

RENEGOTIATION OF WAR CONTRACTS

As a companion and a supplement to the excess profits tax, the renegotiation of war contracts was developed in World War II, and Congress has already made provision for its future use.

The theory of renegotiation. Billions of dollars in military orders are let out to industry in any large scale war. The contracts covering these must often be drawn up hastily; costs and profits cannot always be determined accurately. It is essential for government to get the materials quickly, and the specific terms under which they are obtained are of secondary importance at the time.

To help combat excess profits which may arise from too generous governmental terms to war contractors, the excess profits tax has a valuable ally in the form of renegotiation of contracts. The principles of contract renegotiation were developed mainly in the years of World War II. They permit the government to negotiate an initial contract for supplies at a determined price. Upon later investigation, when the facts are available on production costs, government agents determine whether prices and profits are reasonable. If profits on the war orders are deemed too high, the government is empowered to reduce the profits to a reasonable level through the renegotiation of the contract.

Renegotiation in World War II. During World War II from 1942-46, renegotiation cut sales under renegotiable contracts from $193.9 billion to $184.8 billion and cut operating profits before taxes from $25.3 billion to $16.2 billion. This was a cut of profits on sales before taxes from 13.1 per cent to 8.7 per cent.[9]

The 8.7 per cent margin of profits was only an average. During World War II, profit margins after renegotiation ranged from 2 per cent to as much as 35 per cent. The Defense Department set its own standards for a fair profit, and each case was determined by its particular circumstances. In general the principles which the government used to determine whether profits were fair were based upon the efficiency of a firm, the costs involved, the amount of capital employed in fulfilling a contract, the risk assumed by a contractor, and the contribution a contractor made to national security.

The government rewarded an efficient contractor more than an inefficient one. Furthermore it attempted to cover only those costs that appeared reasonable and did not appear to be padded or unnecessary. A contractor investing his own capital or using a large amount of private investment was permitted a larger return than a contractor using governmental funds or working only on a "shoestring." The seller taking the greater risk in buying, selling, and storing or in developing a new product was rewarded accordingly.

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[9] *U. S. News and World Report*, July 28, 1950, p. 40, as taken from Munitions Board figures; see also Richard C. Osborn, *The Renegotiation of War Profits*, Bureau of Economic and Business Research, University of Illinois, 1949; and "Renegotiation of Defense Contracts," National Planning Association, Special Report No. 28, December 1950.

Renegotiation in the future. Renegotiation will be a greater factor in the future financing of war than it was in World War II. A law enacted in 1948 covers all contractors who deliver more than $100,000 worth of materials a year on contracts negotiated with the Defense Department, whether the contractor deals primarily with war materials or not. The previous wartime law covered only those contracts above the $500,000 level. Sub-contractors as well as original contractors are now included. The law does not apply to contracts let through competitive bidding, however.

FEDERAL SELECTIVE EXCISE TAXES

Substantial selected federal excise taxes clearly have a place in financing a war. Most of these taxes are on luxury or semi-luxury goods or goods the consumption of which is sought to be discouraged for war purposes. The rates on these items can very well run from 25 to 30 per cent or more in wartime. They can make a fairly substantial revenue contribution. In 1942 all federal excise taxes amounted to about $2.7 billion out of total revenues of $13.4 billion. In 1945, however, they tallied $5.4 billion out of total revenues of $44.1 billion. They also make anti-inflation contributions in that they "mop up" purchasing power which might otherwise be spent on other consumers' goods. They also curb spending for certain classes of goods because many persons will save rather than pay the high taxes. Selected federal excise taxes should be an integral part of a wartime tax structure and should contribute 12 to 15 per cent of the revenues.

SOCIAL SECURITY PAYROLL TAXES

In wartime, social security payroll taxes should play an anti-inflationary role. Rates can and should be raised during this period of full employment and high wages. These taxes can also absorb purchasing power which otherwise might be spent for scarce consumption goods. The war period is also a good time to strengthen the social security reserves for possible postwar unemployment. However, care must be taken not to raise the rates unduly because of their regressive effect upon the lower-income groups. A forced savings plan perhaps could be operated on the payroll principle. If additional anti-inflationary instruments are necessary, the money could be taken under the payroll tax and returned to the workers after the war.

MISCELLANEOUS TAXES

A number of other taxes can at least contribute some revenue. Estate taxes perhaps should not be geared to war finance purposes. There is probably no reason to adjust customs duties upward in wartime. Foreign trade tends to fall off during such a period anyway. Certain types of goods might be welcomed if they are in short supply within the economy.

The use of a general retail sales tax or an over-all spendings tax was advocated as an anti-inflationary device during World War II, but neither was adopted. Such taxes would be difficult to administer at the federal level for the entire economy. The income tax and payroll taxes with collection at the source can accomplish everything that sales or spendings taxes can achieve as an anti-consumption measure, and income and payroll taxes can do it more efficiently and more cheaply.

Conclusions on Taxation in Wartime

ALTHOUGH complete reliance on taxation in wartime might be ideal, it is not feasible. However, taxation should play the major role in the financing of any future major war in which the American economy is asked to perform. Not less than 50 per cent of the war costs should be paid for currently by taxation. Substantially, the economy should pay as it fights. A war tax system should be inaugurated at once upon the outbreak of the war, or if the dangers can be anticipated, such a tax system should be set in motion before formal hostilities begin. It should not take three years to acquire a full-fledged wartime tax system.

The main reliance should be placed upon (1) the personal income tax (40 to 50 per cent of total revenues), (2) the corporate net income tax (10 to 12 per cent), (3) the excess profits tax (25 to 30 per cent), and (4) selected excises (12 to 15 per cent). Other taxes such as payroll, estate and gift, customs, and so on, can render supplementary assistance.

A war tax system so set up should be able to meet the financial needs of the wartime emergency and make substantial contributions to combating inflation, distributing the burdens and sacrifices equitably, distributing the income equitably, and minimizing the postwar legacy of debt, burden, and economic disorder.[10]

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[10] See Roy Blough, "Fiscal Policy in a Defense Economy," *National Tax Journal*, Vol. 3, December 1950, pp. 273-282; "The Economics of National Defense," Fifth Annual Report to the President by the Council of Economic Advisers, December 1950.

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Taxation and Tax Policy in Prosperity

IT WOULD BE *a major achievement if, at the policy and legislative level, agreement could be reached on the fundamental principle that . . . taxes in relation to public expenditures should be higher in periods of rising and high business activity than in periods of declining and low business activity.*

—LOUIS SHERE.[1]

Overview

THE TYPE OF fiscal policy to be applied in periods of prosperity has not thus far received the consideration which it deserves. This is in part due to the human tendency not to worry when things appear to be going well —the tendency to "eat, drink and be merry."

But prosperity is a more crucial phase of the business cycle than most people realize. Beneath the prosperous exterior may be developing the stresses and strains that contribute to recession and depression. Much of the economic behavior during the period tends to be extreme and often motivated by short-run purposes. Spending, borrowing, investing, and speculating tend to become too optimistic. The seeds of depression are often sown during the prosperous phase of the business cycle.

The period of prosperity contains many of the features of a wartime economy. This includes a high demand for goods and services as well as for productive equipment, relatively full employment of capital and labor, speculation, an abundance of money income and expenditures, and the resulting threat of inflation. In times of prosperity, however, the conditions are caused by the generative character of the private-enterprise system itself, rather than by increased government demand. In addition, the psychological urgency to rational action by the people and Congress is lacking.

And yet our best hope for success in controlling the business cycle lies

[1] Louis Shere, "An Economist's Viewpoint on Tax Policy," *The Annals* of the American Academy of Political and Social Science, Vol. 266, November 1949, p. 168.

in preventive action during the full employment phase of the cycle. The policy we follow in that period helps determine how soon we shall have a depression and how bad it will be. It is during the prosperous period that a firm tax policy can make a material contribution of an anti-cyclical character.

This chapter has several purposes: (1) to outline the economic conditions and tendencies of peacetime prosperity and the manner in which they differ from those of wartime; (2) to state the broad objectives of tax (and fiscal policy) in periods of prosperity; (3) to state the general tax policy and to suggest specific tax measures to carry out that policy; (4) to appraise some of the limiting factors in tax policy in the times of prosperity; and (5) to recognize the value of co-ordination with other types of fiscal and economic policy.

General Economic Conditions in Prosperity

AN INTELLIGENT TAX PROGRAM requires knowledge of the economic characteristics of the period to which it is to be applied. Many characteristics of prosperity are undoubtedly desirable and should be permitted to continue. These include high levels of real income, production, consumption, investment, and employment of capital and labor. These are characteristics which every economic system should seek to achieve and retain.

Prosperity is also characterized by excesses. The very stimulants which bring about the desirable conditions can in the end lead to depression. In overdose, they whip the economy to a frenzy of short-lived activity—or "boom and bust."

THE PERIOD OF EXPANSION

Stimulated by some originating force, the economy expands from its depression lethargy. Entrepreneurs see increased profit prospects, hire more men, and order more materials. Newly employed workers expand the volume of consumer demand. Bank loans come easier. Plants and durable equipment are expanded to meet increased demand. This generates further income to raise consumer prices still higher.

Yet even before full employment is reached, prices increase because of shortages (or bottlenecks) of supply of certain types of labor and goods. Upon the attainment of full employment, attempts to increase total activity through bank credit expansion lead only to further inflation.

BOOM CHARACTERISTICS

When approximately full employment is reached, the undesirable characteristics of the boom become prominent. Increased bank credit

expansion and purchasing power applied to the limited resources lead to inflation—that is, to price and income disturbances. In general, salaries, costs, and fixed incomes lag behind prices. The lag of costs behind prices increases profits of most concerns. The higher profits stimulate the already excessive optimism.

The favorable business conditions stimulate still more borrowing of bank credit to spend on expansion of plant and equipment. This bank credit creates additional purchasing power and inflates still further the income stream. The prices of consumer goods continue to rise. The continuing prospect for inflation encourages speculation in securities, commodities, and real estate. Businessmen build inventories and consumers buy goods recklessly because they expect the price rise to continue; or they buy in utter disregard of prices.

THE RISKS OF RECESSION

All of these conditions prevail, but not without risks and injuries to some elements in the economy. The steadily rising commodity and service prices injure the low- and fixed-income groups. They cannot maintain their volume of purchases at the higher prices. Their purchasing power in effect is cut, and this results in a drop in effective demand in the market. Prices may get so far out of line that even those who possess purchasing power refrain from buying goods, securities, real estate, plant, and equipment. Out of this situation would come tendencies toward oversaving and underconsumption.

On the savings and investment side other forces operate. It may be that there has been overinvestment in plant, equipment, and machinery. This in turn may result in an overproduction of consumers' goods. Prices fall and entrepreneurs begin to doubt the prospects for profits. Under these circumstances the propensity to risk and invest drops off. The production goods industries suffer from a decline in the demand for their products. Unemployment begins in these industries and in some measure spreads to the consumption goods industries.

These tendencies may precipitate a downward spiral in many kinds of markets. Without reviewing all the business cycle theories and without carrying through the whole analysis, it appears that the boom is over and the economy may be headed for a serious recession. The general observation to make, however, is that forces of recession have their sources in the boom and excess characteristics of a prosperity period.

DIFFERENCES FROM THE WARTIME ECONOMY

The normal prosperity economy contains features significantly dissimilar to those arising during wartime inflation. These differences have implications which give rise to differences in the types of policies and the

degree to which they may be applied in periods of peacetime full employment. Among these differences are: (1) Government demand plays a lesser role in business expansion. (2) There is no urgent problem of shifting from civilian to war goods, and therefore there is no positive decrease in civilian goods. The problem is largely that purchasing power and demand go up faster than the supply of goods. (3) Ordinarily there is no need for substantial government borrowing and no need to increase the public debt. In peacetime it is the expansion of private credit that is the stronger inflationary factor. (4) The most significant difference between the two periods lies in the weaker psychological motivation to the public interest that prevails in peacetime prosperity as compared to a war period. Individuals and businesses will make positive sacrifices in wartime, but they are quite unwilling to have their prerogatives tampered with during peacetime. In the latter period they resist certain types of taxes and oppose higher rates vigorously. Because of these public attitudes, Congress itself loses some of its "fiscal fortitude" and hesitates to do some things, even though it realizes that it ought to do them.

Broad Objectives of Prosperity Tax Policy

IT SHOULD BE the aim of a prosperity tax policy to reduce the dosage of the economic stimulants and to temper their effects without sending the patient into a relapse. Tax and fiscal policies cannot accomplish the task alone, but they can be helpful in combination with other antidotes. Among the basic objectives a prosperity tax policy should seek to achieve are: (1) to combat excess purchasing power and inflation, (2) to maintain budgetary surpluses to retire public debt, (3) to discourage spendthrift consumption, and (4) to discourage overinvestment and highly speculative investment. Tax policy can do some of these directly and others indirectly by absorbing excess spending and speculating power.

COMBAT INFLATION AND EXCESS PURCHASING POWER

It is desirable, first of all, to combat inflation and any increase in purchasing power (after the point of full employment is reached) without precipitating actual deflation. Tax and fiscal policy can assist in preventing inflation. One authority has proclaimed that the only adequate measures to be taken against over-all inflation are to tax and to save.[2] However, the application of monetary and credit controls can play a strong co-ordinate role.

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[2] Alvin H. Hansen, *Economic Policy and Full Employment.* New York: McGraw-Hill Book Co., 1947, p. 10.

BUDGETARY SURPLUS TO RETIRE THE FEDERAL DEBT

Assuming realistically that the federal debt will be of substantial size for some time to come, a budgetary surplus should be achieved to retire as much of the debt as possible during periods of prosperity. Otherwise the continued increase of the debt during depression and war may well overburden the economy. If the retirement is at such a rate that the federal debt does not increase faster than the national income, the more serious effects may be avoided.

Sufficient retirement to offset completely the debt incurred during the preceding depression may not be economically feasible, but every effort should be made to maximize debt reduction when inflationary forces are sufficiently strong. This means that the over-all tax program must be sufficient to produce a surplus. Retirement should be concentrated on the inflationary portion of the debt, including primarily the debt instruments which are held by commercial and Federal Reserve banks, and secondarily those which are in the hands of the wealthier individuals.

DISCOURAGE EXCESSIVE CONSUMPTION

Tax policy must attempt to discourage over-extended consumption. This may be done effectively through taxes specifically on consumption goods. Such a policy may tend to cause many individuals to refrain from buying and thus take some of the pressure off prices. One authority has written:

> In a highly dynamic economy in which investment booms are vigorous, the appropriate type of taxes to apply during the boom is some form of tax on consumption. On the one side, this policy would tend to hold in check an abnormal rise in consumption and thus tend to dampen the induced stimulus... to investment. On the other side, such a policy would provide funds for investment more largely from voluntary savings and thereby minimize the excess of bank credit.[3]

DISCOURAGE OVERINVESTMENT

Unless other controls are sufficient, a prosperity tax policy must try to discourage overinvestment in factories and equipment. This helps decrease one of the primary sources of demand for bank credit and thus tends to reduce inflation. This may be done directly through tax policy directed at profits or indirectly by decreasing the profitability of business by discouraging consumption. Discouraging investment furthermore prevents the bogey of ultimate "overproduction" which sends the price level reeling downward.[4]

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[3] Hansen, *Fiscal Policy and Business Cycles*, pp. 299-300.

[4] Many economists today claim, however, that such general overproduction is impossible except in terms of income contraction which decreases purchasing power. Otherwise, Say's Law reveals that the total income paid out to the factors of produc-

As noted, the benefits of discouraging investment in prosperity may far offset the disadvantages. If other inflationary controls are sufficient, however, it would probably be desirable economically to permit investment to proceed at its own pace.

OTHER OBJECTIVES

Tax policy can serve to curb excessive optimism by reducing the prospects of inflation, by reducing consumption, and by reducing the return on invested capital. In the same way it may help reduce speculation in securities and commodities and reduce hoarding and the accumulation of inventories.

CONCLUSIONS

Despite what some critics may say, tax policy can get at some of the basic forces of the business cycle directly. Tax policy, in addition, alleviates some of the other tendencies indirectly. It reduces the lag between costs and prices by reducing the inflation which causes it. It may be able to reduce the magnified fluctuations in demand for capital goods by reducing consumption and the prospects for investment. It may alleviate so-called "overproduction" which is supposed ultimately to lead to a recession. Tax policy can offset and reduce some of the excessive expansion of bank credit which tends to occur.

During times of prosperity taxes should be used to check the economy rather than stimulate it. They must be high. But they must not be high enough to destroy economic incentives. Taxes must be carefully chosen to accomplish the purposes desired.

Specific Tax Measures in Prosperity

INDIVIDUAL TAX ADJUSTMENTS should in most cases be similar to those desirable during wartime inflation, although they are likely to be applied with less severity.

INDIVIDUAL INCOME TAX

The initial step at the approach of inflation is to raise the rates of the personal income tax. Changes should be both broad and deep. Exemptions should be lowered and rates raised all along the line. This will accomplish two purposes. First, it will take excess money out of the

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tion as costs is the same as the total demand for the goods of industry which must necessarily be sufficient to cover the costs of production.

hands of the consumers so that they will not be in a position to bid against each other for goods. Second, it will limit the amount of money available to the higher-income groups for speculation and overinvestment.

Discretion must be exercised to set the rates according to the degree of boom and inflation. If the rates are set too high, they will cut into the standard of living of the low-income consumers and destroy the incentive of the higher-income groups to invest. This may precipitate the downward cycle immediately. A careful analysis of the economic indicators should give a clue to the desirable rate level to be established. Current collection at the source and quarterly payments of estimated tax make the lag in the personal income tax of less consequence than formerly. These methods of collection are among the strongest anti-inflationary weapons. Though they are not "trigger-quick," they operate more rapidly and effectively (for anti-inflation purposes) than the old "annual collection" method.

THE CORPORATE NET INCOME TAX

Increased rates on the corporate net income tax act as a double-edged blade in the attack upon inflationary pressures. In a way, it is an ideal weapon. Insofar as corporate taxes are shifted to the consumer, they reduce consumer purchasing power and the propensity to purchase, and thus they take some pressure off prices. Insofar as they are borne by the corporation, they reduce profits and thus the capacity to reinvest, and thus they curb tendencies to overinvest. They thus inhibit both phases of an inflationary economy. In the absence of an excess profits tax, rates could be raised higher than in wartime, if it is thought that inflationary tendencies are sufficiently strong.

EXCESS PROFITS TAXES

Excess profits taxes have been a standard wartime device. In such times they have been widely accepted as desirable and just. In peacetime, however, public sentiment ranges against excess profits taxes as a means of inflationary control. First, such taxes appear to be too extreme in their reduction of corporate profits and of corporate incentive and ability to invest. Second, as mentioned, there is less opportunity for profiteering in peacetime inflation than during war. Profits are more evenly spread throughout the system, and they are generally needed for building up reserve funds for hard times. Many believe the corporate net income tax can be satisfactorily adjusted to perform the functions of the excess profits tax in peacetime.

Perhaps the most justifiable use of an excess profits tax in peacetime would be during the inflationary period following a war, when the pent-up demand for consumers' goods and the shortage of those goods makes

continuation of wartime controls temporarily essential. Often the early postwar profits are in fact war-induced profits.

CAPITAL GAINS TAX

Capital gains could well be taxed more severely during an inflationary period to help reduce the incentive to speculative purchases and sales. It might also be well to lengthen the short-term capital gains period and thus tighten the opportunity for speculative gains. A capital gains tax can have some controlling effect on consumer buying because it may cause taxpayers to hold inflated assets rather than take the gain. Especially those holders of capital assets in the lower- and middle-income groups will then not have the "easy gains" available for easy spending.

FEDERAL EXCISES AND RETAIL SALES TAX

Most federal excises hit certain classes of consumption goods quite severely. They are thus ideal for restricting consumption and inflation. An extension of the base and an increase in the rates on such excises appear desirable in boom periods.

They should not be made the main source of additional revenue during prosperity, however. It has already been pointed out that for a number of reasons the personal net income tax appears to be the more equitable and administratively the more satisfactory device to strike at consumer purchasing power, especially in peacetime.

The argument is doubly strong against a federal retail sales tax which was rejected even as a wartime anti-inflationary measure. Even though the tax is excellently suited for anti-inflation timing, its disadvantages appear far too great for peacetime purposes.

SOCIAL SECURITY TAXES

An increase in the social security payroll tax promises to be one of the most effective anti-inflationary measures for use during a period of prosperity (provided, however, that Congress shows the fiscal fortitude to act). Heavier rates on such taxes would tend to fall largely on the wage earner. The tax would therefore strike strongly at consumption. When combined with a downward adjustment of social security payments during full employment periods, the tax promises to be a superior device. Its main defect is its failure to provide for personal exemptions and deductions as does the personal net income tax. However, in the long run this purchasing power comes back to the worker in a more needy period.

Limiting Factors in Tax Policy in Prosperity

IN TIMES OF PROSPERITY we find a number of limiting factors in tax and fiscal policy. Many factors are inherent in the characteristics of prosperity itself. These are in addition to the general limitations of using taxation to help control the functioning of the economy.

The very economic and psychological conditions prevailing during the prosperity period militate against the application of counter-cycle tax and fiscal policy. The struggle against special interests, against political pressure, against lethargy, and against unwillingness to sacrifice in times of prosperity make the passage of such a program very difficult, to say nothing about hindering it if it were passed. Finally, Congress and the Executive tend to lose the "fiscal fortitude" necessary to the application of such a policy in prosperous periods. There is the tendency to shy away from the utilization of the social and economic disciplines which the excesses of the period require. Some would say that this tendency was evidenced in both the Executive and Congress by the early repeal of the excess profits tax at the close of World War II. It was evidenced in Congress alone in the tax reduction and split-income features of the *Revenue Act of 1948*. The latter act resulted in a reduction of about $5 billion in annual revenues in what was essentially an inflationary period. In the latter situation the President, however, demonstrated the requisite fiscal courage.

Need for Co-ordination of Taxation with Other Policy

THE CO-ORDINATION OF tax policy with other fiscal and economic programs in times of full employment is essential to its success. Prosperity is a period for preventive action in which individuals must discipline themselves and government must act with determination. The desire for gain and immediate satisfactions are usually stronger than good judgment. There is need for greater reasonableness and discretion in economic conduct. Fundamentally there is a need for better economic education.

Although it is difficult to know exactly where we are in the cycle at any given moment, the use of economic indicators by the Council of Economic Advisers may minimize this difficulty. Possibly a little foresight and planning in prosperity may avoid the need for general economic planning for the system as a whole. At least it can prevent the misapplication of tax policy which yields adverse effects.

NEED FOR ECONOMIC EDUCATION

There is need for a more widespread economic education for all the American people. This was dynamically illustrated in the stock market speculation period of 1928 and 1929 and in the highly negative behavior of too many people in the depression of the 1930's. More recently this lesson was driven home by the selfish economic behavior of our people after the outbreak of the Korean war—wholesale hoarding by millions created serious economic problems for themselves and millions of other good citizens. Most of this type of conduct grows out of selfishness and greed, economic ignorance, and fear. A more stable economic behavior of our people can contribute something of value in counter-cycle policy. This, however, may be a matter of long-run thrift, consumer, and investment education.

CO-ORDINATION WITH OTHER FISCAL POLICY

Over-all fiscal policy in times of prosperity should be well timed and well planned. Taxes in general should be high and strategically placed. Government spending and investing should be kept at a minimum. The federal budget should be balanced with a surplus to pay off the inflationary part of the debt. Social security taxes and contributions should be kept high.

Public works planning may be a wise investment. A few million dollars spent in this manner to prepare for a possible depression could pay off manifold both in anti-deflationary achievement and in the worthiness of the projects planned for depression.

CO-ORDINATION WITH OTHER ECONOMIC POLICY

The banking system must be kept sound qualitatively. Deposit insurance should help discourage excessive spending for fear of loss. Accurate timing of money, banking, and credit policy is necessary. This includes intelligent use of the rediscount rate, reserve requirements, margin controls on the stock market, direct control over consumer and business credit, open-market operations, and other elements of Federal Reserve control. The Treasury Department and the Federal Reserve System should so adjust their governmental bond support policy as to revive credit control powers of the Federal Reserve System. Probably such powers can be made more effective in the prosperity phase than during depression.

Conscious effort by organized labor and management to increase productivity and reduce costs and prices in times of prosperity would benefit the economic system generally. Direct controls (such as price control, wage control, and rationing) could be kept as a stand-by but should prove unnecessary economically, if other devices are applied intelligently.

As a long-run policy, a better distribution of wealth and income through increased productivity, higher wages, and lower prices appears desirable for the purposes of economic stability. Anti-monopoly policy should be firm in order to reduce rigidity of costs and prices. And a well-planned and executed social security system will help to sustain demand in a depression and reduce it during a boom period.

Conclusions on Tax Policy in Prosperity

FIRM AND DECISIVE fiscal action is just as essential in prosperity as in wartime. However, the mood of public opinion in peacetime prosperity is entirely different from that in a war economy. There is a strong propensity to want to "let well enough alone," "Business is good, why disturb it?" The fiscal courage of the Executive and Congress is much weaker than in wartime. The task of formulating and applying adequate tax and fiscal policy is much more difficult.

Nevertheless, the excesses of inflation require a firm tax policy; it must emphasize the personal income tax, corporate net income tax, federal excise taxes, and payroll taxes to strike at spendthrift consumption on the one hand and overinvestment and speculation on the other. Tax policy should be co-ordinated with other fiscal, monetary and credit policy, and other economic policy in the struggle against inflation, speculation, and overinvestment. To the degree that we can keep the "boom" in reasonable check, to that degree can we also keep the collapse from being extremely severe. A firm and strong tax policy is definitely a keystone in counter-cycle policy in periods of full employment.

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Taxation and Tax Policy in Depression

THE NUB *of the problem of economic 'balance' is to encourage sufficient funds and incentives for the growth of productive facilities which fully absorb our technology and man power, while promoting sufficient flow of income to ultimate consumers to clear the market of goods and thus to avoid periodic 'overproduction.'*

—COUNCIL OF ECONOMIC ADVISERS.[1]

Overview

ONE OF THE vital challenges to the continued existence of the free-enterprise system in America is the recurrence of a major economic depression with its mass unemployment. The use of tax policy in promoting an active and expanding economy can be a strong social tool in mitigating these periodic business collapses.

Most depressions have been associated with a decline in expenditure for both consumption and investment goods. The causes are multifold: external influences, psychology, and maladjustments in the economic system. Despite the complexity of the causes, many economists feel that the severity of these collapses may be alleviated by measures designed to keep up the aggregate level of consumption and investment. This is where tax policy can play its role.

The *Employment Act of 1946* commits the federal government to maintain high levels of production and employment. Nevertheless, many theoretical and practical problems remain before tax policy can be adapted to the needs of incipient depression and depression itself. First of all, should an anti-deflation tax structure be developed on a secular basis or as an anti-cyclical weapon? Can stability in tax policy, so necessary for business confidence, be reconciled with anti-cyclical tax adjustments? Can "tax reductions" be of value in combating recession? The reduction of which taxes would be of greatest value in an anti-depression policy?

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[1] *Fourth Annual Report of the Council of Economic Advisers,* December 1949.

The primary objectives of this chapter are: (1) to explore the possibilities of tax policy as an instrument to combat depression and (2) if possible, to construct a set of tax policies that will be useful to check the downward tendencies of recession and to contribute to the forces of recovery. The chapter is basically concerned with counter-depression *tax policy*. Though other aspects of fiscal policy are considered in passing, no detailed analysis of these aspects is possible here.

Removing the Tax Deterrents to Business

LESSENING THE DETERRENTS to business activity is a prime requisite of a depression tax policy. This involves reducing the tax rates and adjusting the tax system in such a manner as to hinder the least or positively stimulate *investment* in new capital goods and *consumption* of goods and services. The guides seem quite clear. Nevertheless, attempting to do all these simultaneously brings the legislatures and policy administrators face-to-face with several dilemmas.

DILEMMAS IN DEPRESSION TAX POLICY

Attempting to stimulate business during a depression through increasing private investment and consumption, leads to several conflicts in tax policy. If carried too far, each goal impinges on the other.

Most tax measures which alleviate the burden on investment tend to increase the burden on consumption. Encouraging consumption in turn may require compensating taxes which may be detrimental to investment. However, in depression tax policy there is no reason why some reduction in both areas is not possible—in which case there need be no serious conflict. Furthermore, the concern for stability of the tax system is not so relevant in a depression; in fact, downward revisions are actually appreciated on both the investment and consumption sides. Anticipated reductions, however, sometimes cause hesitation in business activity until the tax reduction is in fact effected.

SECULAR VS. ANTI-CYCLICAL POLICY

Depression or deflation requires tax adjustments which will hinder the least or give the greatest possible inducement to private investment and consumption expenditures. But whether such tax adjustments should be operated as a long-term, secular policy or applied as more flexible tools to be adjusted upward or downward to suit the phases of the cycle is a fundamental question which must be determined before any long-range tax program can be formulated.

If the economy has a persistent tendency toward secular stagnation and

under-employment, tax inducements to investment and consumption must become a permanent fixture of our economy—a fixture to be altered only in periods of threatening inflation.

The author is not one who believes that the American economy is faced with secular stagnation in the forseeable future. The economic reactions within our economy seem likely to be cyclical in character for some time to come. In addition, wars and international problems will tend to maintain that cyclical character for at least several phases of the cycle into the future. Though both our tax and economic policy must have long-run objectives, many factors in these policies will of necessity have to be adjusted to the phases of the business cycle. In fact, cyclical prosperity and depression will compel that type of approach.[2]

REDUCING TAX RATES AND YIELDS

Few economists would advocate attempting to increase tax rates or revenues during depression. Most would feel that a lower yield is desirable. This could be the result of either an actual decrease in rates or of constant rates applied to a lower total national income. With constant or increased governmental expenditures, this would require at least some deficit financing.

STIMULATING INVESTMENT

In Chapter 28 were revealed numerous measures asserted to be stimulating to investment. Some were based on the Neoclassical assumption that relieving profits and higher incomes from taxation stimulates investment through preserving incentive and the supply of investible funds. Keynesians, believing in a chronic tendency toward oversaving, demand emphasis on preserving consumption as a far more important influence in maintaining a high level of investment.[3] Despite such contradictions on basic principles, it is possible to find some tax measures which both points of view can probably agree will have a net beneficial influence. This is because certain measures readjust taxation at points exceptionally strategic to incentive or savings supply. The detrimental consumption effect in such cases may be nil or very minor.

Preserving the supply of strategic savings. It is probably true that after the postwar demand for consumer durables is met, there will be no *general*

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[2] See Alvin H. Hansen, *Business Cycles and National Income.* New York: W. W. Norton & Co., 1951, Chap. 25, "Is Cycle Policy Obsolete?"

[3] Alvin Hansen, for example, has asserted, "It is highly probable that taxes on consumption played a far greater role as a deterrent to full recovery in 1936-7 than did corporate and personal income taxes: ... To the extent that our tax system could be shifted away from regressive taxes bearing on consumption to progressive taxes on that part of the income stream which flows into the savings channel, private consumption expenditures would rise. Such an increase in expenditures would stimulate private investment." *Fiscal Policy and Business Cycles,* pp. 398-399.

shortage of savings. Nevertheless, there may be a shortage of *strategic* savings which, if untaxed, would flow rapidly into new investment. For example, small and new business has exceptional difficulty accumulating sufficient capital to finance its investment activities. Taxation can help preserve these supplies of capital by giving special tax treatment to such business. Such a policy would also help preserve the competitive vigor of our economic system and the social values inherent in small business.

Strategic savings can be injured in another manner. Even though progressive income taxation leaves a large enough total supply of savings, it may curtail those personal savings of high-income groups which would have been most likely to flow into *risk* investment. Intelligent surtax planning requires more information regarding investment patterns by various income groups. The structure of progressive taxation must allow for the qualitative aspects of capital supply.[4]

Reduction of surtax rates. Lowering surtax rates stimulates incentive, but that reduction would necessitate higher taxes on consumption, unless national income were increased sufficiently to increase the tax yield. Here, again, a study of investment patterns would be useful. From an observation of the economic system, it should be possible to obtain a rough approximation of how low the surtax rates may go before the beneficial effects on investment are offset by the extra burden on consumption.

The problem is *more* than that of mere *reduction of rates* at the top brackets. The whole progressive rate structure must be molded to obtain maximum investment incentive. This includes the incentive of the dollar-wise and significant middle income groups as well as the top income recipients. The $25,000 to $100,000 income recipients probably supply the bulk of equity investment.

Many estimates place 50 per cent to 65 per cent as the top rate limit. Estimates concerning the middle incomes indicate that the present federal rate structure already progresses too rapidly. Some reduction of surtax rates in a depression may be essential. Fortunately, the total revenue loss from reduced tax rates on medium and higher incomes would be relatively small, while investment effects may be large. This reduction could be supplemented to some extent over the long run by a strengthening of death and gift taxes.

Reduction of double taxation of corporate income. The combined burden of corporate and personal income taxes tends to be especially destructive of both incentives and the supply of capital funds. Of the two, corporate taxes are usually the more important strategically. Nevertheless, some integration between corporate and personal income is needed. Possible methods of integration have been mentioned in connection with

[4] Richard A. Musgrave, "Federal Tax Reform," *Postwar Economic Studies*, U. S. Board of Governors of the Federal Reserve System, No. 3: *Public Finance and Full Employment*, Washington, December 1945, p. 30.

the taxation of corporations. Such a policy would be particularly helpful in a depression era.

Insofar as the corporation tax is shifted, integration becomes less urgent. Some studies indicate that the corporate net income tax, especially of large firms whose prices are administered below the maximum profit position, tend to be shifted to consumers.

Carry-over of losses. Carry-back or carry-forward of losses for both corporations and individuals can offer substantial inducement to risk investment. Such policy could be of strategic significance during low-profit periods. For new firms having no income taxes from which to deduct losses, the Treasury could make a "refund" equal to a fraction of the tax rate.[5] Carry-over of losses is valid basically as a long-range policy, but it does make a contribution as an anti-cyclical device. Losses in depression are not so discouraging when business knows that losses can be recovered out of future taxes when "things pick up" (carry-forward), or recaptured out of past taxes paid when profits were more substantial (carry-back).

Averaging personal income over time. Risk investments tend to yield uncertain and irregular gains. Our present income tax procedure discriminates harshly against these irregular gains. For this reason, some technique of averaging personal income appears desirable to inspire risk investment. Combined with loss offset provisions, the stimulus could be substantial. Such an averaging scheme would include capital gains and losses and therefore would have risk and incentive value also. This, too, should be established as a relatively permanent feature of the tax system, but again it has direct value in anti-depression tax policy.

Special tax treatment of dividends. Various types of special tax treatment have been proposed for dividend income. One plan contemplates revision of the tax law to permit individuals to deduct from their income tax liability an amount equal to 10 per cent of the dividends they have received on common stocks. One proclaimed advantage of this plan is the fact that stockholders in the lower-income brackets would receive the greatest proportional reduction in the rate of tax paid on dividend income.[6]

Another proposal is the special exemption of dividend income so that it pays no more than a 40 per cent tax.[7] These proposals could be adopted either as short-range or long-range adjustments.

Other methods. Other proposals are useful as investment-encouraging devices for *both* depression *as well as* long-run purposes. These include

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[5] Musgrave, *op. cit.*, p. 33.

[6] Emil Schram, "Taxation and Venture Capital," *The Annals* of the American Academy of Political and Social Science, Vol. 266, November 1949, p. 90.

[7] G. Sidney Houston, "Taxation and Corporate Enterprise," *The Annals* of the American Academy of Political and Social Science. Vol. 266, November 1949, p. 96.

emphasizing the personal income tax and avoiding many minor taxes on business, abolishing tax-exempt securities, removing any excess profits tax, granting "accelerated depreciation," and exempting reinvested earnings (subject only to the capital gains tax) from current income taxation. The latter three are suitable for short-run, compensatory tax policy.

STIMULATING CONSUMPTION

Most tax techniques which relieve the burden of taxation on consumption are discussed in Chapter 28. A large portion of them are suitable for short-run, counter-cycle policy. However, they should be carried out only to the extent that the benefit of any additional adjustment exceeds the detrimental influence on investment.

Shifting tax burden to higher-income groups. Purchasing power theorists advocate shifting the tax burden to higher-income groups as part of a policy against both chronic unemployment and short-run cyclical unemployment. But this may interfere with incentives to invest and the supply of investible funds. Therefore, as noted earlier, the ideal tax structure during a depression must represent a carefully selected position between the extremes—a position that gives the greatest net advantage to both consumption and investment.

Some of the techniques for shifting this burden are increasing exemptions for lower-income groups under the income tax, lowering normal and surtax rates in lower brackets, avoiding or removing sales taxes, and reducing or removing excise taxes. All are suitable for short-run, counter-depression policy. As a result of these reductions, added burdens must be borne by other sections of the tax system or by deficit financing. The tax most suitable as a substitute appears to be a strengthened death and gift tax, although the revenue yield here is low. Taxation of capital gains at death is another alternative. The advisability of increasing the tax burden on business as such in time of depression is doubtful, however.

Limitations on progression increases. Personal income tax progression is much more limited in reducing the consumption impact of taxes than is generally believed. This is because of two reasons. First, most taxable income lies in the lower- and middle-income groups. Second, the *marginal fraction* of income saved may not differ greatly between lower- and higher-income groups. Taxation takes marginal, not average, dollars. One authority asserts,

> Data upon which such estimates can be based are rather inadequate, yet quantitative analysis suggests that no major reduction in tax pressures on consumption can be achieved by pushing the degree of progression within feasible limits, once excise, pay roll, or other high consumption taxes have been eliminated and a reasonable degree of progression in income taxation has been obtained.[8]

[8] Musgrave, *op. cit.*, p. 28.

This would suggest, then, that an increase in tax progression to any large degree is on the whole disadvantageous economically either as cyclical or even as long-run, depression policy. The detriment to risk investment could far outweigh the slight gain in purchasing power. Caution is indicated.

Gearing social security taxes to levels of employment. The level of social security payroll taxes may be adjusted to the stage of the business cycle as determined by the level of employment. This, in conjunction with increased social security benefits, can be an effective consumption-stimulating device during cyclical depression.

Lowering corporate net income taxes. Increasing evidence points to the fact that perhaps a portion of the net income tax on large corporations is shifted to the consumer. If this is the case, corporate net income taxes may be more of a burden on consumption than is usually thought to be true. The reduction of such taxes would, therefore, appear to be one of the more important ingredients of anti-depression policy. Both investment and consumption would be encouraged with one wave of the tax wand.

The Administration of Depression Tax Policy

A CONSTITUTIONAL DEMOCRACY creates special problems in administering anti-depression tax adjustments. Several alternative programs of administration have been proposed. Those include *built-in* devices, *administrative* devices, and *legislative* devices.[9] Other important problems of administration also serve to harass the administrator.

BUILT-IN DEVICES

Built-in tax devices apply an antidote to depression and unemployment automatically. No human discretion need enter into the adjustments made. There are two major types of built-in devices.

Flexibility in yield. All taxes show greater or less flexibility in yield even with no change in rates over the period of the business cycle. Generally, those taxes showing the greatest flexibility in yield are the same as the taxes which throw the least burden upon consumption. In order of greatest to least flexibility, the taxes range from the corporation income tax, personal income tax, and payroll tax, to the excises on necessities. The yield from taxes on lower incomes and consumption are the least flexible.[10] Some programs for counter-cycle tax policy place almost

[9] Arthur Smithies, "Federal Budgeting and Fiscal Policy," *A Survey of Contemporary Economics,* Howard S. Ellis, (ed.). Philadelphia: The Blakiston Company, 1948, p. 205.

[10] Musgrave, *op. cit.,* pp. 41-2.

exclusive reliance upon flexibility of yield for compensating changes.[11]

Several disadvantages of relying on flexibility in yield are advanced. First, the anti-cycle effect is too weak to do more than dampen the swings. Second, it assumes that the economy automatically tends toward full employment, which Keynesians dispute.[12] However, as a "contributory attack" on depression and the cycle, few would doubt its usefulness.

Automatic adjustment in rates. It has been suggested that the rates of taxes be tied to some indicator of economic activity. The adjustment would then be made as a matter of course as soon as the indicator reaches the appropriate level. One expert suggests, for example, that the rate of the tax depend on the movement of money income during the past month.[13] However, tax policy should theoretically be based upon a number of indicators, not just one. The fallibility of human judgment is the greatest flaw of such a plan.

Although built-in devices are rapid and automatic, they lack the adjustability to different circumstances which discretionary action would have.

ADMINISTRATIVE DEVICES

Some proposals for anti-depression policy recommend obtaining executive discretion over rates of expenditure and tax rates. For example, it has been suggested that Congress delegate to the administration the power of changing the first-bracket rate on individual income during the fiscal year.[14] There could be even more discretion permitted if there were guideposts (such as a schedule of rates stepped up or down according to changes in the volume of unemployment) set up by Congress. But the Executive should not be tied down rigorously to any single set of indicators.

The President could report periodically to Congress (probably quarterly, as well as in his annual economic report) on action taken and not taken and the reasons.[15] In order to retain legislative responsibility, the administrative authority could include representatives from both the legislative and executive branches of the government.[16]

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[11] Exemplified by Committee for Economic Development, *Taxes and the Budget*, New York, November 1947. Also, see Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," *American Economic Review*, Vol. 38, June 1948, pp. 245-246.

[12] Hansen, *Monetary Theory and Fiscal Policy*, pp. 177 ff.

[13] Kenneth E. Boulding, *The Economics of Peace*. New York: Prentice-Hall, Inc., 1945, pp. 161-162. See also Friedman, *op. cit.*, pp. 245-264.

[14] Committee for Economic Development, *Jobs and Markets*, New York, 1946, as cited by William Fellner, "Employment Theory and Business Cycles," in *A Survey of Contempory Economics*, p. 91.

[15] Hansen, *Monetary Theory and Fiscal Policy*, p. 182.

[16] Musgrave, *op. cit.*, p. 43.

LEGISLATIVE DEVICES

Many economists feel that Congress would balk at more than a very limited delegation of taxing power to an administrative authority. Great reliance must therefore be placed on other measures passed by Congress, aside from built-in flexibility. This seems to be in line with the intent of the *Employment Act.*[17] It has been suggested that Congress pass the tax laws in advance concerning changes in rates to be put into effect by joint resolution. Meanwhile, the executive could prepare its plans.[18]

PROBLEMS OF FORECASTING AND TIMING

Both timing the anti-depression action and forecasting when it will be necessary involves the highest analytical skill and judgment.

Forecasting and timing. There are two major approaches which might be made to anti-depression fiscal policy. First, a forecast might be made of the time and extent of the threatened economic contraction. Then the appropriate type and degree of measures could be readied for application at or before the first signs of recession.

But because of the inadequacies of present-day economic forecasting, a second approach would, perhaps, be more workable. This would involve preparing a tax program in advance to fit the most probable type and degree of deflation which might occur. Then action could be taken promptly as soon as the fact of deflation had been definitely established. This may not be until several months after first signs of the downturn, however.

Economic indicators for timing. Both timing and forecasting depend upon the reliability of the indicators used. Assuming that action will not be taken until after the deflation has been certified, several indicators for determining the state and trend of the economy appear promising. An *unemployment index* can be found in the Department of Labor's "Monthly Report on the Labor Force." It has been suggested that anti-depression policy be applied after three months of 4 million unemployed, or after one month of over 6 million unemployed. Better still, perhaps the index should be expressed as a "percentage" of the total labor force unemployed for a given period.

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[17] Smithies, *op. cit.*, pp. 206-207.

[18] Various other degrees of administrative discretion have been proposed. For example, it has been suggested that the administrative discretion be subject to Congressional veto. If the President approves, and a resolution of both houses opposes, the action fails of enactment. If the President approves, and only one house opposes, the action passes. If complete administrative discretion were given, the authority would be similar to that of the Board of Governors of the Federal Reserve System. See Everett E. Hagen, "The Problem of Timing Fiscal Policy," *Proceedings*, American Economic Association, May 1948, Vol. 38, pp. 417-429.

Other indices are those on *national income* or *personal income*. Both of these are at present too slow of calculation for rapid anti-deflation action. *Price series* offer promise, such as an index of consumer's prices. Perhaps a combined *unemployment-price index* would give sufficient speed and pertinence.[19] Nevertheless, reference should be made to other indicators of business activity such as production statistics, bank debits and credits, the security markets, car loadings, business failures, corporate profits, retail and wholesale trade, inventories, and the like. An important observation to make is that "pin-point timing" is not necessary in applying depression fiscal policy. Nor is it necessary to wait several years before action is taken.

Economic indicators for forecasting. The economic indicators for determining what the future condition of the economy will be are not as well developed as those indicating the present condition. This is the problem of forecasting. Progress has been made in this direction. One authority believes it will be possible to make reliable business cycle forecasts for the near-future months through a study of "expenditure streams." The method requires a detailed breaking down and study of investment expenditure, consumer expenditure, and government expenditure, as well as consumer stocks, income payments, employment, business payrolls, and net profits.[20] Even if forecasting techniques should be slow in developing, reliance on *ex post facto* action should still be useful as an anti-depression device.

Timing agency. The Council of Economic Advisers to the President, created by the *Employment Act of 1946*, is the most suitable agency to collect and co-ordinate statistical information for purposes of forecasting and timing. Some material can be gathered originally. But the majority of it could probably be derived from the regular statistical agencies, such as the Bureau of Labor Statistics, Department of Commerce, and private economic services. For modern forecasting, many new types of data would have to be developed.

TIME LAGS

One of the primary purposes of the administration of tax policy must be to reduce as much as possible the time lag between the need for action and the effects of the tax adjustments upon the economy. There are three elements of the time lag to be considered: (1) the lag between the need for action and the recognition of this need; (2) the lag between recognition of the need for action and the taking of action; and (3) the lag between the action and its effects. Discretionary action would have

[19] Hagen, *op. cit.*, pp. 421-422.

[20] E. C. Bratt, "Data Needed to Forecast the Business Cycle," *Journal of Business*, University of Chicago, Vol. 21, July 1946.

to consider all three lags, whereas automatic or "built-in" action would have to consider only two.[21]

Much of the lag has been reduced by the war-installed devices of pay-as-you-go for the personal income tax with its withholding and quarterly payments. Three-fifths of the total income tax yield is collected at the source. And it is administratively feasible in the course of a few weeks to change the level of withholding rates. This might be useful until more extensive counter-measures can be taken.[22]

BALANCING WITH EXPENDITURE POLICY

Public expenditures, debt, monetary and banking policy, and other economic policy must all play their co-ordinate roles with *tax policy* in the attack on depression. In fact, the part played by taxation depends to a large degree upon the burden placed upon these other techniques of governmental control. One of the major problems revolves around the relative roles that must be played by *increased expenditures* and *decreased taxes* in a depression, or by increased debt as compared with alterations in the tax structure.

Increased expenditures vs. decreased taxes. One of the decisions which must be made in the administration of fiscal policy is whether during depression it is more desirable to increase public expenditures or to decrease taxes in attempting to achieve a given employment level. Both techniques have a particular role they can play.

Tax reductions may have a more favorable effect on private investment than an equal increase in public expenditures. This is because taxes tend to affect profits and incentive to invest. They are also superior to public expenditures when the backlog of useful public works is used up, or when public works become competitive with private industry. Furthermore, tax reduction is more evenly spread and thus more suitable to general economic control.

Government expenditures, however, may be more *selective* because they may be limited to given areas. Or they may be more suitable where tax reductions will tend to be "saved" rather than spent. Expenditures may also be superior where public works are of high utility. The particular part played by each, then, will depend upon the specific conditions during the depression. The problem will be that of "striking" the right "balance" between tax reduction and increase of expenditure.

Increased debt vs. alterations in the tax structure. Decreasing tax yield with constant or increasing public expenditures must mean an increase in the public debt. Since a large public debt has disadvantages, it is desirable to decrease tax yield as little as is consistent with restoring a high

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[21] Friedman, *op. cit.*, pp. 255-256.
[22] Musgrave, *op. cit.*, p. 43.

level of employment. This creates an incentive to alleviate the depression by means of alterations in the tax structure. The less deflationary the tax system as a whole, the smaller the deficit required to achieve high employment.

OTHER ADMINISTRATIVE PROBLEMS

Administration of tax fiscal policy presents difficulties, but they are not insurmountable. Careful analysis, prescription, and execution are necessary.

Alleviate or prevent depressions? It will probably never be possible to prevent completely fluctuations in a capitalistic economy. Many economists believe that it might be economically and socially undesirable to try to do so. Therefore the most that should be sought is an alleviation of the degree of the business slump to permit desirable price, wage, regional, and industrial readjustments to take place. Tax policy is ideally suited for such a role.

Stability vs. tax adjustments. Stability of the economic environment is one of the prime requisites of business confidence and expansion. This is part of a "favorable business climate." Frequent and radical adjustments of the tax system in the name of fiscal policy may upset business calculations and cause a retraction of normal investment plans. Tax changes also create serious administrative problems. Business tax changes necessitate developing new sets of rules, regulations, and court decisions, and such changes create uncertainty in tax liability as well as in business decisions.

For these reasons, most tax authorities do *not* recommend very extensive changes in *tax structure* as a part of anti-depression policy. They are satisfied mainly with a careful selection of taxes in the first instance and a downward adjustment in the *rates* of these taxes. Changes in the *kinds of taxes* applied should be made to the greatest extent possible as a part of long-run policy based on long-term economic tendencies.[23] Those tax adjustments which are most suitable for long-range policy have already been indicated.

Business "anticipation" of tax changes. There is always some danger that business anticipation of changes in tax policy will tend to counteract

[23] For official support of the theory that greater stability in tax policy will lessen the need for compensatory finance, see the *Fourth Annual Report of the Council of Economic Advisers*, December 1949. It asserts, "The credit and spending and regulatory and tax policies of the Government are so highly conditioning to the whole economy that the degree of stability of these policies affects the degree of stability throughout the whole business world. Some short-run shifts, indeed, are necessary to enable the Government to alter its position and thus to 'compensate' for changes in the private business situation. But we have already in this report indicated that if the Government moved gradually toward placing somewhat more of its own activities on a somewhat more stable and longer-range basis, this might add greatly to the stability of the whole economy."

that policy. For example, in anticipation of lower taxes in the future, firms may restrict the marketing of their goods in times of inflation and thus add to the inflationary pressures. Then the goods may be disposed of when the pressures are already deflationary.

It is more likely, however, that anticipation of tax changes (especially reductions) will have a beneficial effect if the businessmen have confidence that the changes will contribute to the restoration of prosperity. They may be impelled to continue their investment and employment creating policies. Anticipation of *tax reduction* in depression is bound to have some encouraging and stimulating effects. This is especially true when federal tax collections run high and the reductions could amount to $5 billion or more per year.

CONCLUSIONS ON ADMINISTRATION

The administrator should follow an orderly and logical procedure in the application of tax policy. This involves four elements. There must be (1) orderly economic analysis and diagnosis. This requires knowledge of economics and various theories of the business cycle. The research agency must observe and analyze the conditions and forces at work. This includes a study of all indicators, including magnitudes of movement, trends, rates of change, and the like.

Within the limits imposed by Congress, the administrator must formulate (2) tax prescriptions and remedies. He must be accurate in the (3) timing of tax policies. This requires less fortitude during a depression than during a period of inflation. And finally, there must be (4) application of the tax policy to the right degree.

State and Local Tax Policy

UNITY OF ANTI-DEPRESSION ACTION among most states and local units would be difficult to achieve. Strong reliance on the property tax and consumption taxes tends to have a depressing effect in hard times. And aside from taxes, sufficient credit resources are not available to state and local governments to finance an anti-depression policy. There is no control of currency and credit; there are sharp borrowing limitations; and the units are a poor credit risk in depression. As a result, state and local policy tends to aggravate rather than alleviate cyclical swings and depression.[24]

Probably the most that can be done from the tax standpoint is the creation by state and local units of tax reserves in prosperous years to

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[24] Robert S. Ford, "State and Local Finance," *The Annals* of the American Academy of Political and Social Science, Vol. 266, November 1949, pp. 21 ff.

be spent during periods of depression.[25] Large flexibility in yield would be the goal. A program of that nature is partially carried out in New York State. On the whole, however, political drawbacks would militate against its success for most state governments and local units.

Another alternative is keeping local tax rates for debt service at a constant level and treating the surplus collected as a levy for capital improvements to be carried out in bad years.[26] But federal fiscal policy probably must resign itself for the time being to regressive tax systems and some aggravating policies on the state and local levels. In the long run by education and co-operation it is to be hoped that state and local governments will co-ordinate their tax and fiscal policies with those of the federal government, especially in periods of war, peacetime inflation, and depression.

Proposed Federal Revenue Program in Depression

IT WILL PROBABLY be found that the most suitable federal tax structure for an anti-depression policy is strong reliance on the personal income tax and less reliance on the corporate income tax, with some integration between the two. An attempt at increasing the progression of the personal income tax during depression should be minimized, unless it can be demonstrated that over-saving is substantial. The rate structure should be adjusted according to previously acquired data to maximize both consumption and investment. Loopholes in the tax should be plugged.

Favorable influence on consumption should be sought mainly through the reduction or removal of "necessity" excises and sales taxes, and through reduction of social security payroll taxes. A plugging of the loopholes in death and gift taxes and the taxation of capital gains at death may help replace some of the revenue released by removal of consumption taxes. Co-operative action with state and local governments on tax policy should be encouraged as much as practicable.

As a long-run objective, small and new business investment must be stimulated through special tax treatment either as a partnership or under partial exemption from the corporate net income tax. Furthermore, other investment-encouraging techniques should be adopted, as allowing carry-back and carry-over of losses, abolishing tax-exempt securities, an

[25] Louis Shere, "Tax Reserves for State and Local Governments," *Proceedings*, National Tax Association, 1945, pp. 187-195.

[26] Frederick L. Bird, "Municipal Fiscal Policy and the Business Cycle," *Proceedings*, National Tax Association, 1945, p. 212.

averaging treatment of capital gains, averaging general income, and permitting current deductions for research and development.

Reliance should be placed on a decrease in revenue extractions, by reductions in the rates of corporate and personal income taxes, and consumption taxes. In fact, "tax reduction" can well be the keynote of counter-depression tax policy, once the recession has set in. The reduction in collections desirable depends on the size of expenditures, debt policy, and the drop in national income. If the depression remains serious, special incentive devices may have to be adopted, including accelerated depreciation, complete current exemption of reinvested earnings, special personal income tax treatment of risk-investment returns, and only as a last resort, taxation of idle funds and income.

Conclusions

IT IS NOT KNOWN as yet to what degree tax policy can contribute to alleviating a depression. It seems quite certain that basic tax adjustments can be made which will contribute over the long run to a more satisfactory level of business activity and investment and to a rapid rate of technological change. But whether compensatory cyclical tax policy can offer material assistance against the downswings of an enterprise economy remains yet to be seen.

One of the basic needs for recovery is a favorable economic climate, and compensatory tax changes can provide a part of this. Nevertheless, the need is great, and perhaps tax policy in conjunction with debt, expenditure, monetary and banking policy, and other economic policy may serve to keep us from getting too far into the trough of depression. It is also hoped that tax policy can contribute to "recovery" from our periodic economic slumps. The next recession (if and when it comes) may demonstrate the true possibilities.

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Taxation and Balanced Fiscal Policy

TAXATION, *borrowing, spending and debt management have become decisive factors influencing business activities. When the federal budget was small we were mainly concerned with equity and administrative convenience in the selection of financial resources for covering expenditures. The way in which we finance a 25-billion dollar budget will inevitably affect the economy as a whole.*

—HAROLD D. SMITH.[1]

The Concept of Over-all Fiscal Policy

FISCAL POLICY in the more modern sense of that term is here to stay, whether we like it or not and regardless of the political party in power. This concept of fiscal policy and its utilization was forced upon us as the result of two world wars and a major depression.

The over-all purpose and mechanism is provided under the *Employment Act of 1946*, which is a declaration of national policy on employment, production, and purchasing power. The Council of Economic Advisers is functioning under the Act. Almost invariably a discussion of fiscal policy is the Number One item in its reports.

What is fiscal policy? It is the integrated and co-ordinated use of the "financial powers" of government directed to the financial housekeeping of government and the better functioning of our economic system. Fiscal policy includes: (1) taxation and tax policy, (2) budgetary policy, (3) spending and investing policy, (4) borrowing policy, and (5) debt management policy.

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[1] Harold D. Smith, former Director of the Budget, *Hearings* on S. 380, 79th Congress, 1st Session, p. 682.

Taxation Only One Phase of Fiscal Policy

AS WE HAVE ALREADY OBSERVED, taxation is only one phase of over-all fiscal policy. It is one of the most dynamic aspects, but it is only one aspect. In Part Eight of this book we have dealt with taxation and the functioning of our enterprise system. The emphasis necessarily has had to be upon the taxation phase of fiscal policy. However, from time to time we have commented upon the other aspects, especially the "borrowing" and "spending-investing" policy as they are related to tax policy. Tax policy cannot be applied in a vacuum, but it must be operated in conjunction with the other aspects of fiscal policy. Tax policy must be carefully integrated with all the other members of the fiscal policy family, if it is to be successful in achieving its objectives. However, fiscal policy in all its other aspects is a sufficiently large area in government finance to warrant additional treatment and could well serve as the basis for another book.

Moreover, even fiscal policy cannot be segregated and dealt with entirely apart. A close companion has to do with another of the "financial powers" of government—monetary and credit policy. These are concerned with the money, credit, and banking institutions and policies. Again, fiscal and monetary policy must be co-ordinated, or the two policies can work at cross purposes to the disadvantage of the operation of our economic system.

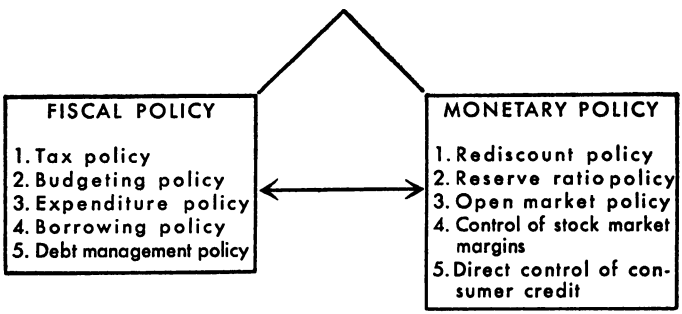


FIGURE 24. *The Integration of Fiscal and Monetary Policy.*

It must also be remembered that fiscal and monetary policy are but a part of over-all economic policy, which includes many direct controls such as wage policy, price policy, agricultural policy, anti-monopoly policy, and a number of others. And again, sound over-all economic policy requires the integration of fiscal and monetary policy with all the others. All this is a very complex task and responsibility.

Limiting Factors in Tax Policy

THERE ARE MANY LIMITATIONS to the use of taxation as an economic control device; these limitations have been touched upon from time to time in the previous discussion. For this reason we must not expect too much from taxation alone; we must be cautious and scientific in its application.

There is, for example, the complexity of the whole problem of the economic effects of taxation and of the application of tax changes of the "right kind" at the "right time" to the "right degree" to achieve the effects desired. There is the correlative problem of getting the legislative body to exercise fiscal fortitude and discipline once it has been advised what is the best policy under the given circumstances. There is the danger of overcompensation; in prosperity in particular, there is the danger of impairing private incentive or of carrying tax remedies so far as to bring about a recession rather than merely to curb prosperity's inflationary excesses.

Taxes must never be so severe as to impair the revenue productivity of the tax sources. This risk can occur on either the investment or consumption side of the balance. Taxes should avoid harming the total national real income and economic progress. If too highly graduated, they bring about inefficiencies and waste in business. They must not only be economically suitable but also sufficiently just in distribution to gain the general acceptance of the nation as a whole. This can only be achieved through a knowledge of the shifting and incidence of the various taxes.

Frequent changes in the kinds of taxes and tax rates react harmfully upon the confidence and morale necessary for business planning. Time lags between proposals for tax changes and their adoption, between tax changes and their effects, and between tax receipts and expenditures create uncertainty and hesitation in the making of business decisions. This contributes in some measure to business instability.

For these reasons taxation must not attempt to do the whole job of ironing out cyclical fluctuations and bringing about more prosperous conditions. But when rationally used, taxation has an important role to play along with the other facets of fiscal, monetary, banking, and general economic policy.

Tax Policy and Taxable Capacity

SECULARLY increasing governmental expenditures are becoming an increasing challenge to America's "taxable capacity." "Taxable capacity" refers to the tax burden which an economic system can bear without seriously

impairing the operation of that system. The "tax burden" may be defined as the weight or impact of taxes on the income of the individual or the people as a whole.[2] Its best measurement is the ratio of taxes to national income.

However, "taxable capacity" is not some definite or fixed ratio for all times and places. It is a *relative matter* that depends upon a number of factors. Basically, it depends upon the productivity of the economy and the level of the national income. It depends upon the psychology of the people and their attitude toward the government, the present state of the economic system, whether prosperity, recession, depression, or hyper-inflationary boom, and whether the time is war or peace. Many criteria which would be accepted as the limit in peacetime could be far exceeded without qualms in times of an emergency such as war when a hundred billion dollars must be raised a year for defense. And many levels of taxation which might otherwise depress the economic system can become bearable with proper fiscal, debt, and monetary policy. The degree of "acceptability" depends in part on the type of economic system to which the taxes are applied. Communism and socialism, for example, have a much greater "taxable capacity" than a capitalistic, free-enterprise system.

During peacetime the limit of taxable capacity is more nearly that part of the people's income which is "above" the margin to cover basic needs for food, clothing, shelter, and reasonable pleasures. It depends upon the levels of investment, consumption, and production in the country and the standard of living the people insist upon maintaining. It depends, too, upon the distribution of functions between the public and private sectors of the economy. At times, governmental functions complement and stimulate the operations of the private economy. The psychology of the people is also a determinant of taxable capacity, insofar as taxation influences their sense of "fairness," their incentives to work, to produce, and to invest, and their willingness to forego satisfactions.

How government spends the money received through taxation is also of prime importance. If expenditures are economically productive and capital-creating, taxable capacity is much greater than if expenditures are economically neutral or harmful. And, most important for our study, taxable capacity depends upon the nature of the tax structure, the kinds and diversity of the taxes, and the intelligence with which they are applied in the economic system.

Is there any measurable danger point in our capacity to bear taxes? Estimates have been made that the present taxable capacity in the United States in peacetime is approximately 25 per cent of the gross national

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[2] Lewis H. Kimmel, "Our Tax Burdens and Taxable Capacity," *The Annals* of the American Academy of Political and Social Science, Vol. 266, November 1949, p. 152.

income. That figure is mentioned on the assumption that we wish to maintain a free-enterprise system under democratic institutions. One authority (Colin Clark, an Australian economist) maintains that historical experience in Europe, Australia, and New Zealand supports the conclusion that the safe political and economic limit of taxation is in the vicinity of 25 per cent of the national income.[3] He points out that this figure does not indicate what proportion of "individual" income can be safely taken by taxation; it merely measures the fraction of the "national" income which can be so absorbed.

He relates high levels of taxation to inflation. He points out that the inflationary effects of deficit spending are quite well understood, but the causative relationship between high taxes and inflation is not so generally appreciated. Heavy expenditures supported by taxation may be deflationary at first, but in the long run high taxation tends toward inflation because people won't work as hard and efficiently, and investment and production will not expand as fast as they should. Shortages of goods occur and inflationary rises in prices follow.

Clark submits evidence of such economic behavior in several European countries from the 1920's through the 1940's. And although he recognizes that this evidence is not conclusive, he maintains that 25 per cent of the national income represents the critical level of taxation beyond which inflationary forces tend to come into operation. The 25 per cent figure represents at least a warning signal, but it probably is not an ultimate limit. The major observation to make is that taxation cannot be applied in our system in disregard of the levels of national income and the forces of inflation.

Fiscal Policy and Preservation of the Enterprise System

IT IS PROBABLY TRUE that we are still at the "cockcrowing" of our understanding and our ability to manage and utilize fiscal policy. Many authorities recognize that it is the strongest and most effective of the non-direct, economic control policies. Fiscal policy is a potent and even dangerous instrument. It is one that we will have to learn to use wisely; a great deal still must be done to perfect our knowledge and techniques in the field.

Yet wisely used and judiciously co-ordinated with other democratic economic policies, fiscal policy can serve as an instrument which can strengthen and preserve our enterprise system in the face of powerful

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[3] Colin Clark, "The Danger Point in Taxes," *Harper's Magazine*, December 1950, pp. 67-69.

anti-democratic and anti-capitalistic forces loose in the world. It can preserve the essential characteristics of the enterprise system, because it leaves all the basic business decisions with the businessman. Fiscal policy promotes, stimulates, and allocates by indirection and without heavy socialization of segments of the private economy.

A fitting peroration to this chapter can be found in that portion of the Fourth Annual Report of the President's Council of Economic Advisers recognizing the need for further harmony and consistency in overall economic policy.[4]

> A cardinal task, as the Council sees it, is to achieve even more harmony and consistency among those outstanding programs of government which greatly affect the whole economy. During the critical mid-thirties, when some of the structure of current national policy was built, there was no time to develop symmetry for the various wings of the structure or to connect them with the center. This was inevitable during an economic emergency, but there is no such emergency now. The privilege of men and agencies within a free government to give differing advice should be cherished. But this does not mean that the final execution of public programs touching upon the whole economy should not achieve that internal consistency and that harmonious relationship to defined common objectives which any large undertaking demands.

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[4] *Fourth Annual Report* of the Council of Economic Advisers, December 1949.

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